STUDY MATERIAL

EXECUTIVE PROGRAMME

COMPANY ACCOUNTS AND AUDITING PRACTICES

MODULE II

PAPER 5

THE INSTITUTE OF Company Secretaries of India

IN PURSUIT OF PROFESSIONAL EXCELLENCE

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EXECUTIVE PROGRAMME – COMPANY ACCOUNTS AND AUDITING PRACTICES

Finance and accounting have assumed much importance in today's competitive world of business wherein corporate organisations have to show the true and fair view of their financial position. Thus, the application of accounting in the business sector has become an indispensable factor. Company Secretary has to provide the complete and accurate information about the financial operations of the company to management for decision making. This emphasizes that the books of account are to be maintained accurately, up-to-date and as per the norms.

The subject 'Company Accounts and Auditing Practices' is very important for the students. In the course of his work, a Company Secretary is expected to have the working knowledge of Company Accounts. He should also have the working knowledge of auditing concepts such as verification, vouching, and internal control. This will help a company secretary in carrying out his duties in a more professionalized manner. The entire paper has been discussed in fifteen study lessons. In starting nine study lessons we have discussed about the Share Capital, Debentures, Final Accounts of Companies, Corporate Restructuring, Consolidation of Accounts, Valuation of Shares and Intangible Assets, Liquidation of Company, Corporate Financial Reporting and Accounting Standards. At last six lessons, we have discussed about Auditing Concepts, types of Company Audit, Internal Control and its Review, Audit engagement and documentation.

In this study every efforts has been made to give a comprehensive coverage of all the topics relevant to the subject. In all study lessons the requisite theoretical framework for understanding the practical problems in the subject has been explained and wherever necessary practical illustrations have been given to facilitate better understanding. At the end of each study lesson a brief about the lesson have been given under the caption 'Lesson Round Up' as well a good blend of theoretical and practical questions have been given under the caption 'Self Test Questions' for the practice of students to test their knowledge. In fact, this being a practical paper, students need to have good theoretical knowledge and practice to attain the requisite proficiency and confidence.

This study material has been published to aid the students in preparing for the Company Accounts and Auditing Practices paper of the CS Executive Programme. It is part of the education kit and takes the students step by step through each phase of preparation stressing key concepts, pointers and procedures. Company Secretaryship being a professional course, the examination standards are set very high, with emphasis on knowledge of concepts, applications, procedures and case laws, for which sole reliance on the contents of this study material may not be enough.

Therefore, in order to supplement the information/contents given in the study material, students are advised to refer to the Suggested Readings mentioned in the study material, Student Company Secretary e-bulletin, Business Dailies and Journals.

In the event of any doubt, students may write to the Directorate of Academics the Institute for clarification at ***academics@icsi.edu.***

Although due care has been taken in publishing this study material yet the possibility of errors, omissions and/ or discrepancies cannot be ruled out. This publication is released with an understanding that the Institute shall not be responsible for any errors, omissions and/or discrepancies or any action taken in that behalf.

Should there be any discrepancy, error or omission noted in the study material, the Institute shall be obliged if the same are brought to its notice for issue of corrigendum in the 'Student Company Secretary' e-bulletin.

This study material is based on those sections of the Companies Act, 2013 and the rules made there under which have been notified by the Government of India and came into force w.e.f. April 01, 2014 (Including amendments / clarifications / circulars issued there under upto June, 2014). In respect of sections of the Companies Act, 2013 which have not been notified, applicable sections of Companies Act, 1956 have been dealt with in the Study Material.

SYLLABUS

MODULE 2 – PAPER 5: COMPANY ACCOUNTS AND AUDITING PRACTICES

Level of Knowledge: Advance Knowledge

Objective: *To acquire knowledge and understanding of the concepts, principles and practices of company accounts and auditing in accordance with statutory requirements.*

PART A: COMPANY ACCOUNTS (70 MARKS)

1. **Share Capital**
   - Issue of Shares: at Par, at Premium, at Discount, on Conversion and for consideration other than Cash; Forfeiture and Re-issue of Shares, Buyback of Shares, Redemption and Conversion of Preference Shares, Bonus Shares, Rights Issue, ESOPs, ESPS, Sweat Equity Shares
   - Alteration of Share Capital
   - Underwriting of Shares
2. **Debentures**
   - Issue of Debentures: at Par, at Premium, at Discount and for consideration other than Cash
   - Accounting Treatment and Procedures
   - Redemption of Debentures
   - Conversion of Debentures into Shares
3. **Final Accounts of Companies**
   - Conceptual Framework, Preparation and Presentation of Financial Statements, Schedule VI, Interpretation and Scrutiny of Balance sheet
   - Treatment of Profit Prior to Incorporation, Preoperative and Preliminary Expenses
   - Preparation of Final Accounts under Company Law
4. **Corporate Restructuring**
   - Concept and Accounting Treatment as per AS
   - Methods of Amalgamations Accounting
     - The Pooling of Interests Method
     - The Purchase Method
   - Consideration
   - Treatment of Reserves, Goodwill and Pre-Acquisition & Post-Acquisition Profit
   - Accounting in the books of Transferor and Transferee
   - Merger and De-merger
   - Acquisition of Business
   - Internal Reconstruction

5. **Consolidation of Accounts**

   – Holding and Subsidiary Companies - Accounting Treatment, Disclosures and Consolidation of Accounts

6. **Valuation of Shares and Intangible Assets**

   – Valuation of Shares, Methods of Valuation, Price Earning Multiple Valuation, Discounted Cash Flow (DCF) Method

   – Valuation of Intangibles: Brand, Goodwill and IPRs

7. **Liquidation of Company**

   – Preparation of Statement of Affairs including Deficiency /Surplus Account

8. **Corporate Financial Reporting**

   – Various Requirements of Corporate Reporting

   – Value Added Statements: Economic Value Added (EVA), Market Value Added, Shareholders' Value Added

9. **Accounting Standards**

   – Relevance and Significance

   – National and International Accounting Standards and Authorities

   – Adoption, Convergence and Interpretation of International Financial Reporting Standards (IFRS) and Accounting Standards in India

PART B: AUDITING PRACTICES (30 MARKS)

10. **Auditing Concepts**

    – Nature, Scope and Significance of Auditing

    – Basic Principles Governing an Audit

    – Overview of Auditing and Assurance Standards- National and International

11. **Types of Company Audit**

    – Statutory Audit

    – Internal Audit

    – Branch Audit

    – Joint Audit

    – Special Audit

    – CAG Audit

12. **Internal Audit**

    – Forms of Audit - Propriety Audit, Compliance Audit and Efficiency Audit

    – Nature, Scope and Techniques of Internal Audit; Functions and Responsibilities of Internal Auditors; Organisational Status of Internal Auditing Function, Internal Audit vis-à-vis Statutory Audit

13. Internal Control

- Nature, Scope And Elements
- Internal Control distinguished from Internal Check and Internal Audit
- Techniques of Internal Control System, Flow Charts, Internal Control Questionnaires
- Steps for Internal Control and Audit Evaluation
- Audit Testing – Need For Sampling and Various Approaches to Statistical Sampling
- Inter-Firm and Intra-Firm Comparisons – Ratio And Trend Analysis; Audit In Depth

14. Review of Internal Control

- Review of Purchasing Operations
- Review of Efficacy of Management Information System
- Review of Selling and Distribution Policies and Programmes
- Review of Manufacturing Operations
- Review of Personnel Policies
- Appraisal of Management Decisions

15. Audit Engagement and Documentation

- Audit Procedures: Audit Plan , Audit Programme, Vouching and Verification
- Documentation: Audit Working Papers and Files
- Sampling, Test Checking, Techniques of Test Checks

LIST OF RECOMMENDED BOOKS

PAPER 5: COMPANY ACCOUNTS AND AUDITING PRACTICES

READINGS

1.	M.C. Shukla, T.S. Grewal & S.C. Gupta	:	Advanced Accounts Vol. II; S. Chand & Company Ltd., 7361, Ram Nagar, New Delhi-110 055.
2.	R.L. Gupta & M. Radhaswamy	:	Company Accounts; Sultan Chand & Sons,23, Daryaganj, New Delhi-110 002.
3.	S.P. Jain & K. L. Narang	:	Advanced Accountancy-Vol.II; Kalyani Publishers, 23, Daryaganj, New Delhi - 110 002.
4.	S. N. Maheshwari & S.K. Maheshwari	:	Advance Accounting Vol. II; Vikas Publishing House (Pvt.) Ltd., A-22, Sector 4, Noida – 201 301.
5.	Ashok Sehgal & Deepak Sehgal	:	Advanced Accounting Vol. 2; Taxmann's,59/32, New Rohtak Road, New Delhi-110 005.
6.	J. R. Monga	:	Fundamentals of Corporate Accounting; Mayoor Paperbacks, A-95, Sector 5, Noida-201 301.
7.	Goel, Maheshwari Gupta	:	Corporate Accounting, International Publishers, Daryaganj New Delhi
8.	Kamal Gupta, Ashok Arora	:	Fundamentals of Auditing: Tata McGraw Hill Education Limited
9.	Kamal Gupta	:	Contemporary Auditing: Tata McGraw Hill Education Limited
10.	International Financial Reporting Standards (IFRS)		Taxmann Publication (P) Limited, 59/32, New Rohtak Road, New Delhi-110 005
11.	Dolphy D'Souza	:	Indian Accounting Standards & GAAPP; Snow White Publications Pvt. Ltd., Her Mahal, 532, Kalbadevi Road, Mumbai – 400 002.

(*Note : Students are advised to refer to the latest edition of the publications*)

ARRANGEMENT OF STUDY LESSONS

PART A

1. Share Capital
2. Debentures
3. Final Accounts of Company
4. Corporate restructuring
5. Consolidation of Accounts
6. Valuation of Shares and Intangible Assets
7. Liquidation of Company
8. Corporate Financial Reporting
9. Accounting Standards

PART B

10. Auditing Concepts
11. Types of Company Audit
12. Internal audit
13. Internal Control
14. Review of Internal control
15. Audit Engagement and Documentation

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Lesson 1

Share Capital

LESSON OUTLINE

PART I

- Meaning of shares
- Meaning and kinds of Share Capital
- Issue of Shares
- Under subscription and over subscription of shares
- Forfeiture of Shares
- Re-issue of Forfeited Shares
- Buy-Back of Shares
- Issue of Bonus Shares
- Employee Stock Option Scheme
- Issue of Sweat equity shares
- Right Shares
- Illustrations

PART II

- Issue and Redemption of Preference Shares
- Illustrations

PART III

- Underwriting of shares
- Types of Underwriting
- Underwriting Commission
- Payment of Underwriting Commission
- Marked and Unmarked Applications
- Accounting Treatment Determining the Liability of Underwriters
- Illustrations
- Lesson Round-up
- Self-test Questions

LEARNING OBJECTIVES

The most striking feature of a company is its ownership structure. The capital in a company is divided into small shares of fixed value. The shares of a company may be equity shares or preference shares. The objective of this lesson is to make students aware about accounting of different aspects of share capital. After studying this lesson one should be able to:

- Understand the share capital structure in the balance sheet of a company.
- Discuss the methods and accounting procedure of issue of shares.
- Specify the accounting treatment when shares are issued at par, premium and at discount.
- Explain the meaning and accounting treatment of forfeiture of shares and reissue thereof.
- Understand the accounting procedure of buy-back of shares.
- Enumerate the steps for redemption of preference shares.
- Appreciate the purpose of issuing right shares & Bonus shares.
- Understand the accounting treatment for ESOPs, ESPS, Sweat Equity Shares.
- Understand the meaning of underwriting.
- Familiarize with various types of underwriting.
- Distinguish between marked application and unmarked applications.
- Determine the liability of underwriters.

Shares of a company are not only issued on the face value. In cases, where the company prospectus is good, or the company has got high reserve, the shares may be sold at premium. Even the shares of a company may be issued at discount as well.

MEANING OF SHARES

A share is one unit into which the total share capital is divided. Each share forms a unit of ownership and is offered for sale so as to raise capital for the company. The shares any member in a company are movable property transferable in the manner provided by the articles of the company. Face value of a share is the par value of the share. It is also known as the Nominal value or denomination of a share.

According to Section 2(84) of the Companies Act 2013, "share" means a share in the share capital of a company and includes stock. Thus, in other words, shares are divisions of the share capital of a company. A share represents a fractional part of the share capital of the company. For example, if a company has a share capital of Rs. 5,00,000 divided into 50,000 shares of Rs.10 each and a person who has taken 50 shares of the company is said to have a share of Rs. 500 in the share capital of the company.

Meaning of share capital

When total capital of a company is divided into shares, then it is called share capital. A joint stock company raises its capital by issue of shares to finance its activities. The Memorandum of Association of the company states the amount of capital with which the company is desired to be registered and the number of shares into which it is to be divided. It constitutes the basis of the capital structure of a company.

Kinds of share capital

The share capital of a company limited by shares shall be of two kinds under the Companies Act 2013, namely: –

(a) *Equity share capital* : Equity share capital with reference to any company limited by shares means all share capital which is not preference share capital. Equity share capital can be

   i) with voting rights; or

   ii) with differential rights as to dividend or voting or any other right.

(b) *Preference share capital* : Preference share capital with reference to any company limited by shares means that part of the issued share capital of the company which carries or would carry a preferential right with respect to –

   – payment of dividend, either as a fixed amount or an amount calculated at a fixed rate, which may either be free of or subject to income-tax; and

   – repayment, in the case of a winding up or repayment of capital, of the amount of the share capital paid-up or deemed to have been paid-up, whether or not, there is a preferential right to the payment of any fixed premium or premium on any fixed scale, specified in the memorandum or articles of the company.

   Deemed preference share capital: The capital shall be deemed to be preference capital, notwithstanding that it is entitled to either or both of the following rights, namely: –

   – that in respect of dividends, in addition to the preferential rights to the payment of dividend, it has a right to participate, whether fully or to a limited extent, with capital not entitled to the preferential right aforesaid;

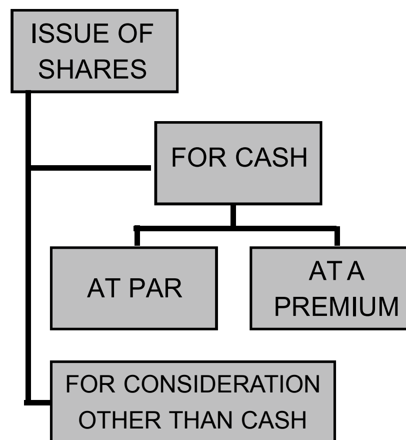
   – that in respect of capital, in addition to the preferential right to the repayment, on a winding up, it has a right to participate, whether fully or to a limited extent, with capital not entitled to that preferential right in any surplus which may remain after the entire capital has been repaid.

Issue of Shares

When a public company desires to raise capital by issuing its shares to the public, it has to invite the public to subscribe for its shares. The person who intends to subscribe to those shares should make an application for the desired number of shares to the company. Then, the company will allot shares to the applicant.

Allotment means the appropriation of a certain number of shares to an applicant in response to his application. The company cannot allot more than the number of shares offered to the public for subscription through the prospectus. Moreover, the company cannot make allotment unless the amount stated in the prospectus as the minimum subscription has been subscribed and the sum payable on application for the stated amount has been received by the company.

If the number of shares applied for is less than the number of shares offered, the allotment can be only for the shares applied for provided minimum subscription is raised.



ISSUE OF SHARES AT PAR

Shares are said to be issued at par when the issue price is equal to the face value or nominal value of the shares i.e. issue price is Rs. 10 and face value is also Rs. 10. When the shares are issued, the company may ask the payment of the shares either payable in one lump sum or in installments.

(a) When shares are issued at par and are payable in full in a lump sum:

(1) On receipt of application money –		
Bank	Dr.	*(With the amount received on application)*
To Share Application and Allotment A/c		
(2) *On allotment of shares -*		
Share Application and Allotment A/c	Dr.	*(With the money received on the number of*
To Share Capital A/c		*shares allotted)*

Note: (i) When the capital of the company consists of shares of different classes, a separate share application account will be opened for each class of shares, i.e. equity shares application account/preference share application account etc.

(ii) Unless shares are allotted by the company, the receipt of application is simply an offer and cannot be credited to Share Capital Account.

(iii) If the company fails to raise the minimum subscription, then no shares can be allotted and the application money has to be returned to the applicants. For this, the entry will be as follows:

Share Application and Allotment A/c	Dr.	(*With the application money received now*
To Bank		*refunded)*

(iv) In actual practice, the cash transactions are not journalised but the same have to be entered in the cash book. The entry in the Cash Book will be as follows:

Cash Book (Bank Columns)

Dr.			Cr.
Particulars	Rs.	Particulars	Rs.
To Share Application and Allotment A/c (Application money on..... shares @ Rs...................per share)	XXX	By Share Application and Allotment A/c (Refund of application money on......... shares @ Rs......... per share)	XXX

(b) When shares are issued at par and the amount is payable in installments:

When shares are not payable in a lump sum, they can be called in a number of installments. After allotment, whenever the need arises, the directors may demand further money from the shareholders towards payment of the value of shares taken up by them. Such demands are termed as calls. The different calls are distinguished from each other by their serial numbers, i.e. first call, second call, third call and so on. The last installment is also termed the final call along with the number of the last call.

– First installment is called ‘application money’

– Second installment is called ‘allotment money’

– Third installment is called ‘first call money’ and

– The last installment is called ‘final call money’.

JOURNAL ENTRIES

(i) On receipt of application money

Bank	Dr.	*with the amount received on application*
To Share Application Account		
(Being the application money received in respect of...... shares @ Rs..........per share)		

(ii) On allotment of shares

Share Application Account	Dr.	*with the amount of application money on allotted*
To Share Capital Account		*shares*
(Being the application money on allotted shares now transferred to share capital account)		

(iii) On refund of application money on rejected applications

Share Application Account	Dr.	*with the amount actually repaid*
To Bank		
(Being application money on ____ shares refunded)		

(iv) On making the allotment money (second installment) due

Share Allotment Account	Dr.	*with the amount due on allotment*
To Share Capital Account		
(Being the allotment money due in respect of allotment of........ shares @ Rs........ each)		

(v) On receipt of allotment money is received the following journal entry is made

Bank	Dr.	*with the actual amount received as allotment money*
To Share Allotment Account		
(Being the amount received on.......shares @ Rs......... each)		

(vi) On making the first call

Share First Call Account	Dr.	*with the amount due on first call*
To Share Capital Account		
(Being the amount due on first call @ Rs...... per share on......shares)		

(vii) On receipt of first call money

Bank	Dr.	*with the amount received on first call*
To Share First Call Account		
(Being the amount received in respect of first call @ Rs...... per share on......shares)		

(viii) When second call is made

Share Second Call Account	Dr.	*with the amount due on second call*
To Share Capital Account		
(Being the amount due on second call @ Rs..... per share on.... shares)		

(ix) On receipt of second call money:

Bank	Dr.	*With the amount actually received on second call*
To Share Second Call Account		
(Being the amount received in respect of second call @ Rs........ per share on .... shares)		

(x) When the final call is made:

Share Final Call Account	Dr.	*with the amount due on final call*
To Share Capital Account		
(Being the amount due on final call @ Rs................ per share on........shares)		

(xi) On receipt of final call money:

Bank	Dr.	*with the amount actually received on final call*
To Share Final Call Account		
(Being the amount received in respect of final call @ Rs................ per share on................. shares)		

ISSUE OF SHARES AT PREMIUM

The shares of many successful companies which offer attractive rates of dividend on their existing capitals fetch a higher price than their face value in the market. When shares are issued at a price higher than the face value, they are said to be issued at a premium. Thus, the excess of issue price over the face value is the amount of premium. For example, if a share of ₹ 10 is issued at ₹ 12, ₹ (12 – 10) = ₹ 2 is the premium.

The premium on issue of shares must not be treated as revenue profits. On the contrary, it must be regarded as capital receipt. The Companies Act requires that when a company issues shares at a premium whether for cash or otherwise, a sum equal to the aggregate amount of the premium collected on shares must be credited to a separate account called "Securities Premium Account". There are no restrictions in the Companies Act on the issue of shares at a premium, but there are restrictions on its disposal. Under Section 52(2) of the Companies Act 2013, the Securities Premium Account may be applied by the company –

(a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;

(b) in writing off the preliminary expenses of the company;

(c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;

(d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or

(e) for the purchase of its own shares or other securities under section 68.

It is to be noted here that utilization of the amount of Securities Premium Account except in any of the modes specified above, will attract the provisions relating to the reduction of share capital of a company under the section 66 of the Companies Act 2013.

The Securities Premium Account must be shown as "Securities premium reserves" separately in the liabilities side of the balance sheet under the head "Reserves & Surplus".

The premium is usually payable with the installment due on allotment. However, some companies may charge premium with share application money or partly with share application money and partly at the time of allotment of shares. It may be included in call money also.

JOURNAL ENTRY

When allotment money becomes due:

Share Allotment A/c	Dr.	*(with the money due on allotment including premium)*
To Securities Premium A/c		*(with the premium amount)*
To Share Capital A/c		*(with the share allotment amount)*
(Being allotment money due on shares issued at premium)		

ISSUE OF SHARES AT DISCOUNT

When shares are issued at a price lower than the face value, they are said to be issued at discount. Thus, the excess of the face value over the issue price is the amount of discount. For example, if a share of ₹ 10 is issued at ₹ 9 then ₹ (10 – 9) = Re. 1 is the discount.

As per companies Act 2013, a company shall not issue shares at a discount except as provided in section 54 for issue of sweat equity shares. Any share issued by a company at a discounted price shall be void.

Where a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.

UNDER-SUBSCRIPTION OF SHARES

In actual practice, it rarely happens that the number of shares applied for is exactly equal to the number of shares offered to public for subscription. If the number of shares applied for is less than the number of shares issued the shares are said to be undersubscribed. When an issue is under-subscribed, entries are made on the basis of number of shares applied for, provided the minimum subscription is raised and the company proceeds to allot the shares.

OVER-SUBSCRIPTION OF SHARES

When the number of shares applied for exceeds the number of shares issued, the shares are said to be over-subscribed. In such situation, the directors allot shares on some reasonable basis because the company can allot only that number of shares actually offered for subscription. Moreover, as per the SEBI, the company cannot reject out-rightly any application for shares unless it has incomplete information or absence of signature(s) or insufficient application money and so on. In short, the following procedure is adopted:

(i) Total rejection of some applications;

(ii) Acceptance of some applications in full; and

(iii) Allotment to the remaining applicants on pro-rata basis.

The shares should be issued in tradable lot. In case of pro-rata allotment, no applicant for shares is refused and no applicant is allotted the shares in full. Each applicant receives the shares in some proportion. In such cases, the excess amount of application money (i.e. overpaid amount) is not refunded but retained and treated as a payment towards allotment money. The following journal entry is made to transfer excess application money to allotment account.

Share Application A/c	Dr.	*(with the excess application money)*
To Share Allotment A/c		
(Being the surplus application money transferred to share allotment account)		

Surplus money exceeding that due on allotment should be refunded to the allottees. However, the company may transfer this to Calls-in-Advance Account if:

(i) Acceptance of calls in advance is permitted by the Company's Articles.

(ii) The consent of the applicant has been taken either by a separate letter or by inserting a clause in the company's prospectus.

The company can retain the calls in advance at the most so much amount as is sufficient make the allotted shares fully paid up ultimately.

The journal entry will be as follows:

Share Application A/c	Dr.	(with the excess application money left over the
To Calls-in-Advance A/c		amount due on application and allotment)
(Being the surplus application money transferred to Calls-in-Advance Account)		

Calls-in-Advance and Interest on Calls-in-Advance

If authorised by the articles, a company may receive from a shareholder the amount remaining unpaid on shares, even though the amount has not been called up. This is known as calls-in-advance. It is a debt of a company until the calls are made and the amount already paid is adjusted. Calls-in-advance may also arise when the number of shares allotted to a person is much smaller than the number applied for and the terms of issue permit the company to retain the amount received in excess of application and allotment money. Of course, the company can retain only so much as is required to make the allotted shares fully paid ultimately. When calls are made, the calls-in-advance account is ultimately closed by transfer to the relevant call accounts. It is noted that the money received on calls-in-advance does not become part of share capital. It is shown under a separate heading, namely 'calls-in-advance' on the liabilities side. No dividend is paid on calls-in-advance.

Accounting Treatment

(i) On receipt of call money in advance:

Bank	Dr.	(with the amount of call money received in advance)
To Call-in-Advance A/c		
(Being the calls received in advance)		

(ii) As and when calls are made:

Calls-in-Advance A/c	Dr.	(with the amount adjusted on relevant call
To Relevant Call A/c		becoming due)

The amount received as calls-in-advance is a debt of the company, the company is liable to pay interest on the amount of Calls-in-Advance from the date of receipt of the amount till the date when the call is due for payment. Generally the Articles of the company specify the rate at which interest is payable. If the articles do not contain such rate, Table F of the Companies Act 2013 will be applicable which leaves the matter to the Board of directors subject to a maximum rate of 12% p.a.

It is to be noted that the interest payable on Calls-in- Advance is a charge against the profits of the company. As such, Interest on Calls-in-Advance must be paid even when no profit is earned by the company.

Accounting Treatment

(i) If Interest on Calls-in-Advance is paid in cash -

Interest on Calls-in-Advance A/c Dr. (with the amount of interest paid)
To Bank

(Interest on Calls-in-Advance paid @ .....% p.a. on Rs........... for............ months)

(ii) If interest on Calls-in-Advance is not paid in cash -

Interest on Calls-in-Advance A/c Dr. (with the amount of interest payable)
To Sundry Shareholders A/c

(iii) At the end of the year, when interest on Calls-in-Advance is transferred to Profit and Loss A/c –

Profit and Loss A/c Dr. with the amount of interest
To Interest on Calls-in-Advance A/c

Note: The liability to sundry shareholders is to be treated as outstanding liability and should be shown under the head “Current Liabilities” in the balance sheet.

Calls in Arrear and Interest on Calls in Arrear

When calls are made upon shares allotted, the shareholders holding the shares are bound to pay the call money within the date fixed for such payment. If a shareholder makes a default in sending the call money within the appointed date, the amount thus failed is called Calls-in-Arrear.

The interest on Calls-in-Arrear is recoverable according to the provisions in this regard in Articles of the company. But if the Articles are silent, Table ‘F’ of Schedule I of the Companies Act 2013, shall be applicable which prescribes that if a sum called in respect of shares is not paid before or on the day appointed for payment, the person who failed to pay shall pay thereof from the day appointed for payment to the time of actual payment at a rate not exceeding 10% per annum. However, the directors have the right to waive the payment of interest on Calls-in-Arrear. The interest on Calls-on-Arrear Account is transferred to the Profit and Loss Account at the end of the year.

Journal Entries

(i) When call money is in arrear:

Calls-in-Arrear A/c Dr. (with the amount-failed by
To Relevant Call A/c the shareholders)

(ii) On receipt of amount of Calls-in-Arrear with interest, on a subsequent date:

Bank Dr. (with the amount received)
To Calls-in-Arrears A/c

Issue of Shares for Consideration other than Cash

A company may also issue shares for consideration other than cash to vendors who sell some assets to the company or to the promoters for their services. When shares are so issued, the Companies Act requires that the same must be clearly stated in the balance sheet and must be distinguished from the issue made for cash.

Issue of Shares to Vendors

A company may purchase assets from the vendors and instead of paying the vendors cash, may settle the purchase price by issuing fully paid shares of the company. This type of issue of shares to the vendors is called issue of shares for consideration other than cash. Such shares may be issued by the vendors either (i) at par, or (ii) at a premium.

Journal Entries

(i) When assets are acquired from the vendors –

Sundry Assets A/c (individually)	Dr.	(with the purchase price payable for the assets
To Vendors		acquired)

(ii) When fully paid shares are issued to vendors at par -

Vendors	Dr.	(with the nominal value of the shares allotted)
To Share Capital A/c		

(iii) When fully paid shares are issued to vendors at a premium –

Vendors	Dr.	(with the purchase price)
To Share Capital A/c		(with the nominal value of the shares allotted)
To Securities Premium A/c		(with the amount of premium)

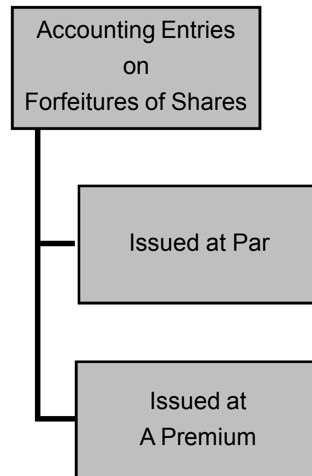
FORFEITURE OF SHARES

If a shareholder fails to pay the allotment money and/or calls made on him, his shares are liable to be forfeited. Forfeiture of shares may be said to be the compulsory termination of membership by way of penalty for non-payment of allotment and/or any call money.

The Companies Act does not contain any specific provisions regarding forfeiture. The directors must follow certain procedure for forfeiting the shares. They have to give notice to the defaulting shareholder calling upon him to pay the amount due from him together with interest before a specified date (not being earlier than the expiry of fourteen days from the date of service of the notice). This notice must also state that if the shareholder fails to pay the amount along with interest due within the specified date, the shares will be forfeited. If the payment is not received within the specified time, the directors meet to consider the forfeiture and they can proceed to forfeit the shares. The directors must pass a resolution for forfeiting the shares at a duly constituted meeting of the Board of Directors and the defaulting shareholder should be informed about the forfeiture of his shares.

The effect of forfeiture of shares is that the defaulting shareholder loses all his rights in the shares and ceases to be a member. The name of the shareholder is removed from the Register of Members and the amount already paid by him is forfeited. He is not entitled in future to dividends and the rights of membership.

Forfeited shares account is to be shown in the balance sheet by way of addition to the paid-up share capital on the ‘liabilities’ side, until the concerned shares are reissued.



FORFEITURE OF SHARES ISSUED AT PAR

Journal entries

The forfeiture of shares can be recorded in two ways:

1. **Where the unpaid calls have already been transferred to Calls-in-Arrear A/c and the respective call accounts have been closed:**

Share Capital A/c	Dr.	with the amount of called up value of shares forfeited i.e. no. of shares forfeited x the called up value per share.
To Shares Forfeited A/c		with the amount already paid-up by the shareholders on the shares forfeited.
To Calls-in-Arrear A/c		with the amount of unpaid calls.

OR

2. **Where the unpaid calls have not been transferred to Calls-in-Arrear A/c and the respective call accounts are showing balances representing unpaid amounts:**

Share Capital A/c	Dr.	with the amount of called up value of shares forfeited i.e., no. of shares forfeited x the called up value per share.
To Shares Forfeited A/c		with the amount already paid up by the shareholders on the shares forfeited.
To Share Allotment A/c		with the amount failed on allotment, if any.
To Share First Call A/c		with the amount failed on first call, if any.
To Share Final Call A/c		with the amount failed on final call, if any.

FORFEITURE OF SHARES ISSUED AT A PREMIUM

Case 1: Where shares to be forfeited were issued at a premium and the premium money remained unpaid:

In this case the credit already given to the ‘Securities Premium A/c’ will be cancelled at the time of forfeiture of the shares by debiting “Securities Premium A/c”.

Journal Entries

Share Capital A/c	Dr.	with the amount of called up value of shares forfeited, i.e., no. of shares forfeited x called up value per share. (excluding premium).
Securities Premium A/c	Dr.	with the amount of premium money remaining unpaid on shares forfeited.
To Shares Forfeited A/c		with the amount already paid by the shareholders on the shares forfeited.
To Calls-in-Arrear A/c		with the amount unpaid on calls.
	OR	
Share Capital A/c	Dr.	with the amount of called up value of shares forfeited, i.e., no. of shares forfeited x called up value per share. (excluding premium).
Securities Premium A/c	Dr.	with the amount of premium money remaining unpaid on shares forfeited.
To Shares Forfeited A/c		with the amount already paid by the shareholders on the shares forfeited.
To Share Allotment A/c		with the amount failed on allotment, if any.
To Share First Call A/c		with the amount failed on first call, if any.
To Share Final Call A/c		with the amount failed on final call, if any.

Case 2: Where shares to be forfeited were issued at a premium and the premium money was duly received on the shares to be forfeited:

In this case Securities Premium Account is already credited at the time of making call will not be cancelled at the time of forfeiture of the shares. In such a case, the accounting entry on forfeiture will be the same as the one passed in case of shares issued at par.

RE-ISSUE OF FORFEITED SHARES

The Board of Directors can sell/ reissue or dispose of forfeited shares on such terms as it thinks fit. However, the amount receivable on re-issue of such shares together with the amount already received from the defaulting member, shall not, in any case, be less than the face value of the shares. Forfeited shares may be re-issued at par, at a premium or even at a discount.

RE-ISSUE OF FORFEITED SHARES - AT PAR : the forfeited shares can be re-issued at par. In such a case, the entire amount standing to the credit of Shares Forfeited Account for those shares would be treated as net gain and transferred to Capital Reserve Account.

Journal entries

1. On re-issue of shares:

Bank	Dr.	with the amount received on reissue i.e. no. of
To Share Capital A/c		shares re-issued x amount received per share.

2. On transfer of Shares Forfeited Account to Capital Reserve Account:

Shares Forfeited A/c	Dr.	with the forfeited amount on shares re-issued.
To Capital Reserve A/c		

RE-ISSUE OF FORFEITED SHARES – AT A PREMIUM : If forfeited shares are re-issued at a premium, the amount of such premium should be credited to Securities Premium Account. In such a case also, the entire amount standing to the credit of Shares Forfeited Account would be treated as net gain and transferred to Capital Reserve Account.

Journal entries

1. **On re-issue of shares:**

Bank	Dr.	with the total amount received on re-issue.
To Share Capital A/c		with nominal value or paid-up value of shares.
To Securities Premium A/c		with the premium amount received.

2. **On transfer of Shares Forfeited A/c to Capital Reserve A/c:**

Shares Forfeited A/c	Dr.	with the forfeited amount on shares re-issued
To Capital Reserve A/c		

Important Note: In case only a part of the forfeited shares are re-issued, only the proportionate amount representing the net gain on the shares re-issued should be transferred to Capital Reserve Account and the balance representing the amount received on forfeited shares not yet re-issued should be left in the Shares Forfeited Account itself. This amount should be shown as addition to the paid up capital on the liabilities side of the balance sheet.

Forfeiture and Re-issue of Shares Allotted on Pro-rata Basis in Case of Over-subscription

In case, the shares of a Company are over-subscribed, it is not possible for the company to satisfy the demand of all the applicants. In such a case allotment may be made on pro-rata basis, i.e., proportionately. For example, 10,000 shares are allotted pro-rata among the applicants for 12,000 shares. In this case, the ratio between allotment of shares and application for shares will be 10,000: 12,000 or 5: 6, i.e., those applying for every 6 shares will be allotted 5 shares.

If shares are allotted on pro-rata basis, the excess application money received on shares allotted will be retained by the company and adjusted subsequently against allotment money and/or call money.

If such shares are subsequently forfeited for non-payment of allotment money and/or call money, the entries will be the same, but it may involve some difficulty in calculation. In such a case, it is to be noted carefully that if there is any excess amount received along with the application and it is adjusted against the allotment money which is failed by the shareholder, such amount should be deducted from the amount due on allotment to arrive at the net amount defaulted by the shareholder.

Buy-Back of Shares

When a company has substantial cash resources, it may like to buy its own shares from the market particularly when the prevailing rate of its shares in the market is much lower than the book value or what the company perceives to be its true value. Buy back of shares enables the company to go back to its shareholders and offers to purchase from them the shares they hold. Buy Back of Securities is a very important tool for Companies who wants to reduce their Share Capital.

Advantages of Buy Back:

- It is an alternative mode of reduction in capital without requiring approval of the Court/CLB(NCLT),
- to improve the earnings per share;

- to improve return on capital, return on net worth and to enhance the long-term shareholders value;
- to provide an additional exit route to shareholders when shares are undervalued or thinly traded;
- to enhance consolidation of stake in the company;
- to prevent unwelcome takeover bids;
- to return surplus cash to shareholders;
- to achieve optimum capital structure;
- to support share price during periods of sluggish market condition;
- to serve the equity more efficiently.

Sections 68, 69 and 70 of Companies Act, 2013 provides for buy back of shares.

According to section 68(1) of the Companies Act 2013, a company may purchase its own shares or other specified securities (referred to as buy-back) out of—

(a) its free reserves;

(b) the securities premium account; or

(c) the proceeds of the issue of any shares or other specified securities:

However, no buy-back of any kind of shares or other specified securities shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

Conditions for buy back:

According to section 68(2), following conditions must be satisfied in order to buy-back the shares.

(a) must be authorized by its articles;

(b) a special resolution has been passed at a general meeting of the company authorizing the buy-back, but the same is not required when:

  i) the buy-back is 10% or less of the total paid-up equity capital and free reserves of the company; and

  ii) such buy-back has been authorized by the Board by means of a resolution passed at its meeting;

(c) the buy-back is twenty-five per cent or less of the aggregate of paid-up capital and free reserves of the company. But in case of Equity Shares, the same shall be taken as 25% of paid up equity capital only.

(d) Debt equity ratio should be 2:1, where: Debt is aggregate of secured and unsecured debts owed by the after buy-back and Equity: is aggregate of the paid-up capital and its free reserves:

(e) all the shares or other specified securities for buy-back are fully paid-up;

(f) If shares or securities are listed, buy back will be in accordance with the regulations made by the Securities and Exchange Board in this behalf; and

(g) the buy-back in respect of unlisted shares or other specified securities is in accordance with Share Capital and Debentures Rules, 2014.

(h) No offer of buy-back shall be made within a period of one year from the date of the closure of the preceding offer of buy-back, if any.

Explanatory Statement - Section 68(3):

The notice of the meeting at which the special resolution is proposed to be passed shall be accompanied by an explanatory statement stating –

a) a full and complete disclosure of all material facts;

b) the necessity for the buy-back;

c) the class of shares or securities intended to be purchased under the buy-back;

d) the amount to be invested under the buy-back; and

e) the time-limit for completion of buy-back.

As per the rules, following more details is to be included in the Explanatory Statement:

f) the date of the board meeting at which the proposal for buy-back was approved by the board of directors of the company;

g) the number of securities that the company proposes to buy-back;

h) the method to be adopted for the buy-back;

i) the price at which the buy-back of shares or other securities shall be made;

j) the basis of arriving at the buy-back price;

k) the maximum amount to be paid for the buy-back and the sources of funds from which the buy-back would be financed;

l) Shareholding:

   i) the aggregate shareholding of the promoters and of the directors of the promoter, where the promoter is a company and of the directors and key managerial personnel as on the date of the notice convening the general meeting;

   ii) the aggregate number of equity shares purchased or sold by persons mentioned in sub-clause (i) during a period of twelve months preceding the date of the board meeting at which the buy-back was approved and from that date till the date of notice convening the general meeting;

   iii) the maximum and minimum price at which purchases and sales referred to in sub-clause (ii) were made along with the relevant date;

m) if the persons mentioned in l(i) intend to tender their shares for buy-back –

   i) the quantum of shares proposed to be tendered;

   ii) the details of their transactions and their holdings for the last twelve months prior to the date of the board meeting at which the buy-back was approved including information of number of shares acquired, the price and the date of acquisition;

n) a confirmation that there are no defaults subsisting in repayment of deposits, interest payment thereon, redemption of debentures or payment of interest thereon or redemption of preference shares or payment of dividend due to any shareholder, or repayment of any term loans or interest payable thereon to any financial institution or banking company;

o) a confirmation:

   i) that the Board of directors have made a full enquiry into the affairs and prospects of the company and that they have formed the opinion- general meeting is convened there shall be no grounds on which the company could be found unable to pay its debts;

   ii) as regards its prospects for the year immediately following that date, that, having regard to their intentions with respect to the management of the company's business during that year and to the amount and character of the financial resources which will in their view be available to the company

during that year, the company shall be able to meet its liabilities as and when they fall due and shall not be rendered insolvent within a period of 1 year from that date; and

iii) the directors have taken into account the liabilities(including prospective and contingent liabilities), as if the company were being wound up under the provisions of theCompanies Act, 2013

p) a report addressed to the Board of directors by the company's auditors stating that-

i) they have inquired into the company's state of affairs;

ii) the amount of the permissible capital payment for the securities in question is in their view properly determined;

iii) that the audited accounts on the basis of which calculation with reference to buy back is done is not more than six months old from the date of offer document; and

iv) the Board of directors have formed the opinion as specified in point 'o' on reasonable grounds and that the company, having regard to its state of affairs, shall not be rendered insolvent within a period of one year from that date.

Other Conditions for Buy back

– Every buy-back shall be completed within a period of one year from the date of passing of the special resolution, or as the case may be, the resolution passed by the Board. ***Section 68(4)***

– The buy-back can be from:

a) from the existing shareholders or security holders on a proportionate basis;

b) from the open market;

c) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity. ***Section 68(5)***

– Before making such buy-back, file with the Registrar, a declaration of solvency signed by at least two directors of the company, one of whom shall be the managing director, if any, Form No. SH.9 may be prescribed and verified by an affidavit to the effect that the Board of Directors of the company has made a full inquiry into the affairs of the company as a result of which they have formed an opinion that it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year from the date of declaration adopted by the Board ***Section 68(6).***

– Company shall extinguish and physically destroy the shares or securities so bought back within seven days of the last date of completion of buy-back ***Section 68(7).***

– Where a company completes a buy-back of its shares or other specified securities, it shall not make a further issue of the same kind of shares or other securities including allotment of new shares or other specified securities within a period of six months except by way of:

a) a bonus issue or

b) in the discharge of subsisting obligations such as conversion of warrants, stock option schemes, sweat equity or conversion of preference shares or debentures into equity shares.

– Company shall maintain a register in Form No. SH.10 of the shares or securities so bought, the consideration paid for the shares or securities bought back, the date of cancellation of shares or securities, the date of extinguishing and physically destroying the shares or securities. The register of shares or securities bought-back shall be maintained at the registered office of the company and shall be kept in the custody of the secretary of the company or any other person authorized by the board in this behalf. The entries in the register shall be authenticated by the secretary of the company or by any other person authorized by the Board for the purpose.

- A company shall, after the completion of the buy-back under this section, file with the Registrar a return in Form No. SH.11 containing such particulars relating to the buy-back within thirty days of such completion. There shall be annexed to the return, a certificate in Form No. SH.15 signed by two directors of the company including the managing director, if any, certifying that the buy-back of securities has been made in compliance with the provisions of the Act and the rules made thereunder.
- If a company makes any default in complying with the provisions of this section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees, or with both.

Transfer of certain sums to capital redemption reserves account (section 69)

Where a company purchases its own shares out of free reserves or securities premium account, a sum equal to the nominal value of the shares so purchased shall be transferred to the capital redemption reserve account and details of such transfer shall be disclosed in the balance sheet. The capital redemption reserve account may be applied by the company, in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

Prohibition on buy back in following circumstances: (section 70)

No company shall directly or indirectly purchase its own shares or other specified securities –

a) through any subsidiary company including its own subsidiary companies;

b) through any investment company or group of investment companies; or

c) if a default, is made by the company, in the repayment of deposits accepted either before or after the commencement of this Act, interest payment thereon, redemption of debentures or preference shares or payment of dividend to any shareholder, or repayment of any term loan or interest payable thereon to any financial institution or banking company. Provided that the buy-back is not prohibited, if the default is remedied and a period of three years has lapsed after such default ceased to subsist.

No company shall, directly or indirectly, purchase its own shares or other specified securities in case such company has not complied with the provisions of:

a) Sections 92: Annual Return

b) Section 123: Declaration and Payment of Dividend

c) Section 127: Failure to pay Dividend

d) Section 129: Failure to give True and Fair Statement

Accounting Enteries

1.	**In case investments are sold for buying back own shares:**	
	Bank	Dr.
	To Investment Account	
2.	**In case the proceeds of fresh issues are used for buy back purpose:**	
	Bank	Dr.
	To debentures/other Investment account	
	To Securities premium account(if any)	

3.	**For Buying back of shares:**		
	Equity Shareholders	Dr.	
	To Bank		(With the amount paid)
4.	**For cancellation of shares bought back:**		
	Equity Share Capital Account	Dr.	(with the nominal value of shares bought back)
	Free reserves/SecuritiesPremium Account	Dr.	(with the excess amount/premium paid over nominal value)
	To Equity Shareholders		(with the amount payable)
5.	**In case the shares are bought back at discount:**		
	Equity Share Capital Account	Dr.	(with the nominal value)
	To Equity shareholders		(with the amount paid)
	To Capital Reserve Account		(with the amount of discount on buy-back)
6.	**For transfer of nominal value of shares purchased out of free reserves/securities premium to Capital Redemption Reserve Account:**		
	Free Reserves	Dr.	(with the amount transferred)
	Securities Premium Account	Dr.	(with the amount transferred)
	To Capital Redemption Reserve Account		(with the nominal value of shares bought back)
7.	**For expenses incurred in buy-back of shares:**		
	Buy-back Expenses	Dr.	(with the amount)
	To Bank		
8.	**For transfer of buy-back expenses:**		
	Profit and Loss Account	Dr.	
	To Buy-back Expenses		

ISSUE OF BONUS SHARES

(*1*) A company may issue fully paid-up bonus shares to its members, in any manner out of –

(i) its free reserves;

(ii) the securities premium account; or

(iii) the capital redemption reserve account.

However, no issue of bonus shares shall be made by capitalising reserves created by the revaluation of assets.

(*2*) No company shall capitalise its profits or reserves for the purpose of issuing fully paid-up bonus shares under (*1*) above, unless –

a) it is authorised by its articles;

b) it has, on the recommendation of the Board, been authorised in the general meeting of the company;

c) it has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;

d) it has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus;

e) the partly paid-up shares, if any outstanding on the date of allotment, are made fully paid-up;

f) The company which has once announced the decision of its Board recommending a bonus issue, shall not subsequently withdraw the same. [Rule 14 of Companies (Share Capital and Debentures) Rules, 2014]

(*3*) The bonus shares shall not be issued in lieu of dividend.

JOURNAL ENTRIES FOR ISSUE OF BONUS SHARES

(A) On capitalization of reserve for issue of shares

Profit & Loss Account Dr.

General Reserve Account Dr.

Capital Reserve Account (realised in cash only) Dr.

Securities Premium Account Dr.

Capital Redemption Reserve Account Dr.

To Bonus to Shareholders Account.

(B) On issue of Bonus share

(a) Bonus to Shareholders Account Dr.

To Share Capital Account.

If some shares are party paid-up, first the shares are to me made fully paid up.

Journal entries on converting partly paid shares into fully paid shares

Profit & Loss Account Dr.

General Reserve Account Dr.

Capital Reserve Account (realised in cash only) Dr.

To Bonus to Shareholders Account

On making the final call due

Share Final Call Account Dr.

To Share Capital Account

On adjustment of final call

Bonus to Shareholders Account Dr.

To Share Final Call Account

EMPLOYEE STOCK OPTION SCHEME

Meaning

As per section 2(37) of the Companies Act,2013 "employees' stock option" means the option given to the directors, officers or employees of a company or of its holding company or subsidiary company or companies, if any, which gives such directors, officers or employees, the benefit or right to purchase, or to subscribe for, the shares of the company at a future date at a pre-determined price.

ESOP or employee stock option plan refers to a basket of instruments and incentive schemes that find favour with the new upward mobile salary class and which are used to motivate, reward, remunerate and hold on to achievers.

Issue of Employee Stock Options

A company, other than a listed company, which is not required to comply with Securities and Exchange Board of India Employee Stock Option Scheme Guidelines shall offer shares to its employees under this scheme after complying of following requirements:

(1) the issue of Employees Stock Option Scheme has been approved by the shareholders of the company by passing a special resolution.

For the purpose of above statement the word "Employee'' means –

(a) a permanent employee of the company who has been working in India or outside India; or

(b) a director of the company, but excluding an independent director; or

(c) an employee as defined in 1(a) or (b) above of a subsidiary, in India or outside India, or of a holding company of the company or of an associate company,

Excluding –

(i) an employee who is a promoter or a person belonging to the promoter group; or

(ii) a director who either himself or through his relative or through any body corporate, directly or indirectly, holds more than ten percent of the outstanding equity shares of the company.

(2) The company shall make the following disclosures in the explanatory statement annexed to the notice for passing of the resolution –

a) the total number of stock options to be granted;

b) identification of classes of employees entitled to participate in the ESOP;

c) the appraisal process for determining the eligibility of employees to the ESOP;

d) the requirements of vesting and period of vesting;

e) the maximum period within which the options shall be vested;

f) the exercise price or the formula for arriving at the same;

g) the exercise period and process of exercise;

h) the Lock-in period, if any ;

i) the maximum number of options to be granted per employee and in aggregate

j) the method which the company shall use to value its options;

k) the conditions under which option vested in employees may lapse e.g. in case of termination of employment for misconduct;

l) the specified time period within which the employee shall exercise the vested options in the event of a proposed termination of employment or resignation of employee; and

m) a statement to the effect that the company shall comply with the applicable accounting standards .

(3) The companies granting option to its employees pursuant to Employees Stock Option Scheme will have the freedom to determine the exercise price in conformity with the applicable accounting policies, if any.

(4) The approval of shareholders by way of separate resolution shall be obtained by the company in case of-

a) grant of option to employees of subsidiary or holding company; or

b) grant of option to identified employees, during any one year, equal to or exceeding one percent of the issued capital of the company at the time of grant of option.

(5) (a) The company may by special resolution, vary the terms of ESOP not yet exercised by the employees

(b) The notice for passing special resolution for variation of terms of ESOP shall disclose full details of the variation, the rationale therefor, and the details of the employees who are beneficiaries of such variation.

(6) (a) There shall be a minimum period of one year between the grant of options and vesting of option. However, in a case where options are granted by a company under its Employees Stock Option Scheme in lieu of options held by the same person under an Employees Stock Option Scheme in another company, which has merged or amalgamated with the first mentioned company, the period during which the options granted by the merging or amalgamating company were held by him shall be adjusted against the minimum vesting period required (i.e; 1 year)

(b) The company shall have the freedom to specify the lock-in period for the shares issued pursuant to exercise of option.

(c) The Employees shall not have right to receive any dividend or to vote or in any manner enjoy the benefits of a shareholder in respect of option granted to them, till shares are issued on exercise of option.

(7) The amount, payable by the employees, at the time of grant of option –

a) may be forfeited by the company if the option is not exercised by the employees within the exercise period; or

b) the amount may be refunded to the employees if the options are not vested due to non-fulfillment of conditions relating to vesting of option as per the Employees Stock Option Scheme.

(8)(a) The option granted to employees shall not be transferable.

(b) The option granted to the employees shall not be pledged, hypothecated, mortgaged or otherwise encumbered or alienated in any other manner.

(c) Subject to clause (d), no person other than the employees to whom the option is granted shall be entitled to exercise the option.

(d) In the event of the death of employee while in employment, all the options granted to him till such date shall vest in the legal heirs or nominees of the deceased employee.

(e) In case the employee suffers a permanent incapacity while in employment, all the options granted to him as on the date of permanent incapacitation, shall vest in him on that day.

(f) In the event of resignation or termination of employment, all options not vested in the employee as on that day shall expire. However, the employee can exercise the options granted to him which are vested within the period

specified in this behalf, subject to the terms and conditions under the scheme granting such options as approved by the Board.

(9) The Board of directors, shall, inter alia, disclose in the Directors' Report for the year, the following details of the Employees Stock Option Scheme:

(a) options granted;

(b) options vested;

(c) options exercised;

(d) the total number of shares arising as a result of exercise of option;

(e) options lapsed;

(f) the exercise price;

(g) variation of terms of options;

(h) money realized by exercise of options;

(i) total number of options in force;

(j) employee wise details of options granted to;-

  (i) key managerial personnel;

  (ii) any other employee who receives a grant of options in any one year of option amounting to five percent or more of options granted during that year.

  (iii) identified employees who were granted option, during any one year, equal to or exceeding one percent of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant;

(10) (a) The company shall maintain a Register of Employee Stock Options in **Form No. SH.6** and shall forthwith enter therein the particulars of option granted to employees under a scheme of ESOP subject to above conditions.

(b) The Register of Employee Stock Options shall be maintained at the registered office of the company or such other place as the Board may decide.

(c) The entries in the register shall be authenticated by the company secretary of the company or by any other person authorized by the Board for the purpose.

(11) Where the equity shares of the company are listed on a recognized stock exchange, the Employees Stock Option Scheme shall be issued, in accordance with the regulations made by the Securities and Exchange Board of India in this behalf.

Issue of Sweat equity shares

(1) Notwithstanding anything contained in section 53, a company may issue sweat equity shares of a class of shares already issued, if the following conditions are fulfilled, namely : –

(a) the issue is authorised by a special resolution passed by the company;

(b) the resolution specifies the 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) not less than one year has, at the date of such issue, elapsed since the date on which the company had commenced business; and

(d) where the equity shares of the company are listed on a recognised stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board in this behalf and if they are not so listed, the sweat equity shares are issued in accordance with such rules as may be prescribed.

(2) The rights, limitations, restrictions and provisions as are for the time being applicable to equity shares shall be applicable to the sweat equity shares issued under this section and the holders of such shares shall rank *pari passu* with other equity shareholders.

Right Shares

(1) Where at any time, a company having a share capital proposes to increase its subscribed capital by the issue of further shares, such shares shall be offered –

(*a*) to persons who, at the date of the offer, are holders of equity shares of the company in proportion, as nearly as circumstances admit, to the paid-up share capital on those shares by sending a letter of offer subject to the following conditions, namely: –

(*i*) the offer shall be made by notice specifying the number of shares offered and limiting a time not being less than fifteen days and not exceeding thirty days from the date of the offer within which the offer, if not accepted, shall be deemed to have been declined;

(*ii*) unless the articles of the company otherwise provide, the offer aforesaid shall be deemed to include a right exercisable by the person concerned to renounce the shares offered to him or any of them in favour of any other person; and the notice referred to in clause (*i*) shall contain a statement of this right;

(*iii*) after the expiry of the time specified in the notice aforesaid, or on receipt of earlier intimation from the person to whom such notice is given that he declines to accept the shares offered, the Board of Directors may dispose of them in such manner which is not dis-advantageous to the shareholders and the company;

(*b*) to employees under a scheme of employees' stock option, subject to special resolution passed by company and subject to such conditions as may be prescribed; or

(*c*) to any persons, if it is authorised by a special resolution, whether or not those persons include the persons referred to in clause (*a*) or clause (*b*), either for cash or for a consideration other than cash, if the price of such shares is determined by the valuation report of a registered valuer subject to such conditions as may be prescribed.

(*2*) The notice referred to in sub-clause (*i*) of clause (*a*) of sub-section (*1*) shall be despatched through registered post or speed post or through electronic mode to all the existing shareholders at least three days before the opening of the issue.

(*3*) Nothing in this section shall apply to the increase of the subscribed capital of a company caused by the exercise of an option as a term attached to the debentures issued or loan raised by the company to convert such debentures or loans into shares in the company:

Provided that the terms of issue of such debentures or loan containing such an option have been approved before the issue of such debentures or the raising of loan by a special resolution passed by the company in general meeting.

ILLUSTRATION 1

B & Co. Ltd issued a prospectus offering 2,00,000 shares of Rs.10 each on the following terms :

On Application	Rs.1 per share
On Allotment	Rs.3 per share (including premium of Rs. 2)
On First Call (three months after allotment)	Rs.4 per share
On Second Call (three months after first call)	Rs.4 per share

Subscriptions were received for 3,17,000 shares on 23rd April and the allotment was made on 30th April as under :

		Shares Alloted
i.	Allotment in full (two applicants paid in full on allotment In respect of 4,000 shares each)	38,000
ii.	Allotment of two-thirds of shares applied for	1,60,000
iii.	Allotment of one-fourth of shares applied for	2,000

Cash amounting to Rs. 31,000 (being application money received with applications for 31,000 shares upon which no allotments were made) was returned to the applicants on 5th May. The amounts due were received on the due dates with the exception of the final call on 100 shares. These Shares were forfeited on 15th November and reissued to Varun on the 16th November for payment of Rs.9 per share. The company paid the interest due on calls-in-Advance on 31st October in cash. Show the journal and Cash Book Entries and draw a Balance sheet of the Company giving effect to the above transactions.

SOLUTION:

JOURNAL

Date	*Particulars*		*Amount(Dr.)*	*Amount(Cr.)*
April 30	Share Application Account	Dr.	2,86,000	
	To Share Capital Account			2,00,000
	To Share Allotment Account			86,000
	(Being application money transferred to Share Capital Account on allotment of 2,00,000 shares and excess application money on 86,000 shares @Rs. 1 per share utilized towards allotment)			
" 30	Share Allotment Account	Dr.	6,00,000	
	To Share Capital Account			2,00,000
	To Securities Premium Account			4,00,000
	(Being allotment money due on 2,00,000 shares @ Rs.3 per share including Rs.2 per share)			
July 31	Share first Call Account	Dr.	8,00,000	
	To Share Capital Account			8,00,000

	(Being amount due in respect of first call on 2,00,000 shares @ Rs.4 per share)			
" 31	Calls in Advance Account	Dr.	32,000	
	To Share First Call Account			32,000
	(Being first call money received on 8,000 shares @ Rs. 4 per share received in advance is debited to the Calls in Advance Account)			
Oct 31	Share Second and final Call Account	Dr.	8,00,000	
	To Share Capital Account			8,00,000
	(Being amount due in respect of second and final call on 2,00,000 shares @ Rs.4 per share)			
" 31	Calls in Advance Account	Dr.	32,000	
	To Share Second and Final Call Account			32,000
	(Being second call money received on 8,000 shares @ Rs. 4 per share received in advance is debited to the Calls in Advance Account)			
Nov. 15	Share Capital Account	Dr.	1,000	
	To Share Second and final Call Account			400
	To Share Forfeited Account			600
	(Being forfeiture of 100 shares for non-payment of second and final call)			
Nov. 16	Share Forfeited Account	Dr.	600	
	To Share Capital Account			100
	To Capital Reserve Account			500
	(Being discount allowed on re-issue of 100 forfeited shares @ Rs. 1 per share and profit on re-issue transferred to Capital Reserve Account)			

CASH BOOK

Date	*Particulars*	*Amount*	*Date*	*Particulars*	*Amount*
April23	To Share Application Account	3,17,000	May 5	By Share Application Account	31,000
April30	To Share Allotment Account	5,14,000	Oct 31	By Interest on Calls-in-Advance	1,440
April30	To Calls-In-Advance Accounts	64,000		By Balance c/d	23,99,060
July31	To Share First Call Account	7,68,000			

Oct.31	To Share Second & Final Call Account	7,67,600			
Nov.16	To Share Capital A/c	900			
		24,31,500			24,31,500
	To Balance b/d	23,99,060			

Interest on Calls-in-Advance has been calculated as follows: **Amount (Rs.)**

On first call money from April 30 to July 31 @ 6% p.a. for 3 months

(Rs.32,000 * 6/100*3/12) 480

On second and final call money from April 30 to October 31@ 6% p.a.

For 6 months (Rs.32,000 * 6/100 * 6/12) 960

1,440

Balance Sheet of B& Co. Ltd.

Particulars	***Amount***
Liabilities:	
Share Capital:	
Issued, Subscribed and Paid Up:	
2,00,000 shares of Rs. 10 each fully paid up	20,00,000
Reserves and Surplus:	
Capital Reserve	500
Securities Premium Account	4,00,000
	24,00,500
Assets:	
Current Assets:	
Cash at Bank	
Interest on Calls in Advance Account (Pending adjustment)	23,99,060
	1,440
	24,00,500

Working notes:

ANALYSIS OF APPLICATION MONEY RECIEVED

Shares Applied	***Shares Allotted***	***Amount Received @ Rs.1 per share***	***Application Money***	***Adjusted as Allotment Money***	***Money Returned to Applicants***
		Rs.	Rs.	Rs.	Rs.
38,000	38,000	38,000	38,000	-	-

2,40,000(160000 * 3/2)	1,60,000	2,40,000	1,60,000	80,000	-
8,000(2,000 * 4/1)	2,000	8,000	2,000	6,000 (2,000 * 3)	-
31,000	Nil	31,000	Nil	-	31,000
3,17,000	2,00,000	3,17,000	2,00,000	86,000	31,000

ILLUSTRATION 2

Pooja Ltd. Invited applications for 80,000 shares of Rs.10 each at a premium of Rs. 2.50 per share payable as follows:

On application	Rs. 3
On allotment	Rs. 4.50 (including premium)
On first call	Rs. 2
On second call	Rs. 3

Applications were received for 1,70,000 shares, out of which applications for 10,000 shares were rejected and money refunded to them. The allotment was made pro-rata to the remaining applicants. Money over-paid on applications was used against allotment money due.

Anil to whom 2,000 shares were allotted failed to pay the allotment money and on his subsequent failure to pay the first call, his shares were forfeited.

Sunil, the holder of 1,200 shares failed to pay the two calls, and his shares were forfeited after the final call. Of the forfeited shares 2,400 shares were reissued at the rate of Rs.8 per share credited as fully paid, including the whole of Anil's forfeited shares.

Show necessary Journal entries.

SOLUTION:

In the Books of Pooja Ltd.

JOURNAL ENTERIES

	Particulars		Amount (Dr.)	Amount (Cr.)
	Bank A/c	Dr.	5,10,000	
	To Share Capital A/c			5,10,000
	(Being receipt of application money on 1,70,000 shares @ Rs. 3 per share)			
	Share Application A/c	Dr.	5,10,000	
	To Share Capital A/c			2,40,000
	To Share Allotment A/c			2,40,000
	To Bank A/c			30,000
	(Being application money on 80,000 shares @ Rs.3 each transferred to Share Capital A/c, surplus application money of 80,000 shares transferred to Share Allotment A/c and application money of 10,000 shares refunded to the unsuccessful applicants)			

	Particulars		Dr. (Rs.)	Cr. (Rs.)
	Share Allotment A/c	Dr.	3,60,000	
	To Share Capital A/c			1,60,000
	To Securities Premium A/c			2,00,000
	(Being Share allotment money due on 80,000 shares @ Rs. 4.50 (including premium of Rs. 2.50) per share)			
	Bank A/c	Dr.	1,17,000	
	To Share Allotment A/c (W.N 1)			1,17,000
	(Being balance of securities premium received @ Rs. 1.50 per share on 78,000 shares; Rs. 3 per share already received as surplus application money. Surplus application money @ Rs.2 will be first utilized as capital and balance of Rs. 1 per share adjusted as premium)			
	Share First Call A/c	Dr.	1,60,000	
	To Share Capital A/c			1,60,000
	(Being first call due on 80,000 shares @ Rs.2 per share)			
	Bank A/c	Dr.	1,53,600	
	To Share First Call A/c			1,53,600
	(Being 1st call money received on shares except 3,200 shares @ Rs. 2 per share)			
	Share Capital A/c	Dr.	14,000	
	Securities Premium A/c	Dr.	3,000	
	To Share Allotment A/c			3,000
	To Share First Call A/c			4,000
	To Share Forfeited A/c			10,000
	(Being forfeiture of 2,000 shares for non- payment of first call, premium @ Rs.1.50 per share cancelled which was not received on allotment)			
	Share Second and Final Call A/c	Dr.	2,34,000	
	To Share Capital A/c			2,34,000
	(Being final call due on 78,000 shares @ Rs. 3 per share)			
	Bank A/c	Dr.	2,30,400	
	To Share Second and Final Call A/c			2,30,400
	(Being second call money received on 76,800 shares @ Rs. 3 per share)			

	Particulars		Dr. (Rs.)	Cr. (Rs.)
	Share Capital A/c	Dr.	12,000	
	To Share First Call A/c			2,400
	To Share Second and Final Call A/c			3,600
	To Share Forfeited A/c(Being forfeiture of 1,200 shares for non-payment of two calls)			6,000
	Bank A/c	Dr.	19,200	
	Shares Forfeiture A/c	Dr.	7,800	
	To Share Capital A/c			24,000
	To Share Premium A/c			3,000
	(Being 2,400 shares reissued @ Rs. 8 per share ; premium @ Rs. 1.50 per share on Anil's 2,000 forfeited shares which was cancelled has been revived)			
	Shares forfeited A/c	Dr.	4,200	
	(Rs.10,000 + Rs.6,000/1,200 * 400 – Rs.7,800)			4,200
	To Capital Reserve A/c			
	(Being unused balance of shares forfeited account in respect of 2,400 shares transferred to Capital Reserve A/c)			

Working Note (1):

			Amount (Rs.)
Amount received on allotment is calculated as follows:			Amount (Rs.)
Amount due on allotment of 80,000 shares @ Rs. 4.50			3,60,000
Less:	Application money on excess 80,000 shares adjusted on allotment @ Rs. 3 (Rs. 2 as capital and Rs. 1 per share as premium)		2,40,000
			1,20,000
Less:	Amount of allotment not received on 2,000 shares:		
	Amount due on allotment of 2,000 shares @ Rs. 4.50 per share	Rs. 9,000	
Less:	Already received with application 2,000 * Rs. 3 (Applied for 4,000 shares and allotted 2,000 shares)	Rs.6,000	
			3,000
	Amount received on allotment		1,17,000

NOTE: If shares issued at a premium on which securities premium has not been received till forfeited shares are reissued, Securities Premium Account will be credited with the amount of the securities premium not received till forfeiture in respect of reissued shares and the amount to be debited to Forfeited Shares Account will be calculated after taking into consideration this credit.

Illustration 3

Divya Paints Ltd

BALANCE SHEET

AS AT 31st March, 2014

I. EQUITIES AND LIABILITIES		₹
1. Shareholders' funds		
(a) Share Capital	1	30,00,000
(b) Reserve & Surplus	2	12,05,000
2. Non-Current Liability		
Long term borrowings	3	14,00,000
3. Current Liability		
Trade payables		4,60,000
TOTAL		**60,65,000**
II. ASSETS		
1. Non-current assets		
(a) Fixed Assets		
(i) Tangible fixed assets	4	33,30,000
(b) Non Current Investment		3,70,000
2. Current Assets		
Inventories	12,00,000	
Trade receivables	5,90,000	
Cash and cash equivalents Balance	5,75,000	23,65,000
TOTAL		**60,65,000**
Notes		
1. Share Capital		
Authorized Share Capital		....
Issued, Subscribed Called Up And Paid-Up Share Capital:-		
3,00,000 shares of ₹ 10 each fully paid-up		30,00,000
2. Reserve and Surplus		
Securities Premium	7,00,000	
General Reserve	5,05,000	12,05,000
3. Long term borrowings		
14% Debentures		14,00,000
4. Tangible Fixed assets		
Land and building	6,30,000	
Plant and machinery	23,50,000	
Furniture and fitting	3,50,000	33,30,000

On 1st April, 2014 the shareholders of the company have approved the scheme of buy-back of equity shares as under:

(i) 15% of the equity shares would be bought back at ₹ 18.

(ii) General reserve balance may be utilised for this purpose.

(iii) Premium paid on buy back of shares should be met from securities premium account.

(iv) Investments would be sold for ₹ 4,00,000.

Pass journal entries to record the above transactions and prepare the balance sheet of the company immediately after the buy-back of shares.

Solution:

Divya Paints Ltd.

Journal Entries

(₹ in '000's)

Particulars		*Dr. (₹)*	*Cr.(₹)*
Bank	Dr.	400	
To Investments			370
To Profit and Loss A/c			30
(Sale of investments, the profit being transferred to profit and loss account as per shareholder's special resolution)			
Shareholders	Dr.	810	
To Bank			810
(Purchase of 45,000 of own shares @ ₹ 18 each)			
Equity Share Capital A/c	Dr.	450	
Securities Premium A/c	Dr.	360	
To Shareholders			810
(Cancellation of 45,000 equity shares bought back, and securities premium utilised as per shareholders' special resolution)			
General Reserve	Dr.	450	
To Capital Redemption Reserve A/c			450
(Transfer of general reserve utilised to the extent of nominal value of shares bought back)			

Divya Paints Ltd

BALANCE SHEET (After Buy-back)

AS AT 1st April, 2014

I. EQUITIES AND LIABILITIES			₹
1. Shareholders' funds			
(a) Share Capital	1		25,50,000
(b) Reserve & Surplus	2		8,75,000
2. Non Current Liability			
Long term borrowings	3		
3. Current Liability			
Trade payables			4,60,000
TOTAL			**52,85,000**
II. ASSETS			
1. Non-current assets			
(a) Fixed assets			
(i) Tangible fixed assets	4		33,30,000
2. Current Assets			
Stock		12,00,000	
Sundry debtors		5,90,000	
Cash and Cash equivalents		1,65,000	19,55,000
TOTAL			**52,85,000**
Notes			
1. Share Capital			
Authorized Share Capital			…………
Issued, Subscribed Called Up And Paid-Up Share Capital			
2,55,000 shares of ₹ 10 each fully paid-up			25,50,000
2. Reserve and Surplus			
Securities Premium		1,45,000	
General Reserve		2,50,000	
Capital Redemption Reserve		4,50,000	
Profit and Loss Account		30,000	8,75,000
3. Long term borrowings			
14% Debentures		14, 00,000	

4. Tangible Fixed assets		
Land and building	6,30,000	
Plant and machinery	23,50,000	
Furniture and fitting	3,50,000	33,30,000

Note: The debt-equity ratio of the company after buy-back of shares:

$$\text{Debt equity ratio} = \frac{\text{Debt}}{\text{Equity (Capital and free reserves)}}$$

$$= \frac{₹\,1{,}400 + 460}{₹\,2{,}550 + 250 + 145 + 30} = \frac{₹\,1{,}860}{₹\,2{,}975} = 0.625 : 1$$

The debt equity ratio is within the limit.

Illustration 4

Powerlink Ltd

BALANCE SHEET

AS ON 31st March, 2014

I. EQUITY AND LIABILITIES			₹
1. Shareholders 'funds'			
(a) Share Capital	1		50,00,000
(b) Reserve & Surplus	2		15,65,000
2. Non-current liabilities			
Long term borrowings	3		38,25,000
3. Current Liabilities			
Trade payables		7,42,000	
Short term provisions	4	1,25,000	8,67,000
TOTAL			**1,12,57,000**
II. ASSETS			
1. Non-current assets			
(a) Fixed Assets		66,00,000	
(b) Non-Current Investments		18,00,000	84,00,000
2. Current Assets			
Inventories		11,87,000	
Trade receivables		9,60,000	
Cash and Cash equivalent		7,10,000	28,57,000
TOTAL			**1,12,57,000**

Notes

1. Share Capital

Authorized Share Capital		…………
Issued, Subscribed Called Up And Paid-Up Share Capital		
5,00,000 shares of ₹ 10 each fully paid-up		50,00,000
2. Reserve and surplus		
Securities Premium	5,40,000	
General Reserve	6,50,000	
Profit and Loss Account	3,75,000	15,65,000
3. Long term borrowing		
12% Debentures	25,00,000	
Term Loan	13,25,000	38,25,000
4. Short term provisions		
Provision for taxation		1,25,000

The shareholders adopted the resolution on the date of the abovementioned balance sheet to:

(i) buy back 20% of the paid-up capital @ ₹ 15 each.

(ii) issue 13% debentures of ₹ 5,00,000 at a premium of 10% to finance the buy back of shares.

(iii) maintain a balance of ₹ 3,00,000 in general reserve account, and

(iv) sell investments worth ₹ 8,00,000 for ₹ 6,50,000.

Pass necessary journal entries to record the above transactions and prepare the balance sheet immediately after the buy back.

Solution:

Powerlink Limited

Journal Entries

Particulars		*Dr. (₹)*	*Cr.(₹)*
Bank	Dr.	6,50,000	
Profit and Loss Account	Dr.	1,50,000	
To Investments A/c			8,00,000
(Sale of investments worth ₹ 8,00,000 the loss is transferred to profit and loss account)			
Bank	Dr.	5,50,000	
To 13% Debentures A/c			5,00,000
To Securities Premium A/c			50,000
(Issue of debentures at a premium of 10% to finance the buy-back of shares)			

Shareholders A/c	Dr.	15,00,000	
To Bank			15,00,000
(Buy-back of 1,00,00 equity shares @ ₹ 15 each)			
Equity Share Capital	Dr.	10,00,000	
Securities Premium A/c	Dr.	5,00,000	
To Shareholders A/c			15,00,000
(Cancellation of re-purchased shares and utilisation of securities premium for the payment of premium amount on buy-back of shares)			
General Reserve A/c	Dr.	3,50,000	
Profit and Loss A/c	Dr.	1,50,000	
To Capital Redemption Reserve A/c			5,00,000
(Utilisation of general reserve and profit and loss account to meet buy-back requirements)			

Powerlink Ltd

BALANCE SHEET

AS ON 31st March, 2014

I. EQUITY AND LIABILITIES			₹
1. Shareholders 'funds			
(a) Share Capital	1		40,00,000
(b) Reserve & Surplus	2		9,65,000
2. Non-current liabilities			
Long term borrowings	3		43,25,000
3. Current Liabilities			
Trade payables		7,42,000	
Short term provisions	4	1,25,000	8,67,000
TOTAL			**1,01,57,000**
II. ASSETS			
1. Non-current assets			
(a) Fixed Assets		66,00,000	
(b) Non-Current Investments		10,00,000	76,00,000
2. Current Assets			
Inventories		11,87,000	
Trade receivables		9,60,000	

Cash and Cash equivalent	4,10,000	25,57,000
TOTAL		**1,01,57,000**
Notes		
1. Share Capital		
Authorized Share Capital		…………
Issued, Subscribed Called Up And Paid-Up Share Capital		
4,00,000 shares of ₹ 10 each fully paid-up		40,00,000
2. Reserve and surplus		
Capital Redemption Reserve	5,00,000	
Securities Premium	90,000	
General Reserve	3,00,000	
Profit and Loss Account	75,000	9,65,000
3. Long term borrowing		
12% Debentures	25,00,000	
13% Debentures	5,00,000	
Term Loan	13,25,000	43,25,000
4. Short term provisions		
Provision for taxation		1,25,000

Note: It is assumed that securities premium has been utilised exclusively for the payment of premium on buy-back of shares. Hence, as a matter of prudence, for the transfer of nominal value of shares bought back to Capital Redemption Reserve, the available balance in general reserve and profit and loss account is taken into account.

ILLUSTRATION 5

ABC Ltd. granted 1000 options on April 1, 2012 at Rs. 20 (nominal value Rs. 10 each) when the market price was Rs. 80, the vesting period was 2 ½ years. The maximum exercise period was one year. On May 1, 2013, 300 unvested options lapsed and 600 options were exercised. On 30th June, 2014 remaining 100 options lapsed at the end of exercise period. Pass necessary journal entries.

SOLUTION:

In the Books of ABC Ltd.

JOURNAL

Date	*Particulars*		*Amount (Rs.)*	*Amount (Rs.)*
2012	Deferred Employee Compensation Expense A/c	Dr.	60,000	
April 1	To Employee Stock Options Outstanding A/c			60,000
	(Being grant of 1,000 options at a discount of Rs. 60,i.e., Rs. 80 – Rs.20)			
2013	Employee Compensation Expense A/c	Dr.	24,000	

March 31	To Deferred Employee Compensation Expense A/c			24,000
	(Being amortization of Deferred Compensation, i.e., Rs. 60,000 / 2 ½)			
2013	Employee Compensation Expense A/c	Dr.	24,000	
March 31	To Deferred Employee Compensation Expense A/c			24,000
	(Being amortization of Deferred Compensation, i.e., Rs. 60,000 / 2 ½)			
2013	Employee Stock Options Outstanding A/c	Dr.	18,000	
March 31	To Employee Compensation Expense A/c			14,400
	[(300 * Rs.60) * 2/2.5]			
	To Deferred Employee Compensation Expense A/c		3,600	
	[(300 * Rs.60) * 2/2.5]			
	(Being reversal of compensation accounting on lapse of 300 unvested options)			
2014	Employee Compensation Expense A/c	Dr.	8,400	
March 31	To Deferred Employee Compensation Expense A/c			8,400
	(Being amortization of Deferred Compensation)			
2014	Bank A/c	Dr.	12,000	
June 30	Employee Stock Options Outstanding A/c		36,000	
	[Rs. 600 * (Rs. 80 - Rs. 20)]			
	To Equity Share Capital A/c (600 * 10)			6,000
	To Securities Premium A/c [Rs.600 *(Rs. 80 - Rs. 10)]			42,000
	(Being excise of 600 options at an excise price of Rs. 20 each and an accounting value of Rs. 60 each)			
2014	Employee Stock Options Outstanding A/c	Dr.	6,000	
Oct. 1	To Employee Compensation Expense A/c			6,000
	(Being reversal of compensation accounting on lapse of 100 vested options at the end of the excise period i.e., Rs.100 * (Rs. 80 - Rs. 20))			

ILLUSTRATION 6

Adarsh Ltd. furnishes the following summarized Balance Sheet as at 31st March, 2014:

	Amount(Rs.000)	*Amount(Rs.000)*
Liabilities		
Share capital:		
Authorised capital		3,000
Issued and Subscribed capital:		
2,00,000 Equity shares of ₹ 10 each	2,500	
2,000, 10% Preference shares of Rs.100 each	200	

(Issued two months back for the purpose of buy-back)		2700
Reserves and surplus:		
Capital Reserve	1,000	
Revenue Reserve	3,000	
Securities Premium	2,200	
Profit and Loss account	3,500	9,700
Current liabilities and provisions		1,400
		1,38,000
Assets		
Fixed assets		9,300
Investments		3,000
Current assets, loans and advances (including cash and bank balance)		1,500
		13,800

The company passed a resolution to buy- back 20% of its equity share capital @ Rs. 50 per share. For this purpose, it sold all of its investment for Rs. 22,00,000.

You are required to pass necessary journal entries and prepare the Balance Sheet.

SOLUTION:

In the Books of Adarsh Ltd.

Journal Enteries

	Particulars		*Amount (Dr.)*	*Amount (Cr.)*
			In Rs.000	
(i)	Bank Account	Dr.	2,200	
	Profit and Loss Account	Dr.	800	
	To Investment Account			3000
	(Being the investments sold at loss for the purpose of buy-back)			
(ii)	Equity Share Capital account	Dr.	500	
	Premium payable on Buy-Back Account		2000	
	To Equity Shares Buy-Back Account			2500
	(Being the amount due on buy- back)			
(iii)	Securities premium Account	Dr.	2000	
	To Premium payable on buy-back Account			2000
	(Being the premium payable on buy-back adjusted against securities premium account)			
(iv)	Revenue Reserve Account	Dr.	300	
	To Capital Redemption Reserve Account			300
	(Being the amount equal to nominal value of equity shares bought back out of free reserves transferred to			

	capital redemption reserve account)		
(v)	Equity shares buy-back Account Dr. To Bank Account (Being the payment made on buy-back)	2500	 2500

Balance Sheet of Adarsh Ltd. as on 1st April, 2014

(After buy back of shares)

Particulars	*Note no*	*Amount (in Rs.000)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	2,200
(b) Reserves and Surplus	2	6,900
(2) Current Liabilities		1,400
Total		10,500
II. Assets		
(1) Non-current assets		
(a) Fixed assets		9,300
(2) Current assets		1,200
Total		10,500

Notes to Accounts

				Amount (,000)
1	Share Capital			
	Authorised capital:			3000
	Issued and subscribed capital:		2000	
	2,00,000 Equity shares of '10 each fully paid up		200	
	2,000 10% Preference shares of Rs. 100 each fully paid up			
2	Reserves and Surplus			
	Capital Reserve		1000	
	Capital redemption reserve		300	
	Securities Premium	22,00		
	Less: Premium payable on Buy back of shares	20,00	2	
	Revenue reserve	30,00		
	Less: Transfer to Capital redemption reserve	3,00	2700	
	Profit and loss A/c	35,00		
	Less: Loss on investment	8,00	2700	6900

PART II

ISSUE AND REDEMPTION OF PREFERENCE SHARES

Issue of preference shares

A company limited by shares may, if so authorised by its articles, issue preference shares which are liable to be redeemed within a period not exceeding twenty years from the date of their issue under section 55 of the Companies Act 2013. No company limited by shares shall, can issue any preference shares which are irredeemable.

A company may issue preference shares for a period exceeding 20 years but not exceeding 30 years for infrastructure projects (Specified in Schedule VI). However, it is subject to redemption of minimum 10% of such preference shares per year from the twenty-first year onwards or earlier, on proportionate basis, at the option of the preference shareholders.

Redemption of preference shares

The preference shares can be redeemed only when **they are fully paid up** –

- out of the profits of the company which would otherwise be available for dividend or
- out of the proceeds of a fresh issue of shares made for the purposes of such redemption.

Capital Redemption Reserve Account

If preference shares are proposed to be redeemed out of the profits of the company, a sum equal to the nominal amount of the shares to be redeemed, shall be transferred to a reserve called the Capital Redemption Reserve Account out of the profits of the company and the provisions of this Act relating to reduction of share capital of a company shall apply as if the Capital Redemption Reserve Account were paid-up share capital of the company

The capital redemption reserve account may be applied by the company, in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

Premium on redemption of preference shares

(a) For the companies whose financial statements comply with the accounting standards as prescribed under section 133, ***the premium payable on redemption shall be provided out of the profits of the company,*** before the shares are redeemed.

(b) For redemption of any preference shares issued on or before the commencement of 2013 Act, ***the premium payable on redemption shall be provided out of the profits of the company,*** or out of the company's securities premium account, before such shares are redeemed.

(c) For the companies whose financial statements need not comply with the accounting standards as prescribed under section 133, ***the premium payable on redemption shall be provided out of the profits of the company,*** or out of the company's securities premium account, before such shares are redeemed.

Case 1: Redemption of preference shares out of the profits of the company which would otherwise be available for dividend.

If the redeemable preference shares are redeemed out of the profits of the company which would otherwise be available for dividend, the "Capital Redemption Reserve Account" has to be created which will represent the redeemable preference shares in the balance sheet after the redemption. This capital redemption reserve should be equal to the amount of Preference Shares to be redeemed. The profits available for dividend have to be transferred to Capital Redemption Reserve Account.

Journal Entries

1. **Transfer profits available for dividend to Capital Redemption Reserve Account:**

General Reserve Account	Dr.	as the case may be
Profit and Loss Appropriation A/c	Dr.	
Dividend Equalization Account	Dr.	
To Capital Redemption Reserve A/c		with the nominal value of the shares to be redeemed

2. **If current assets are realized to provide cash for redemption of preference shares:**

Bank	Dr.	
To Respective Assets Account		with the realized value of assets

3. **On transfer of redeemable preference share capital to be redeemed to Preference Shareholders Account:**

Redeemable Preference Share Capital A/c	Dr.	with the nominal value of the
To Preference Shareholders A/c		shares to be redeemed

4. **If preference shares are redeemed at premium:**

Redeemable Preference Share Capital A/c	Dr.	
Premium on Redemption of Preference Shares A/c	Dr.	with the amount of premium payable
To Preference Shareholders A/c		

5. **For providing premium on redemption of preference shares:**

Securities Premium Account	Dr.	with the amount of premium paid on redemption of preference shares
or Profit and Loss Appropriation A/c	Dr.	
To Premium on Redemption of Preference Shares Account		

6. **On redemption of preference shares:**

Preference Shareholders Account	Dr.	with the amount paid
To Bank		

Case 2: **If the redeemable preference shares are redeemed out of the proceeds of a fresh issue of shares made for the purpose of redemption:**

If the redeemable preference shares are redeemed out of the proceeds of fresh issue of shares, the new Share Capital Account raised by fresh issue will take the place of the Redeemable Preference Share Capital Account after the redemption. Thus, in such a case, new Share Capital Account (Equity or Preference) must be equal to the redeemable preference shares redeemed.

First of all, entries for fresh issue of shares will be passed. Then entries for redemption passed as given in previous case.

Case 3: **If the redeemable preference shares are redeemed partly out of the profits of the company which would otherwise be available for dividend and partly out of the proceeds of a fresh issue of shares made for the purpose of redemption:**

If the redeemable preference shares are redeemed partly out of the profits of the company which would otherwise be available for dividend and partly out of the proceeds of a fresh issue of shares equity or preference, the Capital Redemption Reserve Account and the new Share Capital Account taken together will replace the Redeemable Preference Share Capital redeemed. Thus in such a case, Redeemable Preference Share Capital redeemed = Capital Redemption Reserve Account + New Share Capital Account (Equity or Preference).

Here, all the entries shown under (i) and (ii) have to be passed. But there are certain common entries which can be combined together.

Illustration 1

(When preference shares are redeemed out of the profits of the company).

Vanities Ltd. had an issue 1,000, 12% Redeemable Preference Shares of ₹ 100 each, repayable at a premium of 10%. These shares are to be redeemed out of the accumulated reserves, which are more than the necessary sum required for redemption. Show the necessary entries in the books of the company, assuming that the premium on redemption of shares has to be written off against the company's Securities Premium Reserves.

Solution:

Journal Entries

Particulars		*Dr. (₹)*	*Cr.(₹)*
General Reserve Account	Dr.	1,00,000	
To Capital Redemption Reserve A/c			1,00,000
(Transfer of reserves to Capital Redemption Reserve Account on Redemption of Redeemable Preference Shares)			
12% Redeemable Preference Share Capital A/c	Dr.	1,00,000	
Premium on Redemption of Preference Shares A/c	Dr.	10,000	
To 12% Preference Shareholders A/c			1,10,000
(Amount payable to 12% preference shareholders on redemption of 12% preference shares at a premium of 10%)			
Securities Premium Reserves	Dr.	10,000	
To Premium on Redemption of Preference Share A/c			10,000
(Application of Securities Premium Account to write off premium on Redemption of Preference Shares)			
12% Preference Shareholders A/c	Dr.	1,10,000	
To Bank			1,10,000
(Amount due to 12% preference shareholders on redemption paid)			

Note: Capital Redemption Reserve Account replaces the 12% Redeemable Preference Shares Capital Account and the capital structure of the company remains unchanged.

Illustration 2

(When redeemable preference shares are redeemed out of the proceeds of fresh issue made for the purpose).

Sure and Fast Ltd. has part of its share capital consists of, 12% Redeemable Preference Shares of ₹ 100 each, repayable at a premium of 5%. The shares have now become ready for redemption. It is decided that the whole amount will be redeemed out of a fresh issue of 20,000 equity shares of ₹ 10 each at ₹ 11 each. The whole amount is received in cash and the 12% preference shares are redeemed.

Show the necessary journal entries in the books of the company.

Solution:

Journal Entries

Particulars		*Dr. (₹)*	*Cr.(₹)*
Bank	Dr.	2,20,000	
To Equity Share Application and Allotment A/c			2,20,000
(Application money on 20,000 equity shares @ ₹ 11 per share including a premium of ₹ 1 per share)			
Equity Share Application and Allotment A/c	Dr.	2,20,000	
To Equity Share Capital A/c			2,00,000
To Securities Premium Reserves			20,000
(Allotment of 20,000 equity shares ₹ 10 each issued at a premium of 1 per share as per Board's Resolution dated....)			
12% Redeemable Preference Share Capital A/c	Dr.	2,00,000	
Premium on Redemption of Preference Share A/c	Dr.	10,000	
To 12% Preference Shareholders A/c			2,10,000
(Amount due to 12% preference shareholders on redemption of 8% preference shares at a premium of 5%)			
Securities Premium Reserves	Dr.	10,000	
To Premium on Redemption of Preference Shares A/c			10,000
(Application of Securities Premium Account to write off Premium on Redemption of Preference Shares)			
12% Preference Shareholders A/c	Dr.	2,10,000	
To Bank			2,10,000
(Amount due to 12% preference shareholders on redemption paid)			

Note: Equity Share Capital Account replaces the 12% Redeemable Preference Share Capital Account and the capital structure of the company remains unchanged).

Illustration 3

Oscar India Ltd

BALANCE SHEET

AS AT 31st March, 2014

I. EQUITY AND LIABILITIES			₹
1. Shareholders' funds			
(a) Share Capital	1		5,48,000
(b) Reserve & Surplus	2		1,65,000
2. Current Liabilities			
Trade payable			27,000
TOTAL			**7,40,000**
II. ASSETS			
1. Non-current assets			
(a) Fixed Assets		6,00,000	
(b) Non Current Investments		50,000	6,50,000
2. Current Assets			
Cash and cash equivalent			90,000
TOTAL			**7,40,000**

Notes

1. Share capital

Authorized Share Capital	…………	
Issued, Subscribed Called Up And Paid-Up Share Capital		
2500 Preference shares of ₹ 100 each fully paid-up	2,50,000	
Less: Calls in arrears	2000	2,48,000
30,000 equity shares of ₹ 10 each fully paid up		3,00,000

2. Reserve & Surplus

Securities Premium	15,000	
Surplus Account	1,50,000	1,65,000

On 30th June, 2014, the Board of directors decided to redeem the preference shares at a premium of 10% and to sell the investments at its market price of ₹ 40,000. They also decided to issue sufficient number of equity shares of ₹ 10 each at a premium of ₹ 1 per share, required after utilising the Surplus Account leaving a balance of ₹ 50,000. Premium on redemption is required to be set off against securities premium reserves.

Repayments on redemption were made in full except to one shareholder holding 50 shares only due to his leaving India for good.

You are required to show the journal entries and the balance sheet of the company after redemption. Assumption made should be shown in the working.

Solution:

Journal entries in the books of Oscar Ltd.

Particulars		*Dr. (₹)*	*Cr.(₹)*
Bank	Dr.	40,000	
Surplus A/c	Dr.	10,000	
To Investments			50,000
(Being the sale of investments at a loss of ₹ 10,000)			
Bank	Dr.	1,65,000	
To Share Capital A/c			1,50,000
To Securities Premium Reserves			15,000
(Being the issue of required number of equity shares at a premium of 10%)			
Preference Share Capital A/c	Dr.	2,40,000	
Premium on Redemption A/c	Dr.	24,000	
To Preference Shareholders A/c			2,64,000
(Being the transfer of the amount due to preference shareholders on redemption)			
Securities Premium Reserves	Dr.	24,000	
To Premium on Redemption A/c			24,000
(Being the transfer of securities premium account to write off premium on redemption account)			
Surplus A/c	Dr.	90,000	
To Capital Redemption Reserve A/c			90,000
(Being the transfer of profit used for redemption of preference shares transferred to capital redemption reserve account)			
Preference Shareholders A/c	Dr.	2,58,500	
To Bank			2,58,500
(Being the payment to preference shareholders except for 50 shares)			

Oscar India Ltd

BALANCE SHEET (After redemption)

AS AT 1st July 2014

I. EQUITY AND LIABILITIES			₹
1. Shareholder's Fund			
(a) Share Capital	1		4,58,000
(b) Reserve & Surplus	2		1,46,000
2. Current Liabilities			
Trade payable			27,500
Other current liability	3		5,000
TOTAL			**6,36,500**
II. ASSETS			
1. Non-current assets			
(a) Fixed Assets			6,00,000
2. Current Assets			
Cash and cash equivalents			36,500
TOTAL			**6,36,500**

Notes

1. Share capital		
Authorized Share Capital		…………
Issued, Subscribed Called Up And Paid-Up Share Capital		
100 Preference shares of ₹ 100 each fully paid-up	10,000	
Less: Calls in arrears	2000	8,000
45,000 equity shares of ₹ 10 each fully paid up		4,50,000
		4,58,000
2. Reserve and Surplus		
Capital Redemption reserve	90,000	
Securities Premium Reserves	6,000	
Surplus Account	50,000	1,46,000
3. Other current liability		
Amount due to preference shareholders		5,000

Bank Account

Dr. *Cr.*

Particulars	₹	*Particulars*	₹
To Balance b/d	90,000	By Preference Shareholders A/c	2,58,500
To Investment	40,000	By Balance b/d	36,500
To Share Capital A/c	1,50,000		
To Securities Premium Reserves	15,000		
	2,95,000		2,95,000

3. Premium on redemption of preference shares has been met out of securities premium account.

Illustration 4

(When Redeemable Preference Shares are redeemed partly out of the profits of the company and partly out of the proceeds of fresh issue of shares made for the purpose).

Producers Ltd

BALANCE SHEET

AS AT 31st March, 2014

I. EQUITY AND LIABILITIES			₹
1. Shareholders' funds			
(a) Share Capital	1		3,50,000
(b) Reserve & Surplus	2		64,000
2. Current Liabilities			
Trade Payable		22,500	
Short term provisions	3	19,500	42,000
TOTAL			**4,56,000**
II. ASSETS			
1. Non-current assets			
(a) Fixed Assets			
I. Tangible fixed assets	4		2,10,000
(b) Non-Current Investments			60,000
2. Current Assets			
Inventories		1,30,500	
Trade receivable		49,550	
Cash and cash equivalents		4,950	
Other current assets	5	1,000	1,86,000
TOTAL			**4,56,000**

Notes	
1. Share capital	
Authorized Share Capital	
40,000 equity shares of ₹ 10 each fully paid up	4,00,000
1000, 8% preference shares of ₹ 100 each	1,00,000
	5,00,000
Issued, Subscribed Called Up And Paid-Up Share Capital	
1000 8% Preference shares of ₹ 100 each fully paid-up	1,00,000
25,000 equity shares of ₹ 10 each fully paid up	2,50,000
	3,50,000
2. Reserve and Surplus	
Securities Premium Reserves	9,000
Surplus Account	55,000
	64,000
3. Short term provisions	
Provisions for Taxation	19,500
4. Tangible fixed assets	
Plant and Machinery	1,90,000
Furniture and Fixtures	20,000
	2,10,000
5. Other current assets	
Prepaid expenses	1,000

In order to redeem its preference shares, the company issued 5,000 equity shares of ₹ 10 each at a Premium of 10% and sold its investment of ₹ 70,800. Preference shares were redeemed at a premium of 10%.

Show the necessary journal entries in the books of the company and prepare the balance sheet of the company immediately after redemption of preference shares.

Solution:

Journal Entries

Particulars		*Dr. (₹)*	*Cr.(₹)*
Bank	Dr.	55,000	
To Equity Share Application and Allotment Account			55,000
(Application money received on 5,000 equity shares of ₹ 10 at a premium of 10%).			
Equity Share Application and Allotment A/c	Dr.	55,000	

Particulars		Dr.	Cr.
To Equity Share Capital A/c			50,000
To Securities Premium Reserves			5,000
(Allotment of 5000 equity shares of ₹ 10 each issued at a premium of 10% as per Board's resolution dated....)			
Surplus A/c	Dr.	50,000	
To Capital Redemption Reserve A/c			50,000
(Transfer of the balance amount of the nominal value preference shares to be redeemed not covered by fresh issue, i.e., ₹ 1,00,000 - 50,000 on redemption to Capital Redemption Reserve A/c)			
Bank	Dr.	70,800	
To Investments A/c			60,000
To Surplus A/c			10,800
(Sale on Investments at a profit and transfer of profit on sale to Profit and Loss A/c)			
8% Redeemable Preference Share Capital A/c	Dr.	1,00,000	
Premium on Redemption of Preference Shares A/c	Dr.	10,000	
To 8% Preference Shareholders A/c			1,10,000
(Amount due to 8% preference shareholders on redemption)			
Securities Premium Reserves	Dr.	10,000	
To Premium on Redemption of Preference Shares A/c			10,000
(Application of securities premium to write off premium on redemption of preference shares)			
8% Preference Shareholders A/c	Dr.	1,10,000	
To Bank			1,10,000
(Amount due to 8% Preference Shareholders on redemption paid)			

Producers Ltd

BALANCE SHEET (After redemption of preference shares)

AS AT 31st March, 2014

I. EQUITY AND LIABILITIES			₹
1. Shareholders' funds			
(a) Share Capital	1		3,00,000
(b) Reserve & Surplus	2		69,800
2. Current Liabilities			
Trade Payable		22,500	
Short term provisions	3	19,500	42,000
TOTAL			**4,11,800**
II. ASSETS			
1. Non-current assets			
(a) Fixed Assets			
I. Tangible fixed assets	4		2,10,000
2. Current Assets			
Inventories		1,30,500	
Trade receivable		49,550	
Cash and cash equivalents		20 750	
Other current assets	5	1,000	2,01,800
TOTAL			**4,11,800**
Notes			
1. Share capital			
Authorized Share Capital			
40,000 equity shares of ₹ 10 each fully paid up			4,00,000
1000, 8% preference shares of ₹ 100 each			1,00,000
			5,00,000
Issued, Subscribed Called Up And Paid-Up Share Capital			
30,000 equity shares of ₹ 10 each fully paid up			3,00,000
2. Reserve and Surplus			
Securities Premium Reserves		4,000	
Surplus Account		15,800	
Capital redemption reserve		50,000	69,800

3. Short term provisions		
Provisions for Taxation		19,500
4. Tangible fixed assets		
Plant and Machinery		1,90,000
Furniture and Fixtures		20,000
		2,10,000
5. Other current assets		
Prepaid expenses		1,000

Working Notes:

(i) *Dr.* **Bank A/c** *Cr.*

Particulars	₹	*Particulars*	₹
To Balance b/d	4,950	By 8% Preference Shareholders A/c	1,10,000
To Equity Share Application and Allotment A/c	55,000	By Balance c/d	20,750
To Investment A/c	60,000		
To Surplus A/c	10,800		
	1,30,750		1,30,750

(ii) Securities Premium A/c

Particulars	₹	*Particulars*	₹
To Premium on Redemption of Preference Shares Account	10,000	By Balance b/d	9,000
		By Equity Share Application	5,000
To Balance c/d	4,000	and Allotment A/c	
	14,000		14,000

(iii) **Profit and Loss A/c**

Particulars	₹	*Particulars*	₹
To Capital Redemption Reserve A/c	50,000	By Balance b/d	55,000
To Balance c/d	15,800	By Bank (Profit on sale of investments)	10,800
	65,800		65,800

Note: Equity Share Capital issued at ₹ 50,000 and Capital Redemption Reserve Account ₹ 50,000 jointly replace 8% Redeemable Preference Share Capital ₹ 1,00,000. Hence the capital structure of the company remains unchanged.

Illustration 5

Kalpataru Construction Ltd

BALANCE SHEET

AS AT 31st March, 2014

I. EQUITY AND LIABILITIES		₹
1. Sources of Funds		
(a) Share Capital	1	17,22,500
(b) Reserve & Surplus	2	6,50,000
2. Current Liabilities		
Other current liability Calls in advance (final call on equity shares)	3	2,500
TOTAL		**23,75,000**
II. ASSETS		
(1) Non-current assets		
(a) Fixed Assets		
Fixed Assets		12,25,000
(b) Non Current Investment		2,00,000
(2) Current Assets		
Cash and cash equivalents		9,50,000
TOTAL		**23,75,000**

Notes

1. Share capital

Authorized Share Capital		
Issued, Subscribed Called Up And Paid-Up Share Capital		
1,00,000 equity shares of ₹ 10 each;		
7.50 per share called-up	7,50,000	
Less: Calls unpaid	7,500	7,42,500
20,000 12% preference shares of ₹ 50 each fully called-up	10,00,000	
Less: Calls unpaid (₹ 10 per share)	20,000	9,80,000
		17,22,500

2. Reserve & Surplus

Securities premium	50,000
General Reserve	6,00,000
	6,50,000

3. Other current liability

Calls in advance (final call on equity shares)	2,500

On 1st April, 2014 the Board of directors decide that:

(a) The fully paid preference shares are to be redeemed at a premium of 5% in May, 2014 and for that purpose 50,000 equity shares of ₹ 10 each are to be issued at par in the month of April, 2014.

(b) The 1,000 equity shares owned by A an existing shareholder, who has failed to pay the allotment money and the 1st call money @ ₹ 2.50 each share are to be forfeited in the month of June, 2014.

(c) The final call of ₹ 2.50 per share is to be made in the month of July, 2014.

All the above are duly complied with according to the time schedule. The amount due on the issue of fresh equity shares and on final call are also duly received except from B who had failed to pay the 1st call money for his 1,000 shares holding, has again failed to pay the final call also. These shares of B have been forfeited, in the month of August, 2014. On the total shares forfeited, 1,500 shares are sold to X in September, 2014 credited as fully paid for ₹ 9 per share, the whole of A's shares being included.

Show the necessary journal entries and prepare the balance sheet of the company as on 30th September, 2014.

Solution:

Journal Entries in the books of Kalpataru Construction Ltd.

Date	*Particulars*		*Dr. (₹)*	*Cr.(₹)*
2014				
April 1	Bank	Dr.	5,00,000	
	To Equity Share Capital A/c			5,00,000
	(Issue of equity shares)			
May	Securities Premium A/c	Dr.	45,000	
	To Premium on Redemption of			45,000
	Preference Shares			
	(Premium on redemption shares transferred)			
May	General Reserve A/c	Dr.	4,00,000	
	To Capital Redemption Reserve A/c			4,00,000
	(Transfer of the required amount from general reserve account)			
May	Preference Share Capital A/c	Dr.	9,00,000	
	Premium on Redemption of	Dr.	45,000	
	Preference Share A/c			
	To Preference Shareholders A/c			9,45,000
	(The amount payable)			
May	Preference Shareholders A/c	Dr.	9,45,000	
	To Bank			9,45,000
	(Amount paid)			

Date	Particulars		Dr. ₹	Cr. ₹
June	Equity Share Capital A/c	Dr.	7,500	
	To Shares Forfeited A/c			2,500
	To Calls in Arrear A/c			5,000
	(A's Shares forfeited)			
July	Equity Share Final Calls A/c	Dr.	2,47,500	
	To Equity Share Capital A/c			2,47,500
	(Amount due on final call i.e. 99,000 shares x 2.50)			
July	Bank	Dr.	2,42,500	
	Calls in Arrear A/c	Dr.	2,500	
	Calls in Advance A/c	Dr.	2,500	
	To Equity Share Final Call A/c			2,47,500
	(Amount received)			
Aug.	Equity Share Capital A/c	Dr.	10,000	
	To Shares Forfeited A/c			5,000
	To Calls in Arrear A/c			5,000
	(B's shares forfeited)			
Sept.	Bank	Dr.	13,500	
	Share Forfeited A/c	Dr.	1,500	
	To Equity Share Capital A/c			15,000
	(1,500 shares re-issued @ 9)			
Sept.	Share Forfeited A/c	Dr.	3,500	
	To Capital Reserve A/c			3,500
	(Profit on reissue of forfeited shares)			

Dr. **Shares Forfeited Account** *Cr.*

	Particulars	₹		*Particulars*	₹
To	Equity Share Capital A/c	1,500	By	Equity Share Capital A/c	2,500
To	Capital Reserve A/c	3,500		(A's shares)	
	(Balancing figure)		By	Equity Share Capital A/c	5,000
To	Balance c/d (500 Shares @ ₹ 5)	2,500		(B's shares)	
		7,500			7,500

Bank Account

Particulars		₹	Particulars		₹
To	Balance b/d	9,50,000	By	Pref. Shareholders	9,45,000
To	Equity Share Capital A/c	5,00,000	By	Balance c/d	7,61,000
To	Equity Share Final Call A/c	2,42,500			
To	Equity Share Capital A/c	13,500			
		17,06,000			17,06,000

Kalpataru Construction Ltd

BALANCE SHEET

AS ON 30 September, 2014

I. EQUITY AND LIABILITIES		₹
1. Shareholders' Fund		
(a) Share Capital	1	15,77,500
(b) Reserve & Surplus	2	6,08,500
TOTAL		**21,86,000**
II. ASSETS		
(1) Non-current assets		
(a) Fixed Assets		
Fixed Assets		12,25,000
(b) Non Current Investment		2,00,000
(2) Current Assets		
Cash and cash equivalents		7,61,000
TOTAL		**21,86,000**
Notes		

1. Share capital		
Authorized Share Capital		…………
Issued, Subscribed Called Up And Paid-Up Share Capital		
1, 49,500 Equity Shares @ ₹ 10		14,95,000
2,000 Preference shares of ₹ 50 each, fully called up	1,00,000	
Less Calls in arrears	20,000	80,000
Equity Shares Forfeited Account		2,500
		15,77,500
2. Reserve & Surplus		
Capital Reserve	3,500	
Capital Redemption Reserve	4,00,000	
Securities Premium Account	5,000	
General Reserve	2,00,000	6,08,500

PART III

UNDERWRITING OF SHARES

Underwriters and Brokers

The persons or institutions underwriting a public issue of shares or debentures are called 'Underwriters'. The underwriters may be individuals, partnership firms or joint stock companies. But, an issue of shares or debentures is hardly underwritten by a single individual as it involves more risk and attaches greater responsibility. Generally, an issue of shares or debentures of a company is underwritten by two or more firms jointly. Some specialised financial institutions set up by the Government in the public sector are also playing an active role these days in underwriting shares or debentures of a company.

Brokers merely promise or try to procure subscriptions to the shares or debentures issued; they do not take any responsibility of subscribing to the shares or debentures of the company. They simply procure subscriptions for shares or debentures from the public on behalf of the company and in exchange of their service rendered to the company, they get remuneration called brokerage.

Types of Underwriting

An underwriting agreement may be of any one of the following types:

Complete Underwriting

If the whole of the issue of shares or debentures of a company is underwritten, it is said to be complete underwriting. In such a case, the whole of the issue of shares or debentures may be underwritten by –

(a) one firm or institution, agreeing to take the entire risk;

(b) a number of firms or institutions, each agreeing to take risk only to a limited extent.

Partial Underwriting

If only a part of the issue of shares or debentures of a company is underwritten, it is said to be partial underwriting. The part of the issue of shares or debentures may be underwritten by -

(a) One person or institution;

(b) A number of firms or institutions each agreeing to take risk only to a limited extent.

In case of partial underwriting, the company is treated as "Underwriter" for the remaining part of the issue.

Firm Underwriting

It refers to a definite commitment by the underwriter or underwriters to take up a specified number of shares or debentures of a company irrespective of the number of shares or debentures subscribed for by the public. In such a case, the underwriters are committed to take up the agreed number of shares or debentures in addition to unsubscribed shares or debentures, if any. Even if the issue is over-subscribed, the underwriters are liable to take up the agreed number of shares of debentures.

Underwriting Commission

The consideration payable to the underwriters for underwriting the issue of shares or debentures of a company is called underwriting commission. Such a commission is paid at a specified rate on the issue price of the whole of the shares or debentures underwritten whether or not the underwriters are called upon to take up any shares or debentures. Thus, the underwriters are paid for the risk they bear in the placing of shares before the public. Underwriting commission may be in addition to brokerage.

Payment of Underwriting Commission

Section 40 (6) of the Companies Act 2013, provides that a company may pay commission to any person in connection with the subscription or procurement of subscription to its securities, whether absolute or conditional, subject to the following conditions which are prescribed under Companies (Prospectus and Allotment of Securities) Rules, 2014:

(a) the payment of such commission shall be authorized in the company's articles of association;

(b) the commission may be paid out of proceeds of the issue or the profit of the company or both;

(c) the rate of commission paid or agreed to be paid shall not exceed, in case of shares, five percent (5%) of the price at which the shares are issued or a rate authorised by the articles, whichever is less, and in case of debentures, shall not exceed two and a half per cent (2.5 %) of the price at which the debentures are issued, or as specified in the company's articles, whichever is less;

(d) the prospectus of the company shall disclose -

  – the name of the underwriters;

  – the rate and amount of the commission payable to the underwriter; and

  – the number of securities which is to be underwritten or subscribed by the underwriter absolutely or conditionally.

(e) there shall not be paid commission to any underwriter on securities which are not offered to the public for subscription;

(f) a copy of the contract for the payment of commission is delivered to the Registrar at the time of delivery of the prospectus for registration.

Thus, the Underwriting commission is limited to 5% of issue price in case of shares and 2.5% in case of debentures. The rates of commission given above are maximum rates. The company is free to negotiate lower rates with underwriters.

Marked and Unmarked Applications

When the issue of shares or debentures of a company is underwritten by two or more persons, it is usual that the applications for shares or debentures sent through the underwriters should bear a stamp of the respective underwriters. Otherwise, it would be very difficult for the company to determine how many applications have been received through a particular underwriter and, unless this is determined properly, the company would face a problem in determining the liability of the individual underwriters. Thus, the applications bearing the stamp of the respective underwriters are called "Marked Applications" while the applications received directly by the company which do not bear any stamp of the underwriters are called "Unmarked Applications".

If the entire issue of shares or debentures is underwritten by only one underwriter, the marking of applications is immaterial since he is to get credit of all the applications whether sent through him or received directly in determining his liability. But, the issue of shares or debentures is, generally, underwritten by more than one underwriter as the risk is distributed among the underwriters in an agreed ratio. In such a case, it is essential that the applications sent through the underwriters should be marked properly so as to determine their respective liability correctly.

Determining the Liability of Underwriters

The liability of the underwriter or underwriters would be determined in the following ways:

Complete Underwriting

(a) ***If the whole of the issue of shares or debentures is underwritten only by one underwriter:*** In such

a case, the underwriter will be liable to take up all the shares or debentures that have not been subscribed for by the public. For determining his liability, it is not material to know how many applications are sent through him and how many applications are received directly by the company. Thus, the liability of the underwriter in such a case will be as follows:

Liability = Shares or debentures offered – Total applications received.

It is to be noted here that if the shares or debentures are oversubscribed or fully subscribed by the public, the underwriter is free from his liability and cannot be called upon to take up any shares or debentures of the company. But he will be entitled to get his commission on the total issue price of the shares or debentures. He must of course take up the shares or debentures as per "Firm Underwriting". Automatically, this will reduce his liability in case there is under subscription.

(b) **If the whole of the issue of shares or debentures is underwritten by a number of underwriters in an agreed ratio:** In such a case, the liability of the respective underwriters can be determined as follows:

The gross liability of each underwriter according to the agreed ratio should be reduced first by the marked applications and then credit may be given in respect of unmarked applications sent directly to the company by way of deduction from the balance left in the ratio of their gross liability. Thus, the liability of each underwriter in such a case will be as follows:

Gross liability according to the agreed ratio	....
Less: Marked applications	....
Balance left	....
Less: Unmarked applications in the ratio of gross liability	....
Net liability	....

Sometimes credit to unmarked application is given in the ratio of gross liability as reduced by the marked applications. The individual liability calculated in this way will differ from the liability calculated as per the earlier procedure.

N.B.: In case some figure is in minus then transfer that figure to other underwriters' account in the ratio of gross liability inter se. This gives the liability of underwriters on account of short fall in the public subscription.

Partial Underwriting

(a) If a part of the issue of shares or debentures is underwritten only by one underwriter: In such a case, only a part of the whole issue, say 60% or 70% is underwritten only by one underwriter and so far as the balance 40% or 30% of the issue is concerned, the company itself is said to have underwritten the same. As such, the unmarked applications are treated as marked as far as the company is concerned.

In such a case, the gross liability of the underwriter will be that part of the issue of shares or debentures which is underwritten, say 60% or 70% and the net liability will be determined by deducting the marked applications (the applications sent through him) from the gross liability. Thus, the net liability will be determined as follows:

Net liability = Gross liability (say 60% or 70% of the issue) – Marked applications.

It is to be noted here that if the marked applications exceed or equal the number of shares or debentures underwritten the underwriter is free from his liability and cannot be called upon to take up any shares or debentures of the company. Similarly, if all the shares or debentures are subscribed the underwriter is free from his liability in spite of the fact the marked applications are less than the number of shares or debentures underwritten.

(b) If the part of the issue of shares or debentures is underwritten by a number of underwriters: In such a case only a part of the whole issue, say 60% or 70% or 80% is underwritten by a number of underwriters and so far as the balance 40% or 30% or 20% is concerned, the company itself is said to have underwritten the same. As such, the unmarked applications are treated as marked so far as the company is concerned.

In such a case, the method of determining the net liability of the respective underwriters is similar to the method discussed (a) above.

Firm Underwriting

In the case of 'firm underwriting', the underwriters take up the agreed number of shares or debentures 'firm underwritten' in addition to unsubscribed shares or debentures, if any. In such an instance, an underwriter is not allowed to set off his firm underwriting against his liability otherwise determined, that he will have to subscribe both for shares/debentures 'underwritten firm' and for shares which he has to take under the underwriting contract, ignoring firm underwriting.

While computing the individual liability of the underwriters, the 'firm underwriting' can be dealt with in any of the following manner in the absence of any specific instructions:

(a) The 'firm underwriting' may be adjusted against the individual liability of each underwriter separately or may be treated at par with marked applications.

When firm underwriting is treated at par with marked applications

In such a case, the statement of liability of underwriters will be as under:

Gross Liability (agreed ratio-total shares underwritten)	....
Less: Marked applications including firm underwriting	....
Balance left	
Less: Unmarked application (ratio of gross liability)	....
Net liability	
Add: Firm underwriting	....
Total Liability	....

(b) The benefit of 'firm underwriting' may be shared by all underwriters or firm underwriting may be treated at par with unmarked applications. In such case, the shares/debentures underwritten firm will be included in the unmarked forms. In such case, the state of liability of underwriters will appear as shown above except that shares/debentures underwritten firm by each underwriter will not be specifically adjusted against his individual liability but will be included in the total unmarked forms to be distributed amongst all underwriters in the ratio of their gross liability.

N.B.: If the question is not specific regarding the treatment of 'firm underwriting' students may follow any one of the treatments discussed above and a foot note to this effect may be given.

Accounting Treatment relating to Underwriting of Shares or Debentures

(a) When the shares or debentures are allotted to the underwriters in respect of their liability:

Underwriters A/c	Dr.	with the value of the shares or debentures taken
To Share Capital A/c		up by the underwriters
To Debentures A/c		

(b) When commission becomes payable to the underwriters:

Underwriters Commission A/c	Dr.	with the amount of commission due on the total
To Underwriters A/c		issue price of the shares under-written

(c) When the net amount due from the underwriters on the shares or debentures taken up by them is received:

Bank	Dr.	with the net amount due
To Underwriters A/c		

Note: Underwriting commission is not generally paid in cash. Instead the same is adjusted against the money due on shares or debentures taken up by the underwriters and only the net amount (i.e., total amount due on shares or debentures taken up by the underwriters minus the underwriting commission) is received from the underwriters.

Illustration 1

Sunflow Ltd. issued 50,000 equity shares. The whole of the issue was underwritten as follows:

Red 40%; White 30%; Blue 30%

Applications for 40,000 shares were received in all, out of which applications for 10,000 shares had the stamp of Red; those for 5,000 shares that of White and those for 10,000 shares that of Blue. The remaining applications for 15,000 shares did not bear any stamp.

Determine the liability of the underwriters.

Solution:

Net Liability of Underwriters

	Red (40%) Shares	*White (30%) Shares*	*Blue (30%) Shares*
Gross liability in the agreed ratio of 40 : 30 : 30	20,000	15,000	15,000
Less: Marked applications	10,000	5,000	10,000
Balance left	10,000	10,000	5,000
Less: Unmarked applications in the ratio of gross liability, i.e., 40 : 30 : 30	6,000	4,500	4,500
Net liability	4,000	5,500	500

Illustration 2

Monlit Ltd., issued 50,000 equity, shares of which only 60% was underwritten by Green. Applications for 45,000 shares were received in all out of which application for 26,000 were marked.

Determine the liability of Green.

Solution:

Gross liability of Green being 60% of 50,000 shares,

i.e., 60/100 x 50,000 = 30,000 shares

Less: Marked applications	= 26,000 shares
Net liability of Green	= 4,000 shares

Notes: (1) If the marked applications were for 30,000 shares or more, Green would have had no liability at all.

(2) If the applications received by the company were for all the 50,000 shares, Green would have no liability at all even though the marked applications were for 26,000 shares.

(3) If the applications received by the company were for 48,000 shares, Green's liability would have been restricted to (50,000 - 48,000) = 2,000 shares, even though the marked applications were for 26,000 shares.

Sometimes, it may so happen that the information as to the marked applications and unmarked applications may not be given in the problem. In such a case, it has to be assumed that out of the total applications received by the company, the number of applications proportionate to that part of the issue underwritten have been received through the underwriters.

Illustration 3

Goods Earths Ltd., issued 30,000 6% Debentures of ₹ 100 each. 60% of the issue was underwritten by Black. Applications for 28,000 debentures were by the company.

Debentures the liability of Black.

Solution:

Gross liability of Black being 60% of 30,000	
debentures i.e., 60/100 x 30,000	= 18,000 debentures
Less: Marked applications assumed 60% of	
28,000 i.e., 60/100 x 28,000	= 16,800 debentures
Net liability of Black	= 1,200 debentures

Alternatively, Black's liability can be determined in the following way:

Number of debentures not subscribed for by the public	= (30,000 – 28,000)
	= 2,000 debentures

Black's liability	= 60% of 2,000 debentures
	= 60/100 x 2,000 = 1,200 debentures

Illustration 4

Satellite Ltd., issued 12% 10,000 Preference Shares of ₹ 10 each. The issue was underwritten as follows:

Apple 30%, Mango 30%, Orange 20%.

Application for 8,000 shares were received by the company in all. Determine the liability of the respective underwriters.

Solution:

	Apple (30%) *Shares*	Mango (30%) *Shares*	Orange (20%) *Shares*
Gross liability in the agreed ratio			

or 30 : 30 : 20	3,000	3,000	2,000
Less: Marked application, i.e., 8,000 application in the ratio of 3/10 : 3/20 : 2/10	2,400	2,400	1,600
Net liability	600	600	400

Alternatively, the liability of the respective underwriters can also be determined in the following manner:

Shares issued	10,000
Less: Applications received	8,000
Unsubscribed shares	2,000
Apple's liability	= 30% of 2,000 = 600 shares
Mango's liability	= 30% of 2,000 = 600 shares
Orange's liability	= 20% of 2,000 = 400 shares

Total liability of Apple, Mango and Orange

= 600 + 600 + 400 = 1,600 shares.

which represent 80% of the total issue underwritten. The balance (2,000 - 1,600) = 400 shares representing 20% of the issue not underwritten will remain as unissued.

Illustration 5

Emess Ltd. issued 40,000 shares which were underwritten as:

P: 24,000 shares Q: 10,000 shares and R: 6,000 shares. The underwriters made applications for firm underwriting as under:

P: 3,200 shares; Q: 1,200 shares; and R: 4,000 shares. The total subscriptions excluding firm underwriting (including marked applications) were 20,000 shares.

The marked applications were - P: 4,000 shares; Q: 8,000 shares; and R: 2,000 shares.

Prepare a statement showing the net liability of underwriters.

Solution:

Statement of Underwriters' Liability

(Firm underwriting shares are treated as unmarked applications)

(Shares)

	P	*Q*	*R*	*Total*
Gross Liability	24,000	10,000	6,000	40,000
Less: Marked applications	4,000	8,000	2,000	14,000
Balance	20,000	2,000	4,000	26,000
Less: Unmarked applications in the ratio of gross liability (12:5:3)	8,640	3,600	2,160	14,400
Balance	11,360	(–1,600)	1,840	11,600

Credit of Q's over subscription to				
P & R in the ratio of 12:3	(1,280)	+1,600	(320)	–
Net Liability	10,080	—	1,520	11,600
Add: Firm underwriting	3,200	1,200	4,000	8,400
Total Liability	13,280	1,200	5,520	20,000

Alternate Answer

Statement of Underwriters' Liability

(Firm underwriting shares are treated as marked applications)

(Shares)

	P	*Q*	*R*	*Total*
Gross Liability	24,000	10,000	6,000	40,000
Less: Unmarked applications 6,000 in ratio of gross liability (12:5:3)	3,600	1,500	900	6,000
Balance	20,400	8,500	5,100	34,000
Less: Marked application plus shares underwritten firm	7,200	9,200	6,000	22,400
Balance	13,200	- 700	- 900	11,600
Credit for Q's and R's oversubscription	- 1,600	+700	+900	–
Net Liability	11,600	–	–	11,600
Add: Firm Underwriting	3,200	1,200	4,000	8,400
Total Liability	14,800	1,200	4,000	20,000

Illustration 6

Sam Limited invited applications from public for 1,00,000 equity shares of ₹10 each at a premium of ₹ 5 per share. The entire issue was underwritten by the underwriters A, B, C and D to the extent of 30%, 30%, 20% and 20% respectively with the provision of firm underwriting of 3,000, 2,000, 1,000 and 1,000 shares respectively. The underwriters were entitled to the maximum commission permitted by law.

The company received applications for 70,000 shares from public out of which applications for 19,000, 10,000, 21,000 and 8,000 shares were marked in favour of A, B, C and D respectively.

Calculate the liability of each one of the underwriters. Also ascertain the underwriting commission @ 2.5% payable to the different underwriters.

Solution:

Liability of Underwriters (No. of shares)

	Total	A	B	C	D
Gross Liability	1,00,000	30,000	30,000	20,000	20,000
Less: Unmarked					

Applications	12,000	3,600	3,600	2,400	2,400
Balance	88,000	26,400	26,400	17,600	17,600
Less: Marked Applications	58,000	19,000	10,000	21,000	8,000
Balance	30,000	7,400	16,400	- 3,400	9,600
Less: Firm Underwriting	7,000	3,000	2,000	1,000	1,000
Balance	23,000	4,400	14,400	- 4,400	8,600
Adjustment	–	- 1,650	- 1,650	+4,400	- 1,100
Net Liability	23,000	2,750	12,750	-	7,500
Total Liability including firm underwriting	30,000	5,750	14,750	1,000	8,500

Note: The above answer is arrived at by treating 'firm underwriting shares' on par with marked applications. Alternatively, the 'firm underwriting shares' may be treated on par with un-marked applications. Then, the answer will be as follows:

	Shares	
Applications received including firm underwriting	77,000	(70,000 + 7,000)
Less: Marked Applications	58,000	
Un-marked Applications	19,000	

Liabilities of Underwriters (No. of shares)

	Total	A	B	C	D
Gross Liability	1,00,000	30,000	30,000	20,000	20,000
Less: Unmarked Applications	19,000	5,700	5,700	3,800	3,800
Balance	81,000	24,300	24,300	16,200	16,200
Less: Marked Applications	58,000	19,000	10,000	21,000	8,000
Balance	23,000	5,300	14,300	- 4,800	8,200
Adjustment		- 1,800	- 1,800	+4,800	1,200
Net Liability	23,000	3,500	12,500	–	7,000
Add: Firm Underwriting	7,000	3,000	2,000	1,000	1,000
Total Liability	30,000	6,500	14,500	1,000	8,000

Underwriting Commission

The underwriting commission is payable at the rate of 2.5% of the issue price of shares.

Thus, commission payable to $A = 30,000 \times 15 \times \frac{2.5}{100} = ₹\ 11,250$

B = ₹ 11,250

$$C = 20,000 \times 15 \times \frac{2.5}{100} = ₹\ 7,500$$

D = ₹ 7,500

Illustration 7

Wye Co. Ltd., invited the public to subscribe to the following:

(i) 10,000 equity shares of ₹ 100 each at a premium of 5% and

(ii) 2,50,000 in 14% Debentures of ₹ 100 @ 96.

60% of the shares and the whole of the issue of debentures were underwritten by M/s Sure and Fast for the commission allowable by the Government. The applications from the public totalled 6,000 shares and 2,000 debentures. The underwriters fulfilled their obligations. Show the journal entries that would appear in the books of the company. Underwritting commission is paid at 2.5%.

Solution:

Journal Entries

Particulars		*Dr. (₹)*	*Cr.(₹)*
Bank	Dr.	8,22,000	
To Equity Share Application and Allotment A/c			6,30,000
To 14% Debenture Application and Allotment A/c			1,92,000
(Receipt of application money on 6,000 Equity Shares @ ₹ 105 each including premium of ₹ 5 each and on 2,000 debentures @ ₹ 96 each at a discount of ₹ 4 each)			
Equity Share Application and Allotment A/c	Dr.	6,30,000	
To Equity Share Capital A/c			6,00,000
To Securities Premium A/c			30,000
(Allotment of 6,000 equity shares of ₹ 100 each at a premium of ₹ 5 each to public as per Board's resolution dated..........)			
14% Debenture Application and Allotment A/c	Dr.	1,92,000	
Discount on Issue of Debentures A/c	Dr.	8,000	
To 14% Debenture A/c			2,00,000
(Allotment of 2,000 14% Debentures of ₹100 each at a discount of ₹ 4 each to public as per Board's resolution dated............)			
M/s Sure and Fast	Dr.	2,52,000	
To Equity Share Capital A/c			2,40,000
To Securities Premium A/c			12,000
(Allotment of 2,400 Equity Shares being 60% of 4,000 shares remaining unsubscribed to M/s Sure and Fast being their			

liability as per Board's resolution dated.,,,,,,,,,,,,,,,,,,...............)			
M/s Sure and Fast	Dr.	48,000	
Discount on Issue of Debentures A/c	Dr.	2,000	
To 14% Debentures A/c			50,000
(Allotment of 500 debentures allotted to M/s Sure and Fast being their liability as per Board's resolution dated.....)			
Underwriting Commission A/c	Dr.	19,830	
To M/s Sure and Fast			19,830
(Underwriting Commission due on issue price of Shares @ 2.5% on 6,30,000 and on debentures @ 1.5% and 2.5% on 1,92,000 and 48,000 respectively)			
Bank	Dr.	2,80,170	
To M/s Sure and Fast			2,80,170
[Receipt of the net amount due from M/s Sure and Fast, i.e., (2,52,000 + 48,000 – 19,830)]			

Working Notes:

(i) Liability of M/s Sure and Fast

		Shares	Debentures
		(60%)	(100%)
Gross liability		6,000	2,500
Less: Marked applications:			
Shares	Debentures		
60% of 6,000	100% of 2,000	3,600	2,000
Net liability		2,400	500

(ii) Underwriting Commission

Underwriting Commission has been calculated as per the rates applicable in force :

Equity Shares		₹
2.5% on issue price of 6,000 shares underwritten = 6,30,000 x 2.5%		15,750
Debentures		
On amounts subscribed by the public:		
2.5% on issue price of 2,000 debentures	₹	
= 2,000 x 96 x 2.5% =	4,800	
On amounts devolved on underwriters:		
2.5% on issue price of 500 debentures		
= 500 x 96 x 2.5% =	1,200	6,000
		21,750

LESSON ROUND-UP

- Accounting records should be prepared to enable the company to ascertain and know : the liabilities and assets of the company, the cost of goods sold or purchased and value of stock, the sales made and profit earned, the expenditure incurred and the losses incurred during the year.
- There are two basic types of share capital which can be issued by a company under the Companies Act, 2013 i.e. (a) preference shares and (b) equity shares.
- Preference shares are those which carry preferential rights as to the payment of dividend at a fixed rate; and the return of capital on winding up of the company.
- An equity share is one which is not a preference share. Equity shares are normally risk bearing shares.
- Balance sheet of a company can be categorized as: Nominal or Authorised Capital; Issued Capital; Subscribed Capital; Called up Capital and Paid-up Capital.
- Shares of a company may be issued at par; at premium and at discount.
- When the number of shares applied for exceeds the number of shares issued, the shares are said to be over-subscribed, in which case some applications may be rejected; of some applications are accepted in full; and allotment is made to the remaining applicants on pro-rata basis.
- When shares are issued at a price higher than the face value, they are said to be issued at a premium.
- When shares are issued at a price lower than the face value, they are said to be issued at discount.
- A company may allot fully paid shares to promoters or any other party for the services rendered by them without payment which is known as issue of shares for consideration other than cash.
- Forfeiture of shares may be said to be the compulsory termination of membership by way of penalty for non-payment of allotment and/or any call money.
- The forfeited shares may be re-issued at par, at a premium or even at a discount. If forfeited shares are re-issued at a discount, the amount of discount can, in no case, exceed the amount credited to Shares Forfeited Account.
- As per Section 68, 69, 70 of the Companies Act, 2013 states that a company may purchase its own shares or other specified securities out of its free reserves, and the proceeds of any shares or other specified securities.
- According to Section 55 of the Companies Act, 2013 a company limited by shares may, if authorised by its articles, issue preference shares, which are, or at the option of the company are liable to be redeemed.
- A company is under legal obligation to offer first the further issue of shares to its existing equity shareholders but the holders are not liable to necessarily accept the offer so made. This right is called rights issue.
- Underwriting is an undertaking or guarantee given by the underwriters to the company that the shares or debentures offered to the public will be subscribed for in full.
- An underwriting agreement may be: Complete Underwriting, Partial Underwriting and Firm Underwriting.
- Applications bearing the stamp of the respective underwriters are called marked applications and the applications received directly by the company which do not bear any stamp of the underwriters are known as unmarked applications.

SELF-TEST QUESTIONS

(These are meant for re-capitulation only. Answers to these questions are not to be submitted for evaluation)

1. A company issued 10,000 shares of ₹ 10 each. Total applications were for 12,000 shares; allotment was made pro-rata. Application money was ₹ 2 per share and allotment money ₹ 3 per share. Rao failed to pay the allotment money on his 300 shares. How much is due from Rao for allotment?

[**Ans.:** ₹780]

2. A company issues 10,000 shares of ₹ 10 each @ a premium of ₹ 2 per share, payable as: on application 4 (including premium), on allotment ₹ 3 and the balance on calls. 8,000 shares were applied for. Which of the following entries is correct for application money:

(a)	Bank	Dr.	32,000	
	To Share Application A/c			16,000
	To Securities Premium A/c			16,000
(b)	Bank	Dr.	32,000	
	To Share Application A/c			32,000

[**Ans.:** (b)]

3. A company offers two shares for every five held to its shareholders. The issue price is ₹ 14 and the rights price in the market is ₹ 19. What is the market value of a right? *[**Ans.:** ₹1.43]*

4. The authorised capital of a company is 1,00,000 shares of ₹ 10 each. On April 10, 2013, 50,000 shares are issued for subscription at a premium of ₹ 2 per share. The share money is payable as follows : ₹ 5 (including the premium of ₹ 2) with application, ₹ 3 on allotment; ₹ 2 on first call and ₹ 2 on second call. The subscription list closes on May 11, 2013 and directors proceed to allotment on May 18, 2013. The shares are fully subscribed and the application money (including the premium) is received in full. The allotment money is received by June 30, 2013, except as regards 500 shares. It is expected that the allotment money on these 500 shares will not be received. The first call and second call money is received by September 30, 2013 and December 31, 2013 respectively, barring the second call money on 200 shares which is not received and which is not likely to be received.

   Show the Cash Book and the structure of the share capital in the Balance Sheet.

5. X Ltd. forfeited 100 shares of ₹ 10 each for non-payment of the final call of ₹ 2; the shares were re-issued @ ₹ 9 per share. How much was credited to shares forfeited account and what amount was transferred to capital reserve? [**Ans.:** ₹800; ₹700]

6. Y Ltd. forfeited 100 shares of ₹ 10 each for non-payment of the fist call of ₹ 2 and final call of ₹ 3. Of these 60 shares were re-issued @ ₹ 8 per share. Arising from this, which new accounts remain and what balances do they show?

[**Ans.:** Shares Forfeited A/c: ₹ 200 (Cr.); and
Capital Reserve A/c: ₹ 180 (Cr.)]

7. Z Ltd. forfeited 150 shares of ₹ 10, issued at a premium of ₹ 2, for non-payment of the final call of ₹ 3. Of these 100 shares were re-issued @ ₹ 11 per share. How much is transferred to capital reserve?

[**Ans.:** ₹ 700]

8. S Ltd. had issued equity shares of ₹ 10 each at a discount of 6%. 200 of these shares had been forfeited for non-payment of the first and final call of ₹ 2 each; 150 of these shares were later re-issued

@ ₹ 9 per share. Indicate the balance in the Share Forfeited Account and the Capital Reserve Account, resulting from the above.

[**Ans.:** Shares Forfeited A/c: ₹ 370 (Cr.);

Capital Reserve: ₹ 1,050 (Cr.)]

9. E Ltd. had allotted 10,000 shares to applicants for 14,000 shares on a *pro rata* basis. The amount payable was ₹ 2 on application, ₹ 5 on allotment (including premium of ₹ 2 each), ₹ 3 on first call and ₹ 2 on final call. Vazir failed to pay the first call and final call on his 300 shares. All the shares were forfeited and out of these 200 shares were re-issued @ ₹ 9 per share. What is the amount credited to capital reserve? [**Ans.:** ₹ 1,200]

10. (a) Redemption of 10,000 preference shares of ₹ 100 each was carried out by utilisation of reserves and by issue of 4,000 equity shares of ₹ 100 each at ₹ 125. How much should be credited to capital redemption reserve account? *[**Ans.:** ₹6,00,000]*

    (b) In the above case, the redemption was carried out of reserves and out of the issue of 4,000 shares of 100 each @ ₹ 95. What is the amount of capital redemption reserve account that is required?

    [**Ans.:** ₹ 6,20,000]

11. A company having free reserves of ₹ 30,000 wants to redeem rupees one lakh preference shares. Calculate the face value of fresh issue of shares of ₹ 10 each to be made at a premium of 10%. *[**Ans.:** ₹ 70,000]*

12. Bhalla and Co. Ltd. has an authorised equity capital of ₹ 20 lakhs divided into shares of ₹ 100 each. The paid-up capital was ₹ 12,50,000. Besides this, the company had 9% Preference Shares of ₹ 10 each for ₹ 2,50,000. Balance on other accounts were - Securities Premium ₹ 18,000; Profit and Loss Account ₹ 72,000 and General Reserve ₹ 3,40,000. Included in Sundry Assets were investments of the face value of ₹ 30,000 carried in the books at a cost of ₹ 34,000.

    The company decided to redeem the Preference Shares at 10% premium, partly by the issue of equity shares of the face value of ₹ 1,20,000 at a premium of 10%. Investments were sold at 105% of their face value. All preference shareholders were paid off except 3 holding 250 shares.

    Give the necessary journal entries bearing in mind that the Directors wanted a minimum reduction in free reserves, while effecting the above transactions. Working should form part of your answer.

    [**Ans.:** Amount paid to preference shareholders: ₹ 2,72,250]

13. The issue of 1,00,000 shares of ₹ 10 each at ₹ 11 made by X Ltd. was underwritten by M/s A and B. Subscriptions totalled 1,25,000 shares. What is the liability of the underwriters and what is the maximum commission that they can get under the law? *[**Ans.:** Nil,₹ 27,500].*

14. M/s X and Y entered into an underwriting agreement with Y Ltd. for 60% of the issue of 15% 50,00,000 Debentures with a firm underwriting of 5,00,000. Marked applications were for 35,00,000 debentures. What is the liability of the underwriter? *[**Ans.:** ₹5,00,000;].*

13. 70% of an issue of 10,00,000 shares of ₹ 10 each is underwritten by M/s K and Y. Applications totalled 8,00,000 shares. Is there a liability of the underwriters? *[**Ans.:** Yes, 1,40,000 shares].*

14. 80% of an issue of 1,00,000 shares of ₹ 100 each, issued at a premium of 20% was underwritten by M/s G and G along with a firm underwriting of 10,000 shares. The total number of shares applied for was 90,000. How many shares must G and G take ? *[**Ans.:** ₹18,000].*

15. The Underwriters Ltd. agreed to underwrite the new issue of 50,000 equity shares of ₹ 100 each of A Ltd. The agreed commission was 5% payable as 40% in cash and rest in fully paid-up equity shares. The public subscribed for 30,000 shares and the rest had to be taken by the underwriters. These shares were subsequently quoted in the market at 10% discount. Pass the necessary journal entries in the books of A Ltd.

16. Rax Ltd. invited applications from public for 1,00,000 equity shares of ₹ 10 each at a premium of ₹ 5 per share. The entire issue is underwritten by the underwriters A, B, C, and D to the extent of 30%, 30%, 20%, and 20% respectively with the provision of firm underwriting of 3,000, 2,000, 1,000 and 1,000 shares respectively. Underwriters are entitled to maximum commission as per law. The company has received applications for 70,000 shares from public out of which applications for 19,000, 10,000, 21,000 and 8,000 shares were marked in favour of A, B, C and D respectively. Calculate the liability of each underwriter treating firm underwriting on par with marked applications. Also ascertain the underwriting commission @ 2.5% payable to each underwriter

17. Suraj Ltd. issued to public 1,50,000 equity shares of ₹ 100 each at par. ₹ 60 per share were payable along with the application and the balance on allotment. This issue was underwritten equally by A, B, and C for a commission of 3%. Applications for 1,40,000 shares were received as per details given below :

18. Rax Ltd. invited applications from public for 1,00,000 equity shares of ₹ 10 each at a premium of ₹ 5 per share. The entire issue is underwritten by the underwriters A, B, C, and D to the extent of 30%, 30%, 20%, and 20% respectively with the provision of firm underwriting of 3,000, 2,000, 1,000 and 1,000 shares respectively. Underwriters are entitled to maximum commission as per law. The company has received applications for 70,000 shares from public out of which applications for 19,000, 10,000, 21,000 and 8,000 shares were marked in favour of A, B, C and D respectively. Calculate the liability of each underwriter treating firm underwriting on par with marked applications. Also ascertain the underwriting commission @ 2.5% payable to each underwriter

19. Suraj Ltd. issued to public 1,50,000 equity shares of ₹ 100 each at par. ₹ 60 per share were payable along with the application and the balance on allotment. This issue was underwritten equally by A, B, and C for a commission of 3%. Applications for 1,40,000 shares were received as per details given below

Underwriter	Firm Underwriting Application	Marked Application	Total Application
A	5000	40,000	45,000
B	5000	46,000	51,000
C	3,000	34,000	37,000
Unmarked Application			7,000

It was agreed to credit the unmarked applications to A and C. Suraj Ltd. Accordingly made the allotment and received the amounts due from the public. The underwriters settled their accounts. You are required to — (i) prepare a statement of liability of the underwriters assuming that the benefit of firm underwriting is given to individual underwriters; and (ii) journalise the above transactions (including cash) in the books of Suraj Ltd.

Lesson 2

Debentures

LESSON OUTLINE

- Issue of Debentures
- Issue of debentures at
  - Par
  - Premium
  - Discount
- Issue of debentures as a collateral security
- Redemption of debentures at
  - Par
  - Premium
  - Discount
- Purchase of debentures from the open market
- Conversions of debentures
- Lesson Round Up
- Self Test Questions

LEARNING OBJECTIVES

In the previous lesson you have studied the issue of share capital as a means of raising long-term funds for financing the business activities. Equity sources of financing are however not always sufficient to meet the ever growing needs of the corporate expansion and growth. Hence, corporates turn to debt financing through financial institutions, commercial banks or by issuing debt instruments either through the route of private placement or by offering the same for public subscription. Owing tax shield provided by debt instruments, the debt financing not only helps in reducing the cost of capital but also helps in designing appropriate capital structure of the company. This lesson deals with the accounting treatment of different aspects of debenture and bond especially with issue, redemption including conversion of debenture.After studying this lesson, you will be able to :

- State the meaning of debenture and bonds;
- Describe the methods for the issue of debenture for cash and for consideration other than cash;
- Explain the issue of debenture as a collateral security;
- Explain the sources and record transaction relating to redemption of debenture;
- Discuss the methods of redemption of debenture;
- Record the Sinking Fund Investment transactions;
- Deal with cum-interest and ex-interest, open market operations.

Debenture is a written acknowledgement of a debt taken by the company issued under the common seal of the company and a debenture certificate contains an undertaking to pay back the principal sum on or after a specified maturity period and to pay the interest on the debt at a fixed rate whichever is decided at regular intervals generally half yearly until the debt is repaid fully.

INTRODUCTION

Besides raising capital by the issue of shares, a company may supplement its capital by borrowings. Such borrowings may take the form of both short-term and long-term borrowings. Short-term borrowings by way of promissory notes, bills of exchange, bank overdrafts, cash credits, public deposits, etc., are needed by a company to provide for its working capital while long-term borrowings by way of loan on mortgage of property, term loans from financial institutions, public deposits for a long period, issue of debentures, etc., are needed by a company for financing expenditure of a capital nature. Loan Capital of a company refers to the long-term borrowings of which issue of debentures is the most important and common method adopted by companies. Debentures are part of loan capital and the company is liable to pay interest thereon whether it earns profit or not.

ISSUE OF DEBENTURES

Subject to the restrictions imposed by Section 71 of the Companies Act, 2013, a company can issue debentures. The procedure for issuing debentures by a company is very much similar to that of an issue of shares. Applications for debentures are invited from the public through the prospectus and the applicants are asked to pay the application money along with the applications. The company may ask for payment of the whole of the amount along with the application or by instalments.

Debentures may be issued either, (i) at par, or (ii) at a premium, or (iii) at a discount without any legal restriction.

Again debentures may be issued by a company in the following ways:

(1) for cash,

(2) for consideration other than cash, and

(3) as collateral security.

Debentures Issued for Cash

When debentures are issued for cash the amount to be collected on them may be payable in lump sum or in instalments. Where payable in instalments, debenture application account is opened on receipt of applications. Debenture allotment account and debenture calls account are credited as against debenture account.

Issue of Debentures at Par

Debentures are said to be issued at par when the debentureholder is required to pay an amount equal to the nominal or face value of the debentures e.g. the issue of ₹ 1,000 debenture for ₹ 1,000.

(a) If the full amount is payable along with the application

(1) On receipt of application money:

Bank To Debentures Application and Allotment A/c	Dr.	with the money received on application

(2) On allotment:

Debenture Application and Allotment A/c To Debentures A/c	Dr.	with the money received on debentures allotted

(b) If the amount is payable in instalments

1. On receipt of application money:

Bank	Dr.	with the money received on
To Debentures Application A/c		application

2. On Allotment:

Debenture Application A/c	Dr.	with the application money and
Debenture Allotment A/c	Dr.	allotment money due on debentures
To Debentures A/c		allotted

3. On receipt of allotment money:

Bank	Dr.	with the money received on
To Debenture Allotment A/c		allotment

4. On making calls:

Debenture Calls A/c	Dr.	with the money due on respective
To Debenture A/c		calls

5. On receipt of call money:

Bank	Dr.	with the money received on respective calls
To Debenture Calls A/c		

Note: All cash transactions are generally passed through the Cash Book.

Case of Over-subscription: Like shares, the company cannot allot more debentures than issued. The excess application money may be retained by the company against the allotment money due. But the excess application money received on debentures rejected has to be refunded to the applicants. For, this, the accounting entry will be as follows:

Debenture Application A/c	Dr.	with the excess application money
To Bank		refunded

Illustration 1

X Ltd. made an issue of 10,000 12% Debentures of ₹ 100 each, payable as follows:

₹ 25 on Application

₹ 25 on Allotment

₹ 50 on First and Final Call.

Applications were received for 12,000 debentures and the directors allotted 10,000 debentures rejecting an application for 2,000 debentures. The money received on application for 2,000 debentures rejected was duly refunded. All the calls were made and the moneys duly received.

Show the necessary Cash Book and Journal Entries to record the above transactions and prepare the Balance Sheet of the company.

Solution:

Cash Book (Bank Column)

Dr.					*Cr.*
Particulars		₹	*Particulars*		₹
To	12% Debenture Application A/c (Receipt of application money for 12,000 debentures @ ₹ 25 per debenture)	3,00,000	By	12% Debenture Application A/c (Refund of application money on an application for 2,000 debentures @ ₹ 25)	50,000
To	12% Debenture Allotment A/c (Receipt of allotment money on 10,000 debentures @ ₹ 25 per debenture)	2,50,000	By	Balance c/d	10,00,000
To	12% Debenture First and Final Call A/c (Receipt of first and final call money on 10,000 debentures @ ₹ 50 per debenture)	5,00,000			
		10,50,000			10,50,000

Journal Entries

Particulars		*Dr. (₹)*	*Cr.(₹)*
12% Debenture Application A/c	Dr.	2,50,000	
12% Debenture Allotment A/c	Dr.	2,50,000	
To 12% Debentures A/c			5,00,000
(Allotment of 10,000, 12% Debentures of ₹ 100 each and the allotment money due @ ₹ 25 per debenture as per Board's resolution dated...)			
12% Debenture First and Final Call A/c	Dr.	5,00,000	
To 12% Debentures A/c			5,00,000
(First and Final Call money due on 10,000, 12% Debentures @ ₹ 50 per debenture as per Board's resolution dated...)			

X Limited

Balance Sheet

As at ——————

	Note No.	₹
I. EQUITY AND LIABILITIES		
(1) Non-current liabilities		
Long Term Borrowing	1	10,00,000
TOTAL		**10,00,000**
II. ASSETS		
(1) Current Assets		
Cash and cash equivalents		10,00,000
TOTAL		**10,00,000**

Notes No.1

Long term Borrowing	
6% debentures	10,00,000

Issue of Debentures at Premium

If the debentures are issued at a price higher than the nominal value of the debentures, the debentures are said to be issued at a premium. The excess of issue price over the nominal value is regarded as the premium amount.

In such a case, the Debentures Account should be credited only with the nominal value of the debentures and the premium should be credited to "Securities Premium Account". The accounting entry will be as follows:

Bank	Dr.	With the amount received
Debenture Application A/c	Dr.	with the money due on application
Debenture Allotment A/c	Dr.	and allotment including premium
To Debentures A/c		with the nominal value of the debentures
To Securities Premium A/c		with the premium money received on debentures

Illustration 2

B Ltd. issued 2,000, 13% Debentures of ₹ 100 each at ₹ 110 payable as follows:

On Application	₹ 25
On Allotment	₹ 35 (including premium)
On First and Final Call	₹ 50

The debentures were fully subscribed and the moneys were duly received.

Show the necessary Cash Book and the Journal entries and prepare the Balance Sheet of the company.

Solution:

Cash Book (Bank Column)

Dr.				*Cr.*
Particulars	₹	*Particulars*		₹
To 13% Debenture Application A/c (Application money on 2,000 debentures @ ₹ 25 each)	50,000	By	Balance c/d	2,20,000
To 13% Debenture Allotment A/c (Allotment money on 2,000 debentures @ ₹ 35 each including premium of ₹ 10 each)	70,000			
To 13% Debenture First and Final Call A/c (First and final call money on 2,000 debentures @ ₹ 50 each)	1,00,000			
	2,20,000			2,20,000

Journal Entries

Particulars		*Dr. (₹)*	*Cr.(₹)*
13% Debenture Application A/c	Dr.	50,000	
13% Debenture Allotment A/c	Dr.	70,000	
To 13% Debentures A/c			1,00,000
To Securities Premium A/c			20,000
(Allotment of 2,000, 13% Debentures of ₹ 100 each issued at a premium of ₹ 10 each and the allotment money due @ ₹ 35 per debenture on 2,000 debentures including the premium of ₹ 10 per debenture as per Board's resolution dated...)			
13% Debenture First and Final Call A/c	Dr.	1,00,000	
To 13% Debentures A/c			1,00,000
(First and final call money due on 2,000 debentures @ ₹ 50 per debenture as per Board's resolution dated...)			

B Limited

Balance Sheet

As at ——————

	Note	₹
I. EQUITY AND LIABILITIES		
(1) Shareholders' funds		
(a) Share Capital		
(b) Reserve and Surplus	1	20,000
(2) Non-current liabilities		
Long term borrowing	2	2,00,000
TOTAL		**2,20,000**
II. Assets		
(1) Current Assets		
Cash and cash equivalents		2,20,000
TOTAL		**2,20,000**

Notes

1. Reserve and Surplus	
Securities premium	20,000
2. Long term borrowing	
6% debentures	2,00,000

ISSUE OF DEBENTURES AT DISCOUNT

If the debentures are issued at a price lower than the nominal value of the debentures, the debentures are said to be issued at a discount. The difference between the nominal value and the issue price is regarded as the discount.

Such discount on issue of debentures may either be written off against revenue profit or capital profits of the company.

When debentures are issued at a discount the Debentures Account should be credited with the nominal value of the debentures and the discount allowed on issue of debentures, being a capital loss, should be debited to "Discount on Issue of Debentures Account". Thus, the accounting entry will be as follows:

Debenture Application A/c	Dr.	with the money due on application
Debenture Allotment A/c	Dr.	with the money due on allotment
Discount on Issue of Debentures A/c	Dr.	with the amount of discount
To Debentures A/c		with the total

Illustration 3

W Ltd. issued 2,000, 14% Debentures of ₹ 100 each at discount of 5% the discount being adjustable on allotment. The debentures were payable as follows:

On Application -	₹ 25
On Allotment -	₹ 20
On First and Final Call -	₹ 50

The debentures were fully subscribed and the moneys were duly received.

Show the cash book and journal entries and prepare the balance sheet of the company.

Solution:

Cash Book (Bank Column)

Dr. *Cr.*

Particulars	₹	*Particulars*	₹
To 14% Debenture Application A/c (Application money on 2,000 debentures @ ₹ 25 per debenture)	50,000	By Balance c/d	1,90,000
To 14% Debenture Allotment A/c (Allotment money on 2,000 debentures @ ₹ 20 per debenture)	40,000		
To 14% Debenture First and Final Call A/c (First and final call money on 2,000 debentures @ ₹ 50 per debenture)	1,00,000		
	1,90,000		1,90,000

Journal Entries

Particulars		*Dr. (₹)*	*Cr.(₹)*
14% Debenture Application A/c	Dr.	50,000	
14% Debenture Allotment A/c	Dr.	40,000	
Discount on Issue of Debentures A/c	Dr.	10,000	
To 14% Debentures A/c			1,00,000
(Allotment of 2,000 14% debentures of ₹ 100 each issued at a discount of 5% and allotment money due on 2,000 debentures @ ₹ 20 per debenture as per Board's resolution dated..)			
14% Debenture First and Final Call A/c	Dr.	1,00,000	
To 14% Debentures A/c			1,00,000
(First and final call money due on 2,000 debentures @ ₹ 50 per debentures as per Board's resolution dated.....................)			
Profit and Loss A/c	Dr.	10,000	
To Discount on Issue of Debentures A/c			10,000
(Discount of issue of debentures being written off against the profit and loss account)			

W Ltd

Balance Sheet as at.....

I. EQUITY AND LIABILITIES		
Non-current liability		
Long term borrowing	1	2,00,000
TOTAL		2,00,000
II. ASSETS		
Non-current assets		
Other non-current assets	2	10,000
Current Assets		
Cash and cash equivalents		1,90,000
TOTAL		**2,00,000**

Notes

1. Long term borrowings	
14% Debentures	2,00,000
2. Other non-current assets	
Discount on issue of Debentures	10,000

DEBENTURES ISSUED FOR CONSIDERATION OTHER THAN CASH

It may so happen that the company acquires some assets from the vendor and instead of paying the vendor in cash, the company may allot debentures in payment of purchase consideration. The issue of debentures to vendors is known as issue of debentures for consideration other than cash. In such a case, the accounting entries will be as follows:

(1) For acquisition of assets:

Sundry Assets (Individually) A/c	Dr.	(with the value of assets)
To Vendors		(with the purchase price)

Notes: (i) If the value of debentures allotted is more than the agreed purchase price, the difference is debited to Goodwill Account.

(ii) Similarly, if the value of debentures allotted is less than the agreed purchase price, credited to Capital Reserve Account.

(2) (a) On allotment of debentures (at par)

Vendors	Dr.	(with the value of debentures)
To Debentures A/c		

(b) On allotment of debentures (at premium)

Vendors A/c	Dr.	(with the purchase price)

To Debentures A/c (with the nominal value)

To Securities Premium A/c (with the amount of premium)

(c) On allotment of debentures (at discount)

Vendors A/c Dr. (with the amount of purchase)

Discount on Issue of Debentures A/c Dr. (with the amount of discount)

To Debentures A/c (with the nominal value)

Illustration 4

Optimist Ltd. purchased building worth ₹ 1,20,000 and plant and machinery worth ₹ 1,00,000 from Depressed Ltd. for an agreed purchase consideration of ₹ 2,00,000 to be satisfied by the issue of 2,000, 12% Debentures of ₹ 100 each.

Show the necessary journal entries in the books of Optimist Ltd.

Solution:

Journal

Particulars		*Dr. (₹)*	*Cr.(₹)*
Building A/c	Dr.	1,20,000	
Plant and Machinery A/c	Dr.	1,00,000	
To Depressed Ltd.			2,00,000
To Capital Reserve A/c			20,000
(Purchase of sundry assets and transfer of capital profits as per agreement with the vendor dated................................)			
Depressed Ltd.	Dr.	2,00,000	
To 12% Debentures A/c			2,00,000
(Being 2,000, 12% Debentures of ₹ 100 each allotted to vendors for consideration other than cash as per Board's resolution dated.............)			

DEBENTURES ISSUED AS COLLATERAL SECURITY

The term 'Collateral Security' implies additional security given for a loan. Where a company obtains a loan from a bank or insurance company, it may issue its own debentures to the lender as collateral security against the loan in addition to any other security that may be offered. In such a case, the lender has the absolute right over the debentures until and unless the loan is repaid. On repayment of the loan, however, the lender is legally bound to release the debentures forthwith. But in case the loan is not repaid by the company on the due date or in the event of any other breach of agreement, the lender has the right to retain these debentures and to realise them. The holder of such debentures is entitled to interest only on the amount of loan, but not on the debentures. Such an issue of debentures is known as "Debentures issued as Collateral Security".

Accounting Entries: The following are the two alternative ways by which debentures issued as collateral security can be dealt with:

(1) No accounting entry is required to be shown in the books of account at the time of issue of such debentures for the simple reason that the loan against which the debentures are issued as collateral security has already

been credited, the debit being given to Bank. But the existence of such debentures issued as collateral security has to be mentioned by way of a note on the Balance Sheet under the specific loan account.

(2) If it is desired that such an issue of debentures as collateral security is to be recorded in the books of account, the accounting entries will be as follows:

(i) On issue of debentures as collateral security

Debentures Suspense A/c	Dr.	with the nominal value of the
To Debentures A/c		debentures issued

In this case, Debentures Suspense Account will appear on the asset side of the balance sheet under the heading Miscellaneous Expenditure. Debentures Account will appear as a liability on the liabilities side of the Balance Sheet.

(ii) On repayment of the loan and release of debentures

Debentures A/c	Dr.	with the nominal value of the
To Debentures Suspense A/c		debentures released

Note: The net effect of the above two entries is nil. Both the Debentures Suspense Account and the Debentures Account are cancelled on repayment of the loan. As such, this method is rarely followed in practice.

Illustration 5

Z Ltd. secured an overdraft of ₹ 50,000 from the bank by issuing 600, 12% Debentures of ₹ 100 each as collateral security. Prepare the Balance Sheet of the Company.

Solution

First Method:

Balance Sheet of Z Ltd. as at.....

EQUITY AND LIABILITIES		
Current liability		
Short term borrowings	1	50,000

Notes

1. Short term borrowings	
Bank Overdraft	50,000
(Secured by the issue of 600, 12% Debentures of ₹ 100 each as collateral security)	

Second Method:

Journal Entries

		Dr.	*Cr.*
Debentures Suspense A/c	Dr.	60,000	
To Debentures A/c			60,000
(Issue of 600, 12% Debentures of ₹ 100 each as collateral security for a bank overdraft of ₹ 50,000 as per Board's resolution dated.....)			

Balance Sheet of Z Ltd. as at.....

	Note	Amount
I. EQUITY AND LIABILITIES		
Non-Current Liabilities		
Long term borrowing	1	60,000
Current liability		
Short term loan	2	50,000
II. ASSETS		
Non-Current Assets		
Other non-current assets	3	60,000

Notes

1. Long term borrowings	
600, 12% Debentures of ₹100 each (Issued as collateral security as per contra)	60,000
2. Short term borrowings	
Bank Overdraft	50,000
(Secured by the issue of 600, 12% Debentures of 100 each as collateral security)	
3. Other non-current assets	
Debentures Suspense Account (Issued as collateral security as per contra)	60,000

TERMS OF ISSUE OF DEBENTURES

A company may issue debentures on any specific condition as to its redemption. The following possibilities are underway. The accounting treatments are also given below:

(i) Issued at par and redeemable at par:

Bank	Dr.	(with the nominal value of debentures)
To Debentures Account		

(ii) Issued at discount redeemable at par:

Bank	Dr.	(with the amount received)
Discount on Issue of Debentures Account	Dr.	(with the amount of discount)
To Debentures Account		(with the nominal value)

(iii) Issued at premium redeemable at par:

Bank Account	Dr.	(with the amount received)
To Debentures Account		(with the nominal value)
To Securities Premium Account		(with the amount of premium)

(iv) Issued at par redeemable at premium:

Bank Account	Dr.	(with the amount received)
Loss on issue of Debentures Account	Dr.	(with the amount of premium on redemption)
To Debentures Account		(with the nominal value)
To Premium on Redemption		
of Debentures Account		(with the premium on redemption)

(v) Issued at discount, but redeemable at premium

Bank Account	Dr.	(with the amount received)
Discount on Issue of Debentures Account	Dr.	(with the discount allowed on issue)
Loss on Issue of Debentures Account	Dr.	(with the premium payable on redemption)
To Debentures Account		(with the nominal value)
To Premium on Redemption		
of Debentures Account		(with the premium on redemption)

Alternatively

Bank Account	Dr.	(with the amount received)
Loss on Issue of Debentures Account	Dr.	(with the discount on issue and premium on redemption)
To Debenture Account		(with the nominal value)
To Premium on Redemption		(with the premium payable at the
of Debentures Account		time of redemption)

Note : (i) Premium on Redemption of Debentures Account is shown as liabilities side of the balance sheet.

(ii) Loss on Issue of Debentures Account is written off gradually every year during the life of the debentures. The unwritten off amount is shown in the balance sheet under 'Other Current or other Non Current Asset'.

(iii) Premium on Redemption of Debentures Account is transferred to debentureholders account at the time of redemption.

Illustration 6

ABC Company Ltd., proposes to issue 10,000, 14% debentures of ₹ 100 each to its shareholders on right basis. They give you the following terms of issue and ask you to pass the journal entries in every case separately:

(i) The debentures were issued at premium of 10% and redeemable at par.

(ii) The debentures were issued at discount of 5% and redeemable at premium of 10%.

(iii) The debentures were issued at par but redeemable at premium of 10%.

(iv) The debentures were issued at premium of 5% but repayable at premium of 10%.

(v) The debentures were issued at discount of 5% but redeemable at par.

Solution:

Journal Entries

	Particulars		*Dr. (₹)*	*Cr.(₹)*
(i)	Bank Account	Dr.	11,00,000	
	To 14% Debentures			10,00,000
	To Securities Premium Account			1,00,000
	(Being the issue of debentures at premium of 10% but repayable at par)			
(ii)	Bank Account	Dr.	9,50,000	
	Loss on Issue of Debentures	Dr.	1,50,000	
	To 14% Debentures			10,00,000
	To Premium on Redemption of Deb. A/c			1,00,000
	(Being the issue of debentures of discount of 5% but repayable at premium of 10%)			
(iii)	Bank Account	Dr.	10,00,000	
	Loss on Issue of Debentures	Dr.	1,00,000	
	To 14% Debentures			10,00,000
	To Premium on Redemption of Deb. A/c			1,00,000
	(Being the issue of debentures at par but redeemable at premium of 10%)			
(iv)	Bank Account	Dr.	10,50,000	
	Loss on Issue of Debentures A/c	Dr.	50,000	
	To 14% Debentures			10,00,000
	To Premium on Redemption of Deb. A/c			1,00,000
	(Being the issue of debentures at premium of 5% but repayable at premium of 10%)			
(v)	Bank Account	Dr.	9,50,000	
	Discount on Issue of Debentures A/c	Dr.	50,000	
	To 14% Debentures			10,00,000
	(Being the issue of debentures at discount of 5% but repayable at par)			

INTEREST ON DEBENTURES

Wherever a company issues debentures it undertakes to pay interest thereon at a fixed percentage. As the debentures acknowledge a debt, the payment of interest on the debt is obligatory on the part of the company issuing them irrespective of the fact whether the company earns profit or not. Thus, interest payable on debentures is a charge against the profits of the company. Interest on debentures is normally payable half-yearly and it is calculated at the fixed percentage on the nominal value of debentures issued and not on the issue price. Thus,

the issue of debentures at par or at a premium or at a discount would not make any difference for the purpose of calculating interest on debentures. But, the effective rate of interest on the amount paid by the debentureholders would invariably differ in each of the above cases.

According to Income-tax Act, 1961 a company is liable to deduct income-tax at the prescribed rate from the gross amount of interest payable on debentures before the actual payment is made to the debentureholders and to deposit it with the Government. The balance amount after deduction of income-tax is actually payable to the debentureholders. This is known as deduction of tax at source.

It is important to note in this connection that if the debentures are tax-free, the income-tax on such interest will be paid by the company itself on behalf of the debentureholders. However, the interest paid by the company has to be grossed up for calculating the interest expense of the company.

Accounting Entries: The following entries are required to be shown in the books of the company to deal with interest on debentures:

1. On interest becoming due

Debenture Interest A/c	Dr.	with the gross interest due
To Income-tax Payable A/c or Tax Deducted at Source A/c.		with the amount of Income-tax to be deducted at source
To Debentureholders' A/c		with the net amount payable after deduction of income-tax

2. On payment of interest to the debentureholders

Debentureholders' A/c	Dr.	with the net amount of paid interest
To Bank A/c		

3. On payment of income-tax to the Government

Income-tax Payable A/c	Dr.	with the amount of income-tax
To Bank A/c		deducted at source and deposited with the Government

4. On transfer of Debenture Interest to Profit and Loss Account at the end of the year

Profit and Loss A/c	Dr.	with the gross amount of interest on
To Debenture Interest A/c		debentures

Notes: (1) Until and unless Income-tax payable/TDS payable is deposited by the company with the Government it will be treated as a liability and shown as a current liability in the of the Balance Sheet.

(2) While transferring Debenture Interest to Profit and Loss Account at the end of the period, it should be carefully noted whether interest for the full period for which the accounts are being prepared has been provided for or not. If not, the same has to be adjusted first before transferring it to the Profit and Loss Account.

(3) If the debentures are tax-free, the interest payable on debentures has to be grossed up. Since no company can really issue debentures on which no tax is payable. In this case, tax-free means that the relevant tax will be paid by the company.

Illustration 7

(Payment of Debenture Interest)

Zed Ltd. had issued ₹ 2, 00,000, 10% debentures on which interest was payable half-yearly on 30th September and 31st March. Show the necessary journal entries relating to debenture interest for the year ended 31st March, 2014 assuming that all moneys were duly paid by the company. Tax deducted at source is 10%.

Solution:

Journal Entries

Date	*Particulars*		*Dr. (₹)*	*Cr.(₹)*
2011				
Sept. 30	Debenture Interest A/c	Dr.	10,000	
	To Income-tax Payable A/c			1,000
	To Debentureholders A/c			9,000
	(Interest due on ₹ 2,00,000, 10% debentures for 6 months and income-tax deducted at source thereon @ 10%)			
"	Debentureholders' A/c	Dr.	9,000	
	To Bank			9,000
	(Payment of interest to debenture-holders)			
"	Income-tax Payable A/c	Dr.	1,000	
	To Bank			1,000
	(Deposit of income-tax deducted at source from Debenture Interest with the Government)			
2012				
Mar. 31	Debenture Interest A/c	Dr.	10,000	
	To Income-tax Payable A/c			1,000
	To Debentureholders A/c			9,000
	(Interest due on ₹ 2,00,000, 10% debentures for 6 months and income-tax deducted at source thereon @ 10%)			
"	Debentureholders' A/c	Dr.	9,000	
	To Bank			9,000
	(Payment of interest to debenture-holders)			
"	Income-tax Payable A/c	Dr.	1,000	
	To Bank			1,000

	(Deposit of Income-tax deducted at source from Debenture Interest with the Government)			
"	Profit and Loss A/c	Dr.	20,000	
	To Debenture Interest A/c			20,000
	(Transfer of Debenture Interest to Profit and Loss A/c)			

Interest Accrued and Due (Outstanding): As stated above, interest on debentures is usually paid every six months; interest really becomes due when the six months are over and not earlier; in other words no one can demand that the company pay interest before the due date. Suppose a company has issued 13.5% Debentures for ₹ 10,00,000 interest is payable on 30th September and 31st March. The company will pay ₹ 67,500 in every six months. Suppose, the company closes its books on 31st March, the interest due on that date may be unpaid. In that case, there will be a liability which will be recorded by the entry:

Debenture Interest A/c	Dr.	67,500	
To Debenture Interest Outstanding			67,500

The liability will be shown in the Balance Sheet along with debentures.

Interest Accrued but not Due: On the closing date interest for the full period must be brought into books but, it is possible, that due date for payment of interest has not yet come. Suppose, in the example given above, the company closes its books on 31st December. Interest upto 30th September must have been paid but that upto 31st March is not yet due. For proper accounting, however, interest from 1st October to 31st December (3 months) must be taken into account. Interest for such a period is termed as 'Interest accrued but not due'. The entry for recording this interest is:

Debenture Interest A/c	Dr.	33,750	
To Debenture Interest Accrued but not Due			33,750

Debenture Interest Accrued but not Due is shown in the balance sheet under Other Current Liabilities.

WRITING OFF THE DISCOUNT ON ISSUE OF DEBENTURES

Discount on issue of debentures is a capital loss of the company and it is required to be shown on the assets side of the Balance Sheet under the heading Other Current or other Non Current Asset until written off. Although, there is no legal obligation on the part of the company to write off such a loss, sound business policy demands that it should be written off as quickly as possible.

Discount on issue of debentures can be treated in any of the following two ways:

1. Discount on issue of debentures being a capital loss, can be written off against capital profits.
2. Discount on issue of debentures can be treated as deferred revenue expenditure and written off against revenue over the period of life of the debentures.

In case there is no capital profit and it is decided to treat discount on issue of debentures as deferred revenue expenditure, it is desirable to write it off against revenue over the period of life of the debentures on an equitable basis. The following are the two methods which are generally adopted for this purpose.

1. *Fixed Instalment Method*: Under this method, the total amount of discount allowed on issue of debentures is spread over the life of the debentures equally and every year a fixed amount is written off against revenue. For example, if the total discount allowed on issue of debentures is ₹ 10,000 and the debentures are issued for 10 years, the amount of discount to be written off every year will be 1/10th of the total discount, i.e., every year an amount equal to (1/10 x 10,000) = 1,000 will be written off over a period of 10 years. At the end of the 10th year Discount on Issue of Debentures Account would be completely written off. This method is simple and can be applied only if the debentures are redeemed at the expiry of the period. This method has the advantage of spreading the burden of discount equally over the period of the debentures.

2. *Fluctuating Instalment Method*: Where debentures are redeemed by annual drawings, the first method is not suitable for the simple reason that the burden of discount is equally spread over the period of life of the debentures. Under this method, the amount of discount to be written off every year should bear a proportion to the debentures outstanding at the beginning of each year. Thus, the amount of discount to be written off every year under this method cannot be fixed and will go on diminishing every year, i.e., the burden of discount will be in proportion to the benefits derived out of the debentures. The initial year should bear a greater burden of discount than the subsequent years as each subsequent year has the use of a lesser amount of debentures. Let us take an example as follows:

Nu Look Ltd. issued 1,000, 12% Debentures of ₹ 100 each at a discount of 10%. The terms of issue provided the repayment of the debentures at par by annual drawing of ₹ 20,000 over a period of 5 years. How should the amount of discount to be written off be determined?

The total discount on issue of debentures is ₹ 10,000. This total discount of ₹ 10,000 has to be written off in proportion to the debentures outstanding at the beginning of each year. Thus, outstanding balance ratio will be as follows:

1st year	... ...	=	₹ 1,00,000
2nd Year	₹ (1,00,000 - 20,000)	=	₹ 80,000
3rd Year	₹ (80,000 - 20,000)	=	₹ 60,000
4th Year	₹ (60,000 - 20,000)	=	₹ 40,000
5th Year	₹ (40,000 - 20,000)	=	₹ 20,000
Outstanding balance ratio	= 1,00,000 : 80,000 : 60,000 : 40,000 : 20,000		
	= 5 : 4 : 3 : 2 : 1		

Therefore, amount of discount to be written off every year will be as follows:

1st Year	=	₹ 10,000 x 5/15	=	₹ 3,333
2nd Year	=	₹ 10,000 x 4/15	=	₹ 2,667
3rd Year	=	₹ 10,000 x 3/15	=	₹ 2,000
4th Year	=	₹ 10,000 x 2/15	=	₹ 1,333
5th Year	=	₹ 10,000 x 1/15	=	₹ 667
Total				₹ 10,000

Accounting Entries: Every year, when the discount on issue of debentures is written off against revenue, the following entry is required to be shown in the books of the company:

Profit and Loss A/c	Dr.	with the amount written off
To Discount on Issue of Debentures A/c		

Illustration 8

Indra Ltd. issued 10,000 debentures of ₹ 100 each at a discount of 6%. The expenses on issue amounted to ₹ 35,000. The debentures have to be redeemed at the rate of ₹ 1,00,000 each year commencing with end of fifth year. How much discount and expenses should be written off each year?

Solution:

Total amount of discount and expenses is ₹ 95,000.

It should be written off each year according to the ratios of the amounts outstanding.

Years	*Ratio*
1	10
2	10
3	10
4	10
5	10
6	9
7	8
8	7
9	6
10	5
11	4
12	3
13	2
14	1
Total of ratios =	95

In each of the first five years, discount to be written off will be

$$\frac{₹95{,}000 \times 10}{95} = ₹\ 10{,}000$$

In 6th year = $\frac{₹95{,}000 \times 9}{95} = ₹\ 9{,}000$

In 7th year = $\frac{₹95{,}000 \times 8}{95} = ₹\ 8{,}000$

In 8th year = $\frac{₹95{,}000 \times 7}{95} = ₹\ 7{,}000$

In 9th year = $\frac{₹95,000 \times 6}{95}$ = ₹ 6,000

In 10th year = $\frac{₹95,000 \times 5}{95}$ = ₹ 5,000

In 11th year = $\frac{₹95,000 \times 4}{95}$ = ₹ 4,000

In 12th year = $\frac{₹95,000 \times 3}{95}$ ₹ 3,000

In 13th year = $\frac{₹95,000 \times 2}{95}$ = ₹ 2,000

In 14th year = $\frac{₹95,000 \times 1}{95}$ = ₹ 1,000

LOSS ON ISSUE OF DEBENTURES

If a company issues debentures at par or at a discount which are redeemable at a premium, the premium payable on redemption of the debentures should also be treated as capital loss and as such it should be dealt within the same manner as 'Discount on Issue of Debentures'.

Redemption of debentures at a premium is a known loss at the time of issue of debentures as the terms of issue generally contain such provisions for redemption. As such, it would be prudent on the part of the company to write off such loss during the life time of the debentures. The loss to be incurred by a company for a particular issue of debentures is ascertained in the following manner:

(i) If the debentures are issued at par and redeemable at a premium, the loss will be equal to the amount of premium payable on redemption.

(ii) if the debentures are issued at a discount and redeemable at a premium, the loss will be equal to the total of the amount of discount on issue and the amount of premium on redemption. Thus, total loss = Discount on issue of Debentures + Premium Payable on redemption of debentures. In such a case, there is no need to debit Discount on Issue of Debenture Account. Instead, "Loss on Issue of Debentures Account" should be debited with total loss.

When debentures are redeemable at a premium the liability for premium payable on redemption is recorded in the books at the time of issue of the debentures although the actual liability will arise only at the time of redemption. The main advantage derived by the company is that the loss on issue of debentures is completely written off before the debentures are due for redemption.

Accounting Entries: The following accounting entries are required to be shown in the books of the company:

1. On issue of debentures:

Bank A/c	Dr.	with the amount received on issue of debentures
Loss on Issue of Debentures A/c	Dr.	with the amount of total loss to be incurred
To Debentures A/c		with the nominal value of the debentures issued

To Premium on Redemption of Debentures A/c — with the amount of Premium payable on redemption

Note: "Premium on Redemption of Debentures Account" will appear as a liability in the Balance Sheet until it is paid at the expiry on the life-time of the debentures.

2. On writing off loss on issue of debentures every year against revenue:

Profit and Loss A/c	Dr.	with the amount written off
To Loss on Issue of Debentures A/c		

3. On redemption of debentures:

(a)	Debentures A/c	Dr.	with the nominal value of debentures
	Premium on Redemption on		
	Debentures A/c	Dr.	with the Premium payable
	To Debentureholders A/c		with the total
(b)	Debentureholders' A/c	Dr.	with the amount paid
	To Bank A/c		

Note: On redemption of the debentures the liability for the premium on redemption of debentures is wiped out.

Illustration 9

(Writing off the discount on issue of debentures where debentures are redeemable at the expiry of their life-time)

Sona Ltd. issued 1,000, 12% Debentures of ₹ 100 each at a discount of 10% redeemable at par after 5 years. Show the Discount on Issue of Debentures Account for these years if an equal amount of discount is to be written off every year.

Solution:

Total discount allowed on issue of debentures

= ₹ 1,00,000 x 10/100 = ₹ 10,000

As the debentures are redeemable after 5 years, the amount of discount to be charged to revenue every year will be ₹ 2,000.

Discount on Issue of Debentures A/c

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
1st yr. (at the beginning)	To 12% Debentures A/c	10,000	1st yr. (at the end)	By Profit and Loss A/c	2,000
				" Balance c/d	8,000
		10,000			10,000
2nd yr. (at the beginning)	To Balance b/d	8,000	2nd yr. (at the end)	By Profit and Loss A/c	2,000
				" Balance c/d	6,000
		8,000			8,000

3rd yr. (at the beginning)	To	Balance b/d	6,000	3rd yr. (at the end)	By	Profit and Loss A/c	2,000
					"	Balance c/d	4,000
			6,000				6,000
4th yr. (at the beginning)	To	Balance b/d	4,000	4th yr. (at the end)	By	Profit and Loss A/c	2,000
					"	Balance c/d	2,000
			4,000				4,000
5th yr. (at the beginning)	To	Balance b/d	2,000	5th yr. (at the end)	By	Profit and Loss A/c	2,000
			2,000				2,000

Illustration 10

(Writing off the discount on issue of debentures when debentures are redeemable by annual drawings).

Bee Ltd. issued 2,000, 12% Debentures of ₹ 100 each at a discount of 6% on 1.4.2009 repayable by equal annual drawings in four years.

You are required to show the Discount on Issue of Debentures Account over the period.

Solution:

Total amount of discount on issue of debentures:

= ₹ 2,00,000 x 6/100 = ₹ 12,000

This total discount of ₹ 12,000 has to be written off in proportion to the debentures outstanding at the beginning of each year. Thus, outstanding balance ratio will be as follows:

1.4.2009	=	₹ 2,00,000		
1.4.2010	=	₹ (2,00,000 - 50,000)	=	₹ 1,50,000
1.4.2011	=	₹ (1,50,000 - 50,000)	=	₹ 1,00,000
1.4.2012	=	₹ (1,00,000 - 50,000)	=	₹ 50,000

Outstanding balance ratio = 2,00,000 : 1,50,000 : 1,00,000 : 50,000

= 4 : 3 : 2 : 1

Therefore, amount of discount to be written off every year will be as follows:

31.3.2010	=	₹ 12,000 x 4/10	=	₹ 4,800
31.3.2011	=	₹ 12,000 x 3/10	=	₹ 3,600
31.3.2012	=	₹ 12,000 x 2/10	=	₹ 2,400
31.3.2013	=	₹ 12,000 x 1/10	=	₹ 1,200
Total				₹ 12,000

Discount on Issue of Debentures A/c

Dr. *Cr.*

Date	*Particulars*	*₹*	*Date*	*Particulars*	*₹*
1.4.2009	To 6% Debentures A/c	12,000	31.3.2010	By Profit and Loss A/c	4,800
			"	" Balance c/d	7,200
		12,000			12,000

1.4.2010	To	Balance b/d	7,200	31.3.2011	By	Profit and Loss A/c	3,600
				"	"	Balance c/d	3,600
			7,200				7,200
1.4.2011	To	Balance b/d	3,600	31.3.2012	By	Profit and Loss A/c	2,400
				"	"	Balance c/d	1,200
			3,600				3,600
1.4.2012	To	Balance b/d	1,200	31.3.2013	By	Profit and Loss A/c	1,200
			1,200				1,200

Illustration 11

(Writing off the Loss on Issue of Debentures where the debentures are issued at a discount and redeemable at a premium).

Venus Ltd. issued 1,000, 12% Debentures of ₹ 100 each at a discount of 5%. These debentures are redeemable at a premium of 10% after 5 years.

You are required to show:

(i) the journal entry on Issue of the Debentures; and

(ii) the Loss on Issue of Debentures Account over the period.

Solution:

Journal

Particulars		*Dr. (₹)*	*Cr.(₹)*
Bank A/c	Dr.	95,000	
Loss on Issue of Debentures A/c	Dr.	15,000	
To 12% Debentures A/c			1,00,000
To Premium on Redemption of Deb. A/c			10,000
(Allotment of 1,000, 12% debentures of ₹ 100 each issued at a discount of 5% and redeemable at a premium of 10% after 5 years as per Board's resolution dated...)			

Note: Total loss on issue of debentures has been arrived at as follows:

Loss on issue of debentures = Discount on issue + Premium on redemption

= ₹ (5,000 + 10,000) = ₹ 15,000

This total loss of ₹ 15,000 has to be written off over a period of 5 years.

Therefore, every year 1/5 of ₹ 15,000 = ₹ 3,000 have to be written off.

Loss on Issue of Debentures A/c

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
1st yr. (at the beginning)	To 12% Debentures A/c	5,000	1st yr. (at the end)	By Profit and Loss A/c	3,000
	To Premium on Redemption A/c	10,000		" Balance c/d	12,000
		15,000			15,000
2nd yr. (at the beginning)	To Balance b/d	12,000	2nd yr. (at the end)	By Profit and Loss A/c	3,000
				" Balance c/d	9,000
		12,000			12,000
3rd yr. (at the beginning)	To Balance b/d	9,000	3rd yr. (at the end)	By Profit and Loss A/c	3,000
				" Balance c/d	6,000
		9,000			9,000
4th yr. (at the beginning)	To Balance b/d	6,000	4th yr. (at the end)	By Profit and Loss A/c	3,000
				" Balance c/d	3,000
		6,000			6,000
5th yr. (at the beginning)	To Balance b/d	3,000	5th yr. (at the end)	By Profit and Loss A/c	3,000
		3,000			3,000

REDEMPTION OF DEBENTURES

Redemption of debentures refers to the discharge of liability in respect t of the debentures issued by a company. According to Section 71 (1) of the Companies Act, 2013, a company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption. According to Rule 18 of the Companies (**Share Capital and Debentures**) Rules, 2014, the company shall not issue secured debentures, unless it complies with the following conditions, namely:- An issue of secured debentures may be made, provided the date of its redemption shall not exceed ten years from the date of issue. Provided that a company engaged in the setting up of infrastructure projects may issue secured debentures for a period exceeding ten years but not exceeding thirty years.

Therefore, for secured debentures, the date of Redemption of debenture shall not exceed 10 years from the date of issue. A company engaged in the setting up of infrastructure projects may issue secured debentures upto redemption period of thirty years.

Creation of debenture redemption reserve account

Section 71(*4*) states that when debentures are issued by a company under this section, the company shall create a debenture redemption reserve account out of the profits of the company available for payment of dividend and the amount credited to such account shall not be utilised by the company except for the redemption of debentures.

Rule 18(7) of Companies (Share Capital and Debentures) Rules, 2014 prescribes the following conditions.

The company shall create a Debenture Redemption Reserve for the purpose of redemption of debentures, in accordance with the conditions given below –

(a) the Debenture Redemption Reserve shall be created out of the profits of the company available for payment of dividend;

(b) the company shall create Debenture Redemption Reserve (DRR) in accordance with following conditions:-

(i) No DRR is required for debentures issued by All India Financial Institutions (AIFIs) regulated by Reserve Bank of India and Banking Companies for both public as well as privately placed debentures. For other Financial Institutions (FIs) within the meaning of clause (72) of section 2 of the Companies Act, 2013, DRR will be as applicable to NBFCs registered with RBI.

(ii) For NBFCs registered with the RBI under Section 45-IA of the RBI (Amendment) Act, 1997, 'the adequacy' of DRR will be 25% of the value of debentures issued through public issue as per present SEBI (Issue and Listing of Debt Securities) Regulations, 2008, and no DRR is required in the case of privately placed debentures.

(iii) For other companies including manufacturing and infrastructure companies, the adequacy of DRR will be 25% of the value of debentures issued through public issue as per present SEBI (Issue and Listing of Debt Securities), Regulations 2008 and also 25% DRR is required in the case of privately placed debentures by listed companies. For unlisted companies issuing debentures on private placement basis, the DRR will be 25% of the value of debentures.

(c) Every company required to create Debenture Redemption Reserve shall on or before the 30th day of April in each year, invest or deposit, as the case may be, a sum which shall not be less than fifteen percent, of the amount of its debentures maturing during the year ending on the 31st day of March of the next year, in any one or more of the following methods, namely:-

(i) in deposits with any scheduled bank, free from any charge or lien;

(ii) in unencumbered securities of the Central Government or of any State Government;

(iii) in unencumbered securities mentioned in sub-clauses (a) to (d) and (ee) of section 20 of the Indian Trusts Act, 1882;

(iv) in unencumbered bonds issued by any other company which is notified under sub-clause (f) of section 20 of the Indian Trusts Act, 1882;

(v) the amount invested or deposited as above shall not be used for any purpose other than for redemption of debentures maturing during the year referred above: Provided that the amount remaining invested or deposited, as the case may be, shall not at any time fall below fifteen per cent of the amount of the debentures maturing during the year ending on the 31st day of March of that year;

(d) in case of partly convertible debentures, Debenture Redemption Reserve shall be created in respect of non-convertible portion of debenture issue in accordance with this sub-rule.

(e) the amount credited to the Debenture Redemption Reserve shall not be utilised by the company except for the purpose of redemption of debentures.

MOBILISATION OF FUNDS FOR REDEMPTION OF DEBENTURES

If no provision is made for mobilising additional funds required for the redemption of the debentures, the company may find great difficulty in discharging the liability when the debentures become due for payment. When the debentures become due for payment, the company may not have sufficient cash to discharge the liability. Even if it is assumed the liquid position of the company would permit such redemption, the working capital and consequently the profits of the company would be adversely affected if a large sum of money is withdrawn from the business at a time.

In order to overcome the above difficulties the following courses of actions are open to the company for mobilising the additional funds required at the time of redemption:

1. *Utilising a part of the profits of the company*: A part of the profits may be withheld and utilised by the company for the purpose of redemption of the debentures. Here again, the company is having the following options:

(a) The amount of profits withheld by the company may be retained in the business itself as owned capital in the form of General Reserve.

(b) The amount of profits withheld by the company may be withdrawn from the business and the same may be invested either (i) in readily convertible securities or (ii) in taking out an insurance policy to provide funds when needed.

2. *Raising the capital*: In order to provide for additional funds required for the redemption of the debentures, the company may issue new shares or debentures for the purpose. Old debentures will be redeemed out of the proceeds of fresh issue and the new share capital or debentures will take the place of the old debentures.

3. *Disposing of the assets of the* company: Additional funds required for the redemption of debentures may also be provided by the company by disposing of some of its fixed assets.

METHODS OF REDEMPTION OF DEBENTURES

Following are the methods of redeeming the debentures:

(a) By annual drawings

Under this method, a certain portion of the total debentures is redeemed every year over the life-time of the debentures and thus at the end of the life time of the debentures, the debentures are fully redeemed. Which debenture should be paid in which year usually depends on the drawings. What is actually done is that slips bearing the number of debentures are mixed up and put into a drum and then as many slips as the debentures to be redeemed are taken out of the drum at random. This procedure is known as “Drawing by lot”. The amount of debentures to be redeemed every year is generally calculated by dividing the total amount of the debentures by the number of years for which they have been issued. In such a case, the amount of annual drawings will be equal. But the amount of annual drawings may also be unequal in some cases.

When debentures are redeemed by annual drawings, the amount of annual drawings should be transferred to General Reserve Account out of the profits of the company and the same need not be invested in any other way.

(b) By payment in one lump sum at the expiry of a specified period

Under this method the entire amount of the debenture debt is paid to the debentureholders in one lump sum at the expiry of a specified period, i.e., at maturity or at the option of the company at a date within such specified period according to the terms of issue.

As the amount involved is large and the date of which debentures have to be redeemed is known to the company well in advance, it is possible for the company to make necessary arrangement to provide for the additional funds required for the debentures from the very beginning. In such a case, the best method is to set aside every year throughout the life of the debentures a part of the profits of the company which would otherwise be available for dividend and to invest the same in readily convertible securities together with compound interests at a fixed rate will amount to the sum required to pay off the debentures at the specified date.

The investments, thus made, are sold when the debentures become due for payment. This method ensures the availability of sufficient cash for the redemption of debentures when they become due and is known as “Sinking Fund method”.

(c) By purchase of debentures in the open market

Under this method, a company may purchase its own debentures in the open market if it seems to be convenient

and profitable to the company. When the market price of the debentures goes down below par or debentures are quoted at a discount on the stock exchange, the company usually takes the opportunity to buy the debentures in the open market and to cancel them. Own debentures may, also, be purchased by the company for its own investment when it is desired to keep the debentures alive with a view to issuing them in future. The law does not prohibit a company from purchasing its own debentures unless the terms of issue specify otherwise.

In such a case, the purchase of debentures can be made out of the amount realised on sale of investments where sinking funds exists. Where there is no sinking fund, the debentures can be purchased out of the company's cash balance.

(d) By conversion into shares

A company may issue convertible debentures giving option to the debentureholders to exchange their debentures for equity shares or preference shares in the company. The debentureholders are given the right on certain dates or before a specified date to exchange the debentures for the shares. A certain number of shares are offered for each debenture. When the debenture-holders exercise this option and the company issues the shares, it is referred as redemption by conversion.

REDEMPTION OF DEBENTURES OUT OF PROFIT

The company withholds a part of divisible profits for redeeming the debentures. The amount of profit is reduced to the extent of the debentures to be redeemed and hence not available for distribution by way of dividends among the shareholders. The payment to debentureholders in such a case is out of profit earned in the course of the business and therefore it is termed as redemption out of profits. Thus the existing liquid resources are not affected by redemption in this method.

There are two options available to the company in regard:

(A) The amount of divisible profits withheld by the company may be retained in the business itself as a source of internal financing i.e. in the form of general reserve and no investment is made outside to provide cash for redemption. In such a case the following journal entries are passed.

(1) On debentures becoming due for payment

Debentures A/c	Dr.	(with the nominal value)
Premium on Redemption of		
Debentures A/c	Dr.	(with the amount of premium, if any)
To Debentureholders A/c		(with the amount paid)

(2) On redemption

Debentureholders A/c	Dr.	(with the amount paid)
To Bank		

(3) On transfer of Profit to General Reserve

Debenture Redemption Reserve	Dr.	
Profit and Loss Appropriation A/c	Dr.	(with the nominal value of
To General Reserve		debentures redeemed)

(B) The amount of divisible profits withheld from distribution as dividend may be invested either in (i) readily marketable securities or (ii) taking out insurance policy to provide funds when required. In either case, the profit set aside will be accumulated in an account styled as Debenture Redemption Fund or Sinking Fund.

(a) Debenture Redemption Fund/Sinking Fund Method

The Accounting entries in such a case will be as follows:

First Year (At the end)

(1) On transfer of profits to Debenture Redemption Fund Account -

Profit and Loss A/c / Surplus A/c	Dr.	with the annual amount set aside out of profit*
To Debenture Redemption Fund A/c		

(2) On investment of the amount of the profit set aside in readily marketable securities -

Debenture Redemption Fund	Dr.	
Investments A/c		with the amount invested
To Bank		

*Debenture Redemption Fund Investment Account will appear on the Assets side of the Balance Sheet while Debenture Redemption Fund Account will appear on the Liabilities side of the Balance Sheet, under the head "Reserves and Surplus".

Second and subsequent years over the life of the Debentures excepting the last year (At the end) -

(1) On receipt of interest on Debenture Redemption Fund Investment -

Bank To Interest on Debenture Redemption Fund Investments A/c	Dr.	with the amount of interest received on investment

(2) On Transfer of the interest to Debenture Redemption Fund -

Interest on Debenture Redemption Fund Investments A/c To Debenture Redemption Fund A/c	Dr.	with the amount of interest received on investments

(3) On Transfer of Profits to Debenture Redemption Fund Account -

Profit and Loss Appropriation A/c To Debenture Redemption Fund A/c	Dr.	with the annual amount of profit set aside

(4) On investment of annual profit and interest received on investment -

Debenture Redemption Fund Investments A/c To Bank	Dr.	with the total amount of profit set aside plus interest received on investments

In the last year when the debentures become due for redemption (at the end) –

(1) On receipt of interest on Debenture Redemption Fund Investment -

Bank To Interest on Debenture Redemption Fund Investments A/c	Dr.	with the amount of interest received on investment

(2) On transfer of the interest -

Interest on Debenture Redemption Fund Investments A/c To Debenture Redemption Fund A/c	Dr.	with the amount of interest received on investments

(3) On transfer of profits to Debenture Redemption Fund A/c -

Profits and Loss Appropriation A/c To Debenture Redemption Fund A/c	Dr.	with the amount of annual profit set aside

(4) On realisation of Investments made so as to provide cash for the redemption -

Bank To Debenture Redemption Fund Investments A/c	Dr.	with the realised value of investments

(5) If there is any profit or loss on sale of investments, the same has also to be transferred to Debenture Redemption Fund Account -

(a) In case of profit -

Debenture Redemption Fund Investments A/c To Debenture Redemption Fund A/c	Dr.	with the amount of profit

(b) In case of loss -

Debenture Redemption Fund A/c To Debenture Redemption Fund Investments A/c	Dr.	with the amount of loss

(6) On transfer of Debentures to Debentureholders Account for payment to be made -

Debentures A/c To Debentureholders A/c	Dr.	with the nominal value of the debentures

(7) If debentures are redeemable at premium -

Premium on Redemption of Debentures A/c To Debentureholders A/c	Dr.	with the amount of premium on redemption

(8) On Payment -

Debentureholders A/c To Bank	Dr.	with the amount paid

(9) On transfer of Premium on Redemption of Debentures to Debenture Redemption Fund Account (In case Premium on Redemption of Debentures Account is not opened at the time of issue of debentures) -

Debenture Redemption Fund A/c To Premium on Redemption of Debentures A/c	Dr.	with the amount of premium

(10) On transfer of Loss of Issue of Debentures Account to Debenture Redemption Fund Account (In case the loss on Issue of Debentures Account is not yet written off) -

Debenture Redemption Fund A/c To Loss of Issue of Debentures A/c	Dr.	

Either entry (9) or entry (10) may be passed depending upon the circumstances.

(11) On transfer of Debenture Redemption Fund Account balance to General Reserve -

Debenture Redemption Fund A/c To General Reserve A/c	Dr.	with the balance left

Notes:

(1) No investment should be made in the last year for the simple reason that payment have to be made to the Debentureholders in the last year by realising the investments. Therefore, there is no logic behind making investment in the last year and then immediately realising the same.

(2) If the Debentures are redeemable at a premium, the total amount to be accumulated in Debenture Redemption Fund Account must include the amount of premium.

(3) This method assumes the availability of profits and sufficient cash investments.

(4) Sometimes, it may so happen that Sinking Fund may be non-cumulative. In such a case, the interest received on investments should not be credited to the Sinking Fund nor should it be invested. Instead, interest should be treated as interest earned as on general investment and credited to Profit and Loss Account.

(5) The balance in the Debenture Redemption Fund is transferred to General Reserve Account after the redemption of debentures.

(6) While transferring the balance of debenture redemption fund to general reserve, the profit on cancellation of debentures and profit on sale of investments transferred to debenture redemption fund account should be eliminated and the same should be transferred to capital reserve.

Sinking Fund to Replace an Asset and to Repay a Liability - The sinking fund is created to provide the cash on the known date for two specific purposes (a) to replace an asset and (b) to redeem debentures (liability).

Though in practice the sinking funds for redemption of a liability and that for replacement of an asset operate in a similar manner yet there are some differences as stated below:

(i) The annual instalment set aside for sinking fund for the replacement of an asset is really depreciation and is a charge against profit and therefore it is debited to profit and loss account. On the other hand, in case of sinking fund created for redemption of a liability, the annual instalment is an appropriation of profit and debited to profit and loss appropriation account since the purpose is to accumulate profits and not to distribute dividends until the liability is repaid.

(ii) At the end of the estimated useful life of the assets, the sinking fund investments are sold to replace the old asset. The ultimate balance in sinking fund account then is utilised to write off the book value of the old asset requiring replacement. The sinking fund is therefore extinguished. In the other case, the sale proceeds of the investments would be utilised to discharge the liability involving the closure of liability account and sinking fund investment account. The balance in the sinking fund account is transferred to general reserve. It is in the nature of free reserves and which can be used to pay dividends at the discretion of the company.

(b) Insurance Policy Method

Under this method also, profits are set aside and credited to Debenture Redemption Fund Account in the same manner as it is done in case of Sinking Fund Method. But instead of investing the amount of profit set aside in readily convertible securities an Insurance Policy is taken out for the required sum and an amount equal to the profit set aside is paid as premium. Thus, at the maturity of the policy, the required cash would be available for carrying out redemption of debentures. This method differs from the Sinking Fund Method in respect of interest on investment. Unlike Sinking Fund Method, interest will not be received every year but will accrue at a fixed rate. The total amount of premium will always be less than the amount of policy. Thus, the difference between the policy amount and the total amount of premium paid on the policy is the total amount of interest that accrues on the premiums paid. The main advantage of this method is that the policy is not subscribed to any fluctuation in prices unlike securities in the Sinking Fund Method and as such the exact sum insured will be available at maturity. However, the following disadvantages may be accounted for:

(i) the annual rate of interest is lower than that obtainable from investments; and

(ii) if the policy is cancelled on account of non-payment of premium, the surrender value will be very much less than the amount which has been paid by way of annual premiums.

The accounting entries will be as follows:

All the years till the maturity of the policy (including the last year) -

(1) On payment of premium at the beginning of the year -

Debenture Redemption Fund Policy A/c To Bank	Dr.	with the amount of annual premium

(2) On transfer of profit to Debenture Redemption Fund Account at the end of the year -

Profit and Loss Appropriation A/c To Debenture Redemption Fund A/c	Dr.	with the amount of profit set aside

In the last year on maturity of the policy.

In addition to the above two entries, the following entries are also required on maturity of the policy at the end of the last year.

(3) On realisation of the policy amount from the Insurance Company -

Bank To Debenture Redemption Fund Policy A/c	Dr.	with the amount of the policy

(4) On transfer of accrued interest (i.e. the difference between the policy amount and the total premium paid) to Debenture Redemption Fund Account -

Debenture Redemption Fund Policy A/c To Debenture Redemption Fund A/c	Dr.	with the difference between the policy amount and the total premium paid

(5) On transfer of Debentures Account to Debentureholders' Account for payment to be made –

Debentures A/c To Debentureholders	Dr.	with the nominal value of the debentures

(6) If debentures are redeemable at a premium -

Premium on Redemption of Debentures A/c To Debentureholders A/c	Dr.	with the amount of premium of redemption

(7) On payment –

Debentureholders To Bank	Dr.	with the amount paid

(8) On transfer of Premium on Redemption of Debentures to Debenture Redemption Fund A/c (In case Premium on Redemption of Debenture Account is not opened at the time of issue of debentures) -

Debenture Redemption Fund A/c To Premium on Redemption of Debentures A/c	Dr.	with the amount of premium on redemption

(9) On transfer of Loss of Issue of Debentures Account to Debenture Redemption Fund Account (In case Loss on Issue of Debentures Account is not yet written off) -

Debenture Redemption Fund A/c To Loss of Issue of Debentures A/c	Dr.	with the amount

Either entry (8) or entry (9) may be passed depending upon the circumstances.

(10) On transfer of Debenture Redemption Fund Account balance on General Reserve -

Debenture Redemption Fund A/c	Dr.	with the balance left
To General Reserve A/c		

Note: In some cases, the company may decide to take credit every year. In such a case, the entry for interest will be –

Debenture Redemption Fund Policy A/c	Dr.	with the interest
To Debenture Redemption Fund A/c		

Illustration 12 *(When debentures are redeemed out of profits)*

Strong Ltd. issued 10,000, 14% debentures of ₹ 100 each on 1st April, 2009 at a discount of 5% repayable at a premium of 10% after 5 years out of the profits of the company. On 1st April, 2014, balance in the Debenture Redemption Reserve Account stood at ₹ 3,40,000.

You are required to give journal entries in the books of the company both at the time of issue and redemption of debentures.

Solution:

Journal Entries

Date	*Particulars*		*Dr. (₹)*	*Cr. ₹*
2009				
April 1	Bank	Dr.	9,50,000	
	Loss on Issue of Debentures A/c	Dr.	1,50,000	
	To 14% Debentures A/c			10,00,000
	To Premium on Redemption of Debentures A/c			1,00,000
	(Allotment of 10,000, 14% debentures of ₹ 100 each issued at a discount of 5% and redeemable at a premium of 10% as per the Board resolution dated......)			
2014				
April 1	14% Debentures A/c	Dr.	10,00,000	
	Premium on Red. of Debentures A/c	Dr.	1,00,000	
	To Debentureholders A/c			1,00,000
	(Being the amount due on redemption)			
“	Profit and Loss Appropriation A/c	Dr.	1,60,000	
	To Debenture Redemption Reserve A/c			1,60,000

	(Being the transfer of profit to debenture redemption reserve account as required under SEBI guidelines)		
“	Debentureholders Dr.	11,00,000	
	To Bank		11,00,000
	(Being the amount paid to debentureholders)		
“	Profit and Loss Appropriation A/c Dr.	5,00,000	
	To General Reserve		5,00,000
	(Being the transfer of profit to the extent of 50% of the face value of debentures redeemed)		
“	Debenture Redemption Reserve A/c Dr.	5,00,000	
	To General Reserve A/c		5,00,000
	(Being the transfer of balance in debenture redemption reserve account to General reserves on redemption of debentures).		

Note: Loss on Issue of Debentures Account has to be written off by the company over the period of 5 years preferably at the rate of (1,50,000 x 1/5) = ₹ 30,000 per year.

Illustration 13 *(When Sinking Fund is created to redeem debentures at the end of the specified period)*

Steady Ltd. issued 2,000, 9% Debentures of ₹ 100 each at par on 1st April 2009 repayable at the end of 5 years at a premium of 6%. It was decided to institute a Sinking Fund for the purpose, the investments being expected to yield 8% p.a. Sinking Fund tables show that Re. 1 per annum at 8% compound interest amounts to ₹ 5.867 in 5 years. Investments were made in multiples of rupees ten only.

On 31st March, 2014 the investments realised ₹ 1,75,000 and the debentures were redeemed. The bank balance as on that date was ₹ 54,800.

You are required to show the journal entries relating to the creation of Sinking Fund and to prepare the relevant ledger accounts in the books of the company. Ignore debenture interest.

Solution:

Journal Entries

Date	*Particulars*	*Dr. (₹)*	*Cr. ₹*
2009			
April 1	Bank Dr.	2,00,000	
	Loss on Issue of Debentures Dr.	12,000	
	To 9% Debentures A/c	2,00,000	

Date	Particulars		Dr. ₹	Cr. ₹
	To Premium on Redemption of Debentures A/c		12,000	
	(Allotment of 2,000 9% Debentures of ₹ 100 each issued at par redeemable at a premium of 6%)			
2010				
Mar. 31	Profit and Loss Appropriation A/c	Dr.	36,134	
	To Debenture Redemption Fund A/c			36,134
	(Transfer of the amount out of Profit to Debenture Redemption Fund Account to provide for the redemption of debentures)			
"	Debenture Redemption Fund Investment A/c	Dr.	36,130	
	To Bank			36,130
	(Amount of profit set aside invested in outside securities in multiples of ₹ 10)			
2011				
Mar. 31	Bank	Dr.	2,890	
	To Interest on Debenture Redemption			2,890
	Fund Investment A/c			
	(Receipt of interest on investments @ 8% p.a.)			
"	Interest on Debenture Redemption			
	Fund Investment A/c	Dr.	2,890	
	To Debenture Redemption Fund A/c			2,890
	(Transfer of Interest to Debenture Redemption Fund Account)			
"	Profit and Loss Appropriation A/c	Dr.	36,134	
	To Debenture Redemption Fund A/c			36,134
	(Transfer of the amount out of the profit to Debenture Redemption Fund Account to provide for the redemption of debentures)			
"	Debenture Redemption Fund Investment A/c	Dr.	39,020	
	To Bank			39,020
	(Amount of profit set aside together			

Date	Particulars		Dr. (₹)	Cr. (₹)
	with the interest received on investments invested in outside securities in multiples of ₹ 10)			
2012				
Mar. 31	Bank	Dr.	6,012	
	To Interest on Debenture Redemption Fund Investment A/c			6,012
	(Receipt of Interest on Investment @ 8% p.a.)			
"	Interest on Debenture Redemption Fund Investment A/c	Dr.	6,012	
	To Debenture Redemption Fund A/c			6,012
	(Transfer of Interest to Debenture Redemption Fund Account)			
"	Profit and Loss Appropriation A/c	Dr.	36,134	
	To Debenture Redemption Fund A/c			36,134
	(Transfer of the amount out of profit to Debenture Redemption Fund Account to provide for the redemption of debentures)			
"	Debenture Redemption Fund Investment A/c	Dr.	42,150	
	To Bank			42,150
	(Amount of profit set aside together with the interest received on investments invested in outside securities in multiples of ₹ 10)			
2013				
Mar. 31	Bank	Dr.	9,384	
	To Interest on Debenture Redemption Fund Investment A/c			9,384
	(Receipt of interest on investments @ 8% p.a.)			
"	Interest on Debenture Redemption Fund Investment A/c	Dr.	9,384	
	To Debenture Redemption Fund A/c			9,384
	(Transfer of interest to Debenture			

Date	Particulars		Dr. (₹)	Cr. (₹)
	Redemption Fund Account)			
“	Profit and Loss Appropriation A/c	Dr.	36,134	
	To Debenture Redemption Fund A/c			36,134
	(Transfer of the amount out of profit to Debenture Redemption Fund Account to provide for the redemption of debentures)			
“	Debenture Redemption Fund Investment A/c	Dr.	45,520	
	To Bank			45,520
	(Amount of profit set aside together with the interest received on investments invested in outside securities in multiples of ₹ 10)			
2012				
Mar. 31	Bank	Dr.	13,025	
	To Interest on Debenture Redemption Fund Investment A/c			13,025
	(Receipt of interest on Investment @ 8% p.a.)			
“	Interest on Debenture Redemption Fund Investment A/c	Dr.	13,025	
	To Debenture Redemption Fund A/c			13,025
	(Transfer of interest to Debenture Redemption Fund Account)			
“	Profit and Loss Appropriation A/c	Dr.	36,153	
	To Debenture Redemption Fund A/c			36,153
	(Transfer of the amount out of profit to Debenture Redemption Fund Account to provide for the redemption of debentures)			
“	Bank	Dr.	1,75,000	
	To Debenture Redemption Fund Investment A/c			1,75,000

Date	Particulars		Dr.	Cr.
	(Realisation of investments to pay off the debentures)			
"	Debenture Redemption Fund Investment A/c		Dr.	12,180
	To Debenture Redemption Fund A/c			12,180
	(Transfer of profit on sale of investment to Debenture Redemption Fund A/c)			
"	9% Debentures A/c	Dr.	2,00,000	
	Premium on Redemption of	Dr.	12,000	
	Debentures A/c			
	To Debentureholders A/c			2,12,000
	(Amount due on redemption at a premium of 6%)			
"	Debentureholders A/c	Dr.	2,12,000	
	To Bank			2,12,000
	(Payment made for amount due)			
"	Debenture Redemption Fund A/c	Dr.	12,000	
	To Loss on Issue of Debentures A/c			12,000
	(Transfer of loss on issue of debentures account to Debenture Redemption Fund A/c)			
"	Debenture Redemption Fund A/c	Dr.	2,12,180	
	To General Reserve A/c			2,00,000
	To Capital Reserve A/c			12,180
	(Transfer of balance standing at Debenture Redemption Fund Account to General Reserve Account and Capital Reserve A/c)			

Ledger Accounts

9% Debentures Account

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
31.3.2010	To Balance c/d	2,00,000	1.4.2009	By Bank	2,00,000
31.3.2011	To Balance c/d	2,00,000	1.4.2010	By Balance b/d	2,00,000
31.3.2012	To Balance c/d	2,00,000	1.4.2011	By Balance b/d	2,00,000
31.3.2013	To Balance c/d	2,00,000	1.4.2012	By Balance b/d	2,00,000
31.3.2014	To Debentureholder's A/c	2,00,000	1.4.2013	By Balance b/d	2,00,000

Debentureholders Account

Date	Particulars	₹	Date	Particulars	₹
31.3.2014	To Bank	2,12,000	31.3.2014	By 9% Debentures A/c	2,00,000
"				" Premium on Redemption of Debentures A/c	12,000
		2,12,000			2,12,000

Debenture Redemption Fund Account

Date	Particulars	₹	Date	Particulars	₹
31.3.2010	To Balance c/d	36,134	31.3.2010	By Profit and Loss Appropriation A/c	36,134
31.3.2011	To Balance c/d	75,158	1.4.2010	" Balance b/d	36,134
			31.3.2011	By Interest on Deb. Redemption Fund Investment A/c	2,890
			31.3.2011	By Profit and Loss Appropriation A/c	36,134
		75,158			75,158
31.3.2012	To Balance c/d	1,17,304	1.4.2011	By Balance b/d	75,158
			31.3.2012	By Interest on Deb. Redemption Fund Investment A/c	6,012
			"	" Profit and Loss Appropriation A/c	36,134
		1,17,304			1,17,304
31.3.2013	To Balance c/d	1,62,822	1.4.2012	By Balance b/d	1,17,304
			31.3.2013	" Interest on Deb. Redemption Fund Investment A/c	9,384
			"	" Profit and Loss Appropriation A/c	36,134
		1,62,822			1,62,822
31.3.2013	To Loss on Issue of Debentures A/c	12,000	1.4.2013	By Balance b/d	1,62,822
"	To General Reserve A/c	2,00,000	31.3.2014	" Interest on Debenture Redemption Fund Investment A/c	13,025
"	To Capital Reserve A/c (Profit on sale	12,180		" Profit and Loss	36,153

	of Investment treated as capital profit)			Appropriation A/c	
			“	Debenture Redemption Fund Investment A/c (Profit on sales of investments)	12,180
		2,24,180			2,24,180

Debenture Redemption Fund Investment Account

Date	Particulars	₹	Date	Particulars	₹
31.3.2010	To Bank	36,130	31.3.2010	By Balance c/d	36,130
1.4.2010	To Balance b/d	36,130	31.3.2011	By Balance c/d	75,150
31.3.2011	“ Bank	39,020			
		75,150			75,150
1.4.2011	To Balance b/d	75,150	31.3.2012	By Balance c/d	1,17,300
31.3.2012	“ Bank	42,150			
		1,17,300			1,17,300
1.4.2012	To Balance b/d	1,17,300	31.3.2013	By Balance c/d	1,62,820
31.3.2013	“ Bank	45,520			
		1,62,820			1,62,820
1.4.2013	To Balance b/d	1,62,820	31.3.2014	By Bank	1,75,000
31.3.2014	“ Debenture Redemption Fund A/c (Profit on sale)	12,180			
		1,75,000			1,75,000

Interest on Debenture Redemption Fund Investment Account

Date	Particulars	₹	Date	Particulars	₹
31.3.2011	To Debenture Redemption Fund A/c	2,890	31.3.2011	By Bank A/c	2,890
31.3.2012	To Debenture Redemption Fund A/c	6,012	31.3.2012	By Bank A/c	6,012
31.3.2013	To Debenture Redemption Fund A/c	9,384	31.3.2013	By Bank A/c	9,384
31.3.2014	To Debenture Redemption Fund A/c	13,025	31.3.2014	By Bank A/c	13,025

Working Notes:

(1) Sum required for the redemption of debentures has been arrived at as follows:

	₹
Nominal value of 2,000 9% debentures @ ₹ 100	2,00,000
Add: Premium payable on redemption @ 6%	12,000
Sum required after 5 years	2,12,000

(2) Amount of profit set aside every year has been arrived at as follows:

Sinking fund tables show that ₹ 1 per annum at 8% compound interest amounts to ₹ 5.867 in 5 years. Since ₹ 2,12,000 is required, the amount appropriated per annum will be:

2,12,000 ÷ 5.867 = ₹ 36,134 (approx.).

(3) Profit on sale of investment is a capital profit and hence transferred to Capital Reserve Account.

(4) The payment of debenture interest is ignored.

Illustration 14 (When sinking Fund is created and debentures are redeemed partly at any time within the specified period).

S.S. Ltd., had ₹ 1,50,000, 12% debentures outstanding on 1st April, 2014. The Debenture Redemption Fund Account of the Company stood at ₹ 78,000 on the same date represented by investment in securities of ₹ 100 each. The directors of the company decided to sell ₹ 50,000 worth of securities at ₹ 102 and to redeem ₹ 50,000 debentures at a premium of 5%.

You are required to show the journal entries in the books of the company relating to the sale of securities and the redemption of debentures.

Solution:

Journal Entries

Date	*Particulars*		*Dr. (₹)*	*Cr.(₹)*
2014				
April 1	Bank	Dr.	51,000	
	To Debenture Redemption Fund Investment A/c			51,000
	(Realisation of investments in securities of ₹ 100 each at ₹ 102 each to pay off the debentures)			
"	Debenture Redemption Fund Investment A/c	Dr.	1,000	
	To Debenture Redemption Fund A/c			1,000
	(Transfer of profit on sale of investments to Debenture Redemption Fund Account)			
"	12% Debentures A/c	Dr.	50,000	
	Premium on Redemption of Debentures A/c	Dr.	2,500	
	To Debentureholders A/c			52,500

	(Amount due on redemption at a premium of 5%)		
"	Debentureholders A/c Dr.	52,500	
	To Bank		52,500
	(Payment made of amount due)		
"	Debenture Redemption Fund A/c Dr.	2,500	
	To Premium on Redemption of Debentures A/c		2,500
	(Transfer of Premium on Redemption of Debentures to Debenture Redemption Fund A/c)		
"	Debenture Redemption Fund A/c Dr.	50,000	
	To General Reserve A/c		50,000
	(Transfer of the nominal value of debentures redeemed to General Reserve A/c)		
"	Debenture Redemption Fund A/c Dr.	1,000	
	To Capital Reserve A/c		1,000
	(Profit on sale of investment transferred to Capital Reserve)		

Notes:

(1) It has been assumed that the provision has been made for the premium on redemption. Hence, it has been debited to Debenture Redemption Fund Account.

(2) After debentures are redeemed, an amount equal to the nominal value of the debentures redeemed has been transferred to General Reserve from the Debenture Redemption Fund Account.

Illustration 15 *(When Insurance Policy is taken out to provide cash for redemption of debentures).*

Go Go Ltd. issued 500, 12% Debentures of ₹ 100 each at par on 1st April, 2011, repayable at par after 3 years on 31st March, 2014. The directors decided to take out an insurance policy to provide necessary cash for the redemption of the debentures. The annual premium for the policy, payable on 1st April every year was ₹ 15,705.

You are required to show the journal entries and to prepare the relevant ledger accounts in the books of the company relating to the issue and redemption of debentures.

Solution:

Journal Entries

Date	*Particulars*	*Dr. (₹)*	*Cr.(₹)*
2011			
April 1	Bank Dr.	50,000	
	To 12% Debentures A/c		50,000
	(Allotment of 500 12% Debenture of ₹ 100 each as per Board's resolution dated....)		

"	Debenture Redemption Fund Policy A/c	Dr.	15,705	
	To Bank			15,705
	(Payment of annual premium for the policy taken out to provide cash for redemption of debentures)			
2012				
Mar. 31	Profit and Loss Appropriation A/c	Dr.	15,705	
	To Debenture Redemption Fund A/c			15,705
	(Transfer of profit to Debenture Redemption Fund Account)			
April 1	Debenture Redemption Fund Policy A/c	Dr.	15,705	
	To Bank			15,705
	(Payment of annual premium for the policy taken out to provide cash for redemption of debentures)			
2013				
Mar. 31	Profit and Loss Appropriation A/c	Dr.	15,705	
	To Debenture Redemption Fund A/c			15,705
	(Transfer of profit to Debenture Redemption Fund Account)			
April 1	Debenture Redemption Fund Policy A/c	Dr.	15,705	
	To Bank			15,705
	(Payment of annual premium for the policy taken out to provide cash for redemption of debentures)			
2014				
Mar. 31	Profit and Loss Appropriation A/c	Dr.	15,705	
	To Debenture Redemption Fund A/c			15,705
	(Transfer of profit to Debenture Redemption Fund Account)			
"	Bank	Dr.	50,000	
	To Debenture Redemption Fund Policy A/c			50,000
	(Receipt of policy amount on maturity)			
"	Debenture Redemption Fund Policy A/c	Dr.	2,885	
	To Debenture Redemption Fund A/c			2,885
	(Transfer of accumulated interest on the policy to Debenture Redemption Fund A/c)			

"	12% Debentures A/c	Dr.	50,000	
	To Debentureholders A/c			50,000
	(Amount due on redemption)			
"	Debentureholders A/c	Dr.	50,000	
	To Bank			50,000
	(Payment made for the amount due)			
"	Debenture Redemption Fund A/c	Dr.	50,000	
	To General Reserve A/c			50,000
	(Transfer of the balance of Debenture Redemption Fund A/c to General Reserve)			

Ledger Accounts

12% Debentures Account

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
31.3.2010	To Balance c/d	2,00,000	1.4.2009	By Bank	2,00,000
31.3.2012	To Balance c/d	50,000	1.4.2011	By Bank	50,000
31.3.2013	To Balance c/d	50,000	1.4.2012	By Balance b/d	50,000
31.3.2014	To Debentureholders A/c	50,000	1.4.2013	By Balance b/d	50,000

Debenture Redemption Fund Policy Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
1.4.2011	To Bank	15,705	31.3.2012	By Balance c/d	15,705
1.4.2012	To Balance b/d	15,705	31.3.2013	By Balance c/d	31,410
	" Bank	15,705			
		31,410			31,410
1.4.2013	To Balance b/d	31,410	31.3.2014	By Bank	50,000
"	" Bank	15,705			
31.3.2014	" Debenture Redemption Fund A/c	2,885			
		50,000			50,000

Debenture Redemption Fund Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
31.3.2012	To Balance c/d	15,705	31.3.2012	By Profit and Loss Appropriation A/c	15,705
31.3.2013	To Balance c/d	31,410	1.4.2012	By Balance b/d	15,705
			31.3.2013	" Profit and Loss Appropriation A/c	15,705
		31,410			31,410
31.3.2014	To General Reserve A/c	50,000	1.4.2013	By Balance b/d	31,410
			31.3.2014	" Profit and Loss Appropriation A/c	15,705
			31.3.2014	" Debenture Redemption Fund Policy A/c	2,885
		50,000			50,000

REDEMPTION OUT OF THE PROCEEDS OF FRESH ISSUE OF SHARES OR DEBENTURES

Debentures may be redeemed from the funds raised by the issue of fresh shares or debentures. Accounting entries are to be passed for fresh issue of shares/ debentures apart from the entries for redemption. The following entries will be passed:

1. On issue of fresh shares or debentures –

Bank To Share Capital A/c To Debentures A/c	Dr.	with the amount raised by fresh issue

2. On Redemption of old debentures -

(a) Debentures A/c To Debentureholders A/c	Dr.	with the nominal value of the debentures
(b) Debentureholders A/c To Bank	Dr.	with the amount paid

Notes:

(1) Working capital remains intact as the new share capital or debenture takes the place of old debentures.

(2) If the fresh issue is made at a premium or at a discount the entry should be passed accordingly.

(3) If the debentures are redeemable at a premium, Premium on Redemption of Debentures A/c should be credited at the time of issue by debiting Loss on Issue of Debentures A/c and before the payment is made, the same should be transferred to Debentureholders A/c.

(4) The creation of Debenture Redemption Reserve may not be necessary in this case since the additional capital or debentures raised for the purpose of redemption of debentures replaces the existing debentures.

REDEMPTION OUT OF SALE PROCEEDS OF ASSETS OF THE COMPANY

When debentures are redeemed out of the sale proceeds of assets of the company, the accounting treatment is as follows:

(i) On sale of assets

Bank Dr. (with sale proceeds)

To Respective Assets A/c

The profit or loss on sale of the asset will be transferred to profit and loss account.

The entries for redemption of debenture will be the same as discussed before.

Illustration 16

(When Debentures are redeemed out of the proceeds of fresh issue of shares or debentures)

The following is the Balance Sheet of Good Luck Ltd. as at 1st April, 2014

The following is the Balance Sheet of Good Luck Ltd. as at 1st April, 2014

I. EQUITY AND LIABILITIES			
1. Shareholders' funds			
(a) Share capital	1		5,00,000
(b) Reserves and Surplus:	2		50,000
2. Non-current liability			
Long term borrowings	3		1,00,000
3. Current liabilities			
Trade payables			1,50,000
TOTAL			**8,00,000**
II. ASSETS			
1. Non-current assets			
(a) Fixed Assets:			
(i) Tangible fixed assets	4		4,10,000
2. Current Assets			
Inventories		1,70,000	
Trade receivables		2,00,000	
Cash and cash equivalents		20,000	3,90,000
TOTAL			**8,00,000**
Notes			
1. Share capital			
Authorised Capital			
1,00,000 Equity Shares of ₹ 10 each			10,00,000
Issued Subscribed and paid up capital			
50,000 Equity shares of ₹ 10 each fully paid-up			5, 00,000

2. Reserve and surplus		
Profit & Loss A/c		50,000
3. Long term borrowings		
1,000 12% Debentures of ₹ 100 each fully paid-up		1,00,000
4. Tangible Fixed assets		
Land and Building		2,00,000
Plant and Machinery		2,00,000
Furniture and Fixtures		10,000
		4,10,000

The Debenture Trust Deed provides that the company may redeem the debentures at a premium of 5% at any time before the maturity. In order to exercise this option, the directors decided to issue 10,000 equity shares of 10 each at 11 on this day and to redeem the debentures. All the shares were duly subscribed and the debentures were redeemed.

Show the journal entries in the books of the company. Also prepare the Balance Sheet after the redemption of debentures.

Solution:

Journal Entries

Date	*Particulars*		*Dr. (₹)*	*Cr.(₹)*
2014				
April 1	Bank	Dr.	1,10,000	
	To Equity Share Capital A/c			1,00,000
	To Securities Premium A/c			10,000
	(Allotment of 10,000 equity shares of ₹ 10 each issued at a premium of ₹ 1/- per share as per Board's resolution dated....)			
"	12% Debentures A/c	Dr.	1,00,000	
	Premium on Redemption of Debenture A/c	Dr.	5,000	
	To Debentureholders			1,05,000
	(Amount due on redemption of debentures at premium of 5%)			
"	Debentureholders	Dr.	1,05,000	
	To Bank			1,05,000
	(Payment made for the amount due)			
"	Securities Premium A/c	Dr.	5,000	
	To Premium on Redemption of Debentures A/c			5,000
	(Writing off premium on Redemption of Debentures against the Securities Premium A/c)			

Balance Sheet of Good Luck Ltd. as on 1st April, 2014

	Note		
I. EQUITY AND LIABILITIES			
1. Shareholders' funds			
(a) Share capital	1		6,00,000
(b) Reserves and Surplus:	2		55,000
2. Current liabilities			
Trade payables			1,50,000
TOTAL			**8,05,000**
II. ASSETS			
1. Non-current assets			
(a) Fixed Assets:			
(i) Tangible fixed assets	3		4,10,000
2. Current Assets			
Inventories	1,70,000		
Trade receivables	2,00,000		
Cash and cash equivalents	25,000		3,95,000
TOTAL			**8,05,000**

Notes

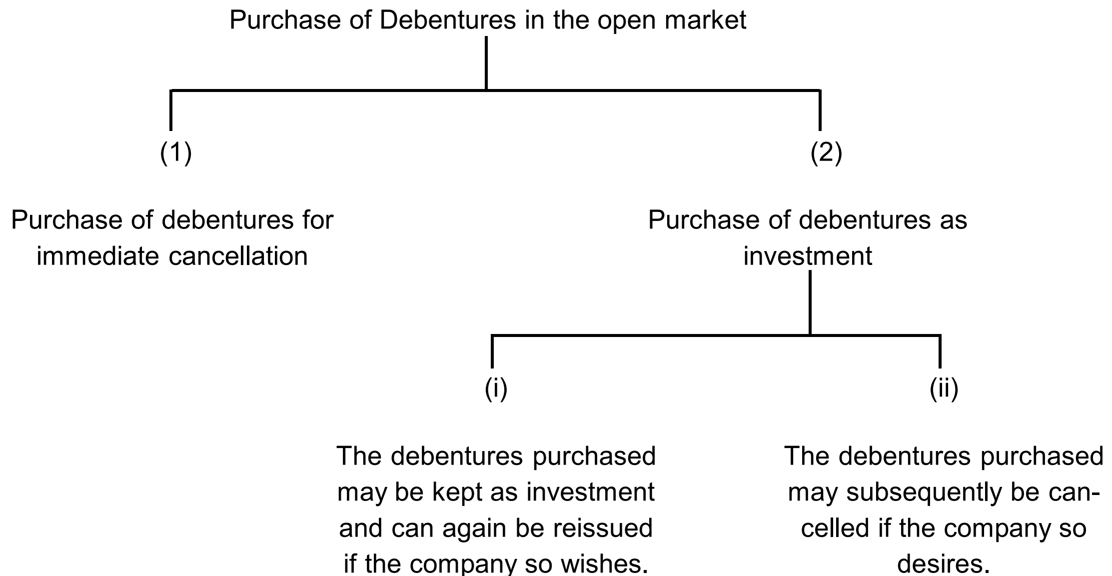
1. Share capital		
Authorised Capital		
1,00,000 Equity Shares of ₹ 10 each		10,00,000
Issued Subscribed and paid up capital		
60,000 Equity shares of ₹ 10 each fully paid-up		6, 00,000
2. Reserve and surplus		
Profit & Loss A/c	50,000	
Securities premium	5,000	55,000
3. Tangible Fixed assets		
Land and Building	2,00,000	
Plant and Machinery	2,00,000	
Furniture and Fixtures	10,000	4,10,000

Notes: (1) In this case, additional equity share capital raised for the purpose of redemption of debentures replaces the debentures. As such transfer to General Reserve out of profits of the company is not required.

(2) Premium on redemption of debentures has been written off against the Securities Premium Account.

PURCHASE OF DEBENTURES IN THE OPEN MARKET

A company if authorised by its articles of association, can buy its own debentures in the open market. The debentures so purchased can be used either for immediate cancellation or redemption of debentures or for investment. The debentures so purchased for investment can subsequently either be reissued when the company requires additional cash or be cancelled if the company so desires. Debentures when purchased for investment are popularly known as "Own Debentures". This can be categorised as follows:



PURCHASE OF DEBENTURES FOR IMMEDIATE CANCELLATION

The accounting entries in such a case will be as follows:

(a) Where no Sinking Fund exists

(1) On purchase and cancellation of debentures -

Debentures A/c	Dr.	with the amount paid
To Bank		

Notes: 1. If there is any difference between the nominal value of the debentures cancelled and the price paid for them, the same has to be treated as profit or loss on cancellation and should be credited or debited to Profit on Redemption of Debentures Account or Loss on Redemption of Debentures Account. Thus, the entry for this will be as follows:

In case of profit -

Debentures A/c	Dr.	with the nominal value of debentures cancelled
To Bank		with the price paid for them
To Profit on Redemption of Debentures A/c		with the profit, if any.

In case of loss -

Debentures A/c	Dr.	with the nominal value of debentures cancelled
Loss on Redemption of Debentures A/c	Dr.	with the loss, if any
To Bank A/c		with the total

Such profit or loss, being of capital nature, should be transferred to Capital Reserve Account (if profit) or written off against the Profit and Loss Account or Capital Profit including Securities Premium Account (if loss). The entry for this will be as follows:

In case of profit -

Profit on Redemption of Debentures A/c	Dr.	with the profit on redemption
To Capital Reserve A/c		

In case of loss -

Profit and Loss A/c	Dr.	with the loss on redemption
Or, Capital Reserve A/c (if any)	Dr.	
Or, Securities Premium A/c (if any)	Dr.	
To Loss on Redemption of Debenture A/c		

2. On transfer of profits which would otherwise be available for dividend to Debenture Redemption Reserve -

Profit and Loss Appropriation A/c	Dr.	with the nominal value of
To Debenture Redemption Reserve A/c		debentures cancelled

Note: As in this case, working capital of the company is adversely affected, it is desirable that an amount equal to the nominal value of the debenture cancelled should be transferred to the Debenture Redemption Reserve Account out of the profits of the company. This will help in maintaining the working capital of the company by not paying as dividend a part of the profit set aside.

(b) Where Sinking Fund Exists -

1. On Sale of Sinking Fund Investments -

Bank	Dr.	with the realisation value
To Debenture Redemption Fund Investment A/c		

Note: If there is any profit or loss on sale of investments, the same has to be transferred to Debenture Redemption Fund Account.

2. On purchase and cancellation of debentures -

Debentures A/c	Dr.	with the amount paid
To Bank		

3. Profit or loss on cancellation or redemption of debentures shall be transferred to Sinking Fund or Debenture Redemption Fund Account. The accounting entries:

In case of profit:

Debentures A/c	Dr.	with the nominal value
To Bank		with the price paid
To Profit on Redemption Debentures A/c		with the amount of profit
Profit on Redemption of Debentures A/c	Dr.	with the profit
To Sinking Fund A/c		

In case of loss:

Debentures A/c	Dr.	with the nominal value
Loss on Cancellation or Redemption of Debentures A/c	Dr.	with the loss on cancellation/ redemption
To Bank		with the amount paid
Sinking Fund A/c	Dr.	with the amount of loss
To Loss on Cancellation or Redemption of Debentures A/c		

4. On transfer of the nominal value of the debentures cancelled to General Reserve Account from the Debenture Redemption Fund Account -

Debenture Redemption Fund A/c	Dr.	with the nominal value of the debentures cancelled
To General Reserve A/c		

PURCHASE OF DEBENTURES AS INVESTMENT (OWN DEBENTURES)

The accounting entries in such a case will be as follows:

(a) Where no Sinking Fund Exists:

On purchase of debentures as investment –

Own Debentures A/c	Dr.	
Or Investment in Own Debentures A/c	Dr.	with the amount paid for the debentures
To Bank		

(b) Where Sinking Fund Exists:

On sale of investments -

Bank	Dr.	with the realised amount
To Debenture Redemption Fund Investment A/c		

Note: If there is any profit or loss on sale of investments the same has to be transferred to Debenture Redemption Fund Account.

On purchase of debentures as investment -

Bank	Dr.	With the amount received
Own Debentures A/c	Dr.	
Or Investment in Own Debentures A/c	Dr.	with the amount paid for the debentures
To Bank		

Notes: (1) Own Debentures Account signifies investment and will be shown as an asset in the Balance Sheet unless such debentures are re-issued or cancelled in future.

(2) Until and unless, these debentures are re-issued or cancelled in future, the question of profit or loss on redemption of debentures will not arise.

Cancellation of Own Debentures

When own debentures are subsequently cancelled -

Bank	Dr.	With the amount received
Debentures A/c	Dr.	with the nominal value of the
To Own Debentures A/c		debentures cancelled
Or To Investment in Own Debentures A/c		

Note: (1) If there is any difference between the nominal value of the debentures cancelled and the amount standing to the debit of Own Debentures Account, the same has to be treated as profit or loss on redemption of debentures and should be credited or debited to Profit on Redemption of Debentures Account or Loss on Redemption of Debentures Account. The entry for this will be as follows:

In case of profit -

Debentures A/c	Dr.	nominal value of the debentures cancelled
To Own Debentures A/c		book value of the own debentures cancelled
To Profit on Redemption of Debentures A/c		with the difference, if any

In case of loss –

Debentures A/c	Dr.	nominal value of the debentures cancelled
Loss on Redemption of Debentures A/c	Dr.	with the difference, if any
To Own Debenture A/c		book value of the own debentures

(2) If Sinking Fund exists, the accounts of profit on redemption of debentures or loss on redemption of debentures should be transferred to debenture redemption fund account.

(3) If no Sinking Fund exists it is desirable that an amount equal to the nominal value of the debentures cancelled should be transferred to Debenture Redemption Reserve Account out of the profit of the company on cancellation.

(4) If Sinking Fund exists, on cancellation, an amount equal to the nominal value of the debentures cancelled should be transferred to General Reserve from the Debenture Redemption Fund Account.

INTEREST ON OWN DEBENTURES

The purchase of its own debentures by a company involves the question of adjustment of interest payable on these debentures. As soon as the company purchases its own debentures, it saves the interest which would have been payable on them. When the company purchases its own debentures for immediate cancellation, outstanding debentures are reduced by the amount cancelled and hence Debenture Interest Account is debited in future only with the net amount of interest payable on the outstanding debentures. But where debentures are purchased as investment, the total debentures are deemed to be outstanding. Some debentures are held by the company itself as its own investment, the interest on these own debentures will be retained by the company and the amount of interest on debentures held by the outsiders will be actually paid by the company. The accounting entries in such a case will be as follows:

(a) Where no Sinking Fund exists:

(1) On interest becoming due on debentures -

Debenture Interest A/c	Dr.	with the total amount of interest on all the debentures
To Debentureholders A/c		with the amount of interest payable on debentures held by outsiders
To Interest on Own Debentures A/c		with the amount of interest on debentures held by the company

(2) On payment of interest on debentures -

Debentureholders A/c	Dr.	with the amount of interest paid to
To Bank		outsiders

(3) On transfer of Debenture Interest to Profit and Loss A/c

Profit and Loss A/c To Debenture Interest A/c	Dr.	with the total interest on all the debentures

(4) On transfer of Interest on Own Debentures to Profit and Loss A/c

Interest on Own Debentures A/c To Profit and Loss A/c	Dr.	with the amount of interest on debentures held by the company

Note: As the adjustment of interest on debentures head as investments by the company involves debiting and crediting the Profit and Loss Account with the same amount, interest on such debentures can be omitted altogether. Thus, alternatively, the following entries can be passed:

(1) On interest becoming due on debentures held by outsiders -

Debenture Interest A/c	Dr.	with the net amount of interest
To Debentureholders A/c		payable on debentures held by outsiders

(2) On payment of interest to debentureholders -

Debentureholders A/c	Dr.	with the net amount of interest
To Bank		payable on debentures held by outsiders

(3) On transfer of Debenture Interest to Profit and Loss A/c

Profit and Loss A/c	Dr.	with the net amount of interest
To Debenture Interest A/c		payable on debentures held by outsiders

(b) Where Sinking Fund exists: Where the debentures are purchased as an investment against the Sinking Fund, the interest on such debentures is credited to the Sinking Fund Account as if the debentures are outside securities. The accounting entries will be as follows:

(1) On interest becoming due on debentures

Debenture Interest A/c	Dr.	with the total amount of interest payable on all the debentures

To Debenture Redemption Fund A/c		with the amount of interest payable on debentures held by the company
To Debentureholders A/c		with the amount of interest payable on debentures held by outsiders

(2) On payment of interest to debentureholders -

Debentureholders A/c	Dr.	with the amount paid
To Bank		

(3) On transfer of interest to Profit and Loss A/c -

Profit and Loss A/c	Dr.	with the total interest payable
To Debenture Interest A/c		

Note: While making payment of interest to debentureholders income-tax has to be deducted at source and deposited with the Government.

PURCHASE OF DEBENTURES BEFORE THE SPECIFIED DATE OF PAYMENT OF INTEREST [CUM-INTEREST AND EX-INTEREST QUOTATIONS]

Interest on debentures is generally paid half-yearly to the holders on certain specified dates, e.g., 30th September and 31st Mach every year. If debentures are purchased exactly on these specified dates, it involves no problem. In such a case, interest is payable to the holders of debentures. But, where debentures are purchased at a date before the specified date of payment of interest the question which naturally arises is whether the price paid for such debentures includes the interest for the expired period (i.e. from the previous date of payment of interest up to the date of purchase) or not.

For this purpose it is important to note whether the price paid for the debentures is quoted as "Cum-interest" or "Ex-interest". If the purchase price for the debentures includes interest for the expired period, the quotation is said to be "Cum-interest". If, on the other hand, the purchase price for the debentures excludes the interest for the expired period, the quotation is said to be "Ex-interest". In case of Ex-interest quotation, interest has to be paid to the holders for the expired period in addition to the price paid for the debentures. In any case, the company must pay interest for the expired period and while making entry in its books at the time of purchase of the debentures, the amount paid by way of interest should be treated separately from the price actually paid for the debentures. For example, if a company purchases 10 of its 9% Debentures of 100 each at 95 each on 1st August, 2014 the dates of payment of Interest being 30th September and 31st March, the treatment of the same for "Cum-interest" and "Ex-interest" quotations will be as follows:

N.B. If nothing is stated, purchase and sale of debentures and government securities should be taken to be on ex-interest basis. That of shares should be presumed to be on cum-dividend basis.

(1) In case of cum-interest quotation: If the purchase price of 95 is taken to be the cum-interest price, it implies that this includes the interest for the expired period of 4 months (i.e. from 1st April, 2014 to 31st July, 2014 which amounts

$$\left(₹100 \text{x} \frac{9}{100} \text{x} \frac{4}{12}\right) = \left(₹100 \text{x} \frac{9}{100} \text{x} \frac{4}{12}\right) = ₹3$$

Therefore, the price actually paid for the debenture should be taken at (₹95 - ₹3) = ₹92. The accounting entry in such a case should be as follows:

(i) If debentures are purchased for immediate cancellation

9% Debentures A/c	Dr.	1,000		with the nominal value of 10 debentures
Debenture Interest A/c	Dr.	30		with the interest for expired period on 10 debentures
To Bank			950	with the price paid
To Profit on Redemption of Debentures A/c			80	with the difference

(ii) If debentures are purchased as investment

Own Debentures A/c	Dr.	920		with the actual price paid
Debenture Interest A/c	Dr.	30		with the interest for expired period on 10 debentures
To Bank			950	with the total

Note: The question of profit or loss on redemption of debentures does not arise here as the debentures are purchased as investment. In such a case, Own Debentures A/c should always be debited with the actual price paid for them.

However, when these debentures are cancelled in future, the entry would be:

9% Debentures A/c	Dr.	1,000	
To Own Debentures			920
To Profit on Redemption of Debentures			80

Profit on cancellation of debentures must be transferred to capital reserve account.

(2) In case of ex-interest quotation: If the purchase price of `95 is taken to be the ex-interest price it implies that this does not include the interest for the expired period of 4 months (i.e. from 1st April, 2014 to 31st July, 2014 which amounts to

$$\left(₹100 \times \frac{9}{100} \times \frac{4}{12}\right) = ₹3$$

In this case, the price of ₹ 95 represents the price actually paid for the debentures and the company is required to pay ₹ 3 for every debenture as interest in addition to the purchase price of ₹95. Therefore, the company is required to pay (₹ 95 + ₹3) = ₹98 for every debenture in total. The accounting entry in such a case should be as follows:

(i) If debentures are purchased for immediate cancellation

9% Debentures A/c	Dr.	1,000		with the nominal value of 10 debentures
Debenture Interest A/c	Dr.	30		with the interest for expired period on 10 debentures
To Bank			980	with the total amount paid on 10 debentures
To Profit on Redemption of Debentures A/c			50	with the difference

(ii) If debentures are purchased as investment

Own Debentures A/c	Dr.	950		with the actual price paid for 10 debentures
Debenture Interest A/c	Dr.	30		with the interest for expired period on 10 debentures
To Bank			980	with the total

When these debentures are cancelled:

9% Debentures A/c	Dr.	1,000	
To Own Debentures			950
To Profit on Redemption of Debentures A/c			50

The Profit on redemption of debenture must be transferred to capital reserve account.

Illustration 17 *(When debentures are purchased for immediate cancellation and there is no Sinking Fund)*

Favourite Ltd. had 2,000, 12% Debentures of ₹100 each as on 1st April, 2013. As per the terms of issue, the company purchased the following debentures in the open market for immediate cancellation:

1st May	-	400 Debentures at ₹ 98 cum-interest
1st January	-	800 Debentures at ₹ 100.25 cum-interest
1st March	-	200 Debentures at ₹ 98.50 ex-interest

Assuming that debenture interest was payable half-yearly on 30th September and 31st March and the Income-tax was deductible at the rate of 10% at source. Show the journal entries in the books of the company and prepare the necessary ledger accounts. The company closes its books on 31st March.

Solution:

Journal Entries

Date	*Particulars*		*Dr. (₹)*	*Cr.(₹)*
2013				
May 1	12% Debentures A/c	Dr.	40,000	
	Debenture Interest A/c	Dr.	400	
	To Bank			39,200
	To Profit on Redemption of Debentures A/c (Cancellation of 400 Debentures of ₹ 100 each by purchase in the open market at ₹ 98 cum-interest)			1,200
	The above entry is the combined entry of the following two entries:			
	12% Debentures A/c	Dr.	40,000	
	To Bank			38,800
	To Profit on Redemption of Debentures A/c			1,200

	Debenture Interest A/c	Dr.	400	
	To Bank			400
Sep.30	Debenture Interest A/c	Dr.	9,600	
	To Debentureholders A/c			8,640
	To Income-tax Payable A/c			960
	(Interest due on the outstanding debentures of ₹ 1,60,000 at 12% p.a. for 6 months less Income-tax @ 10%)			
“	Debentureholders A/c	Dr.	8,640	
	To Bank			8,640
	(Payment made for interest)			
“	Income-tax Payable A/c	Dr.	960	
	To Bank			960
	(Deposit of Income-tax with the Government)			
2014				
Jan. 1	12% Debentures A/c	Dr.	80,000	
	Debenture Interest A/c	Dr.	2,400	
	To Bank			80,200
	To Profit on Redemption of Debentures A/c			2,200
	(Cancellation of 800 Debentures of ₹ 100 each by purchase in the open market at ₹ 100.25-cum-interest)			
2014	12% Debentures A/c	Dr.	20,000	
Mar. 1	Debenture Interest A/c	Dr.	1,000	
	To Bank			20,700
	To Profit on Redemption of Debentures A/c			300
	(Cancellation of 200 Debentures of ₹ 100 each by purchase at ₹ 98.50 ex-interest, ₹ 1,000 paid for interest debited to Debenture Interest A/c)			
2014				
Mar. 31	Debenture Interest A/c	Dr.	3,600	
	To Debentureholders A/c			3,240
	To Income-tax Payable A/c			360
	(Interest due on the outstanding debentures of ₹ 60,000 at 12% p.a. for 6 months less Income-tax @ 10%)			
“	Debentureholders A/c	Dr.	3,240	
	To Bank			3,240
	(Payment made for interest)			
“	Income-tax Payable A/c	Dr.	360	

	To Bank			360
	(Deposit of Income-tax with the Government)			
"	Profit and Loss A/c Dr.		17,000	
	To Debenture Interest A/c			17,000
	(Transfer of Debenture Interest to Profit and Loss A/c)			
"	Profit and Loss Appropriation A/c Dr.		1,40,000	
	To Debenture Redemption Reserve A/c			1,40,000
	(Transfer of nominal value of the debentures cancelled during the year to Debenture Redemption Reserve A/c out of the profits of the company)			
"	Profit on Redemption of Debentures A/c Dr.		4,200	
	To Capital Reserve A/c			4,200
	(Transfer of capital profit to Capital Reserve A/c)			

Note: Income-tax authorities do not recognise interest for the broken period, for them the actual amount paid is the purchase/sale price of the debentures. Hence no income-tax is to be deducted in cases of interest to be recorded on purchase/sale of debentures in the middle of the interest period.

Ledger Accounts

12% Debentures A/c

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
1.5.2013	To Bank (excluding interest)	38,800	1.4.2013	By Balance b/d	2,00,000
"	" Profit on Redemption of Debentures A/c	1,200			
1.1.2014	To Bank	77,800			
"	" Profit on Redemption of Debentures A/c	2,200			
1.3.2014	" Bank	19,700			
	" Profit on Redemption of Debentures A/c	300			
31.3.2014	" Balance c/d	60,000			
		2,00,000			2,00,000

Debenture Interest A/c

Date	Particulars	₹	Date	Particulars	₹
1.5.2013	To Bank	400	31.3.2014	By Profit and Loss A/c	17,000
30.9.2013	" Debentureholders A/c	8,640			
"	" Income-tax Payable	960			
1.1.2014	" Bank	2,400			
1.3.2014	" Debentureholders A/c	1,000			
31.3.2014	" Debentureholders A/c	3,240			
"	" Income-tax Payable	360			
		17,000			17,000

Profit on Redemption of Debentures A/c

Date	Particulars	₹	Date	Particulars	₹
31.3.2014	To Capital Reserve Account	3,700	1.5.2013	By 12% Debentures A/c	1,200
			1.1.2014	By 12% Debentures A/c	2,200
			1.3.2014	By 12% Debentures A/c	300
		3,700			3,700

Notes: (1) ₹98 cum-interest price includes interest ₹1 for the expired period of one month (i.e., April 2012).

(2) ₹100.25 cum-interest price includes interest of ₹3 for the expired period of 3 months (i.e. October, November and December, 2012).

(3) ₹98.50 ex-interest price excludes interest of ₹5 for the expired period of 5 months (i.e., October 2012 to February, 2013).

Illustration 18 *(When debentures are purchased for immediate cancellation and Sinking Fund exists).*

The following balances appeared in the books of Cheerful Ltd. as on 1st April, 2013:

9% Debentures (face value ₹100) -	₹1,50,000
Debenture Redemption Fund -	₹75,000
Debenture Redemption Fund Investment - (in 8% Government Bonds of the face value of ₹90,000)	₹75,000

Interest on the debentures was payable on 30th September and 31st March and interest on Government Bonds was receivable on the same dates.

On 31st May, 2013 the company purchased for immediate cancellation 250 debentures in the market at ₹95 each cum-interest. The amount required for this was raised by selling 8% Government Bonds of the face value of ₹27,000.

On 31st March, 2013 ₹20,800 was appropriated for the Sinking Fund and on the same date 8% Government Bonds were acquired for the amount plus the interest on investments. The face value of the Government Bonds acquired was ₹28,000.

You are required to show the journal entries and ledger accounts in the books of the company. Ignore Income-tax.

Solution:

Journal Entries

Date	*Particulars*		*Dr. (₹)*	*Cr.(₹)*
2013			₹	₹
May 31	Bank	Dr.	23,750	
	To Debenture Redemption Fund Investment A/c			23,390
	To Interest on Debenture Redemption Fund Investment A/c			360
	(Sale of Debenture Redemption Fund Investments of the face value of ₹ 27,000 at ₹ 23,750 including interest for 2 months upto 31.5.2011)			
"	Debenture Redemption Fund Investment A/c	Dr.	890	
	To Debenture Redemption Fund A/c			890
	(Transfer of profit on sale of Investments to Debenture Redemption Fund Account)			
"	9% Debentures A/c	Dr.	25,000	
	Debenture Interest A/c	Dr.	375	
	To Bank			23,750
	To Profit on Redemption of Debentures A/c			1,625
	(Cancellation of 250 Debentures of ₹ 100 each by purchase at ₹ 95 cum-interest)			
Sep.30	Debenture Interest A/c	Dr.	5,625	
	To Debentureholders (Interest) A/c			5,625
	(Interest due on the outstanding debentures of ₹ 1,25,000 at 9% p.a. for 6 months)			
Sep.30	Debentureholders (Interest) A/c	Dr.	5,625	
	To Bank			5,625
	(Payment made for interest)			
"	Bank	Dr.	2,520	
	To Interest on Debenture Redemption Fund Investment A/c			2,520
	(Receipt of interest on the balance of investments of ₹ 63,000 at 8% p.a. for 6 months)			
2014				
Mar. 31	Debenture Interest A/c	Dr.	5,625	

	To Debentureholders (Interest) A/c			5,625
	(Interest due on the outstanding debentures of ₹ 1,25,000 at 9% p.a. for 6 months)			
"	Debentureholders (Interest) A/c	Dr.	5,625	
	To Bank			5,625
	(Payment made for interest)			
"	Bank	Dr.	2,520	
	To Interest on Debenture Redemption			
	Fund Investment A/c			2,520
	(Receipt of interest on the balance of investments of ₹ 63,000 at 8% p.a. for 6 months)			
"	Profit and Loss A/c	Dr.	11,625	
	To Debenture Interest A/c			11,625
	(Transfer of Debenture Interest to Profit and Loss A/c)			
"	Interest on Debenture Redemption			
	Fund Investment A/c	Dr.	5,400	
	To Debenture Redemption Fund A/c			5,400
	(Transfer of interest received on investment to Debenture Redemption Fund A/c)			
"	Profit and Loss Appropriation A/c	Dr.	20,800	
	To Debenture Redemption Fund A/c			20,800
	(Transfer of annual profit to Debenture Redemption Fund A/c)			
"	Debenture Redemption Fund Investment A/c	Dr.	26,200	
	To Bank			26,200
	(Investment of annual profit and interest received on investment)			
"	Debenture Redemption Fund A/c	Dr.	25,000	
	To General Reserve A/c			25,000
	(Transfer of nominal value of 250 debentures cancelled during the year)			
"	Profit on Redemption of Debentures A/c	Dr.	1,625	
	To Debenture Redemption Fund A/c			1,625
	(Transfer of capital profit on redemption of debentures)			

"	Debenture Redemption Fund A/c Dr.	2,515	
	To Capital Reserve A/c		2,515
	(Transfer of profit of capital profit)		

Ledger Accounts

9% Debentures Account

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
31.5.2013	To Bank	23,375	1.4.2013	By Balance b/d	1,50,000
"	" Profit on Redemption of Debenture A/c	1,625			
31.3.2014	To Balance c/d	1,25,000			
		1,50,000			1,50,000
			1.4.2014	By Balance b/d	1,25,000

Debenture Redemption Fund Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
31.3.2013	To General Reserve A/c	25,000	1.4.2013	By Balance b/d	75,000
"	" Capital Reserve A/c (1,625 + 890)	2,515	31.5.2013	" Profit on Redemption of Debenture A/c	1,625
"	" Balance c/d	76,200		" Deb. Red. Fund Investment A/c (Profit on Sale)	890
			31.3.2014	" Interest on Deb. Red. Fund Investment A/c	5,400
			"	" Profit and Loss Appropriation A/c	20,800
		1,03,715			1,03,715
			1.4.2014	By Balance b/d	76,200

Debenture Redemption Fund Investment Acount

Date	Particulars	₹	Date	Particulars	₹
1.4.2013	To Balance b/d (₹90,000)	75,000	31.5.2013	By Bank	23,390
31.5.2013	" Debenture Red. Fund A/c	890	31.3.2014	" Balance c/d	78,700
31.3.2014	" Bank (28,000)	26,200		(face value ₹91,000)	
		1,02,290			1,02,290
1.4.2014	To Balance b/d	78,700			
	(face value ₹ 91,000)				

Profit on Redemption of Debentures Account

Date	Particulars	₹	Date	Particulars	₹
31.3.2014	To Debenture Redemption Fund A/c	1,625	31.5.2013	By 9% Debentures A/c	1,625
		1,625			1,625

Debenture Interest Account

Date	Particulars	₹	Date	Particulars	₹
30.9.2013	" Debentureholders A/c	5,625			
31.3.2014	" Debentureholders A/c	5,625			
		11,625			11,625

Interest on Debenture Redemption Fund Investment A/c

Date	Particulars	₹	Date	Particulars	₹
31.3.2014	To Debenture Redemption	5,400	31.5.2013	By Bank	360
	Fund A/c (transfer)		30.9.2013	" Bank	2,520
			31.3.2014	" Bank	2,520
		5,400			5,400

Working Notes:

1. Purchase price of 250 Debentures of ₹ 95 each cum-interest = 250 x ₹ 95 = ₹ 23,750 which includes interest on ₹ 25,000 (face value of 250 debentures) at 9% p.a. for the expired period of 2 months (i.e., April and May 2013 amounting to 375 i.e., ₹ 25,000 x 9/100 x 2/12.

Therefore, price actually paid for 250 debentures

= ₹ (23,750 – 375) = ₹ 23,375.

2. Profit on Redemption of Debentures

Face value of 250 debentures cancelled = ₹ 25,000

Less: Price actually paid for 250 debentures = ₹ 23,375

Profit on redemption of 250 debentures = ₹ 1,625

3. Sale proceeds of investments: According to the problem, realised value of investments must be equal to the total amount payable for 250 debentures.

Realised value of investments = ₹ 23,750.

This value includes interest on investments for the expired period of 2 months (April and May) on the face value of investments ₹ 27,000 at 8% p.a. which amounts to ₹ 360, i.e., 27,000 x 8/100 x 2/12.

Therefore, net realised value of investments

= ₹(23,750 - 360) = ₹23,390.

4. Profit on sale of investments: Book value of the investments sold:

$$\left(\text{Rs.}\,27{,}000 \times \frac{\text{Rs.}\,75{,}000}{\text{Rs.}\,90{,}000}\right) = ₹\ 22{,}500$$

But net realised value of the investments = ₹ 23,390

Profit on sale of investments = ₹ (23,390 – 22,500)

= ₹ 890.

Illustration 19 *(Where debentures are purchased as investments and no Sinking Fund exists. This also includes treatment of interest on own debentures).*

In the books of Joy Ltd., the 12% Debentures Account showed a credit balance of ₹ 2,00,000 consisting of 2,000 debentures of ₹ 100 each as on 1st April, 2013.

During the year debentures were purchased in the open market as follows:

1st August, 300 Debentures at ₹ 95 ex-interest.

1st November, 200 Debentures at ₹ 98 cum-interest.

The Debentures, thus, purchased were retained as investments of the company. Interest on debentures was payable half-yearly on 30th September and 31st March every year.

You are required to show the journal entries and the ledger accounts in the books of the company. Ignore Income-tax. Also show how the items would appear in the Balance Sheet.

Solution:

Journal Entries

Date	*Particulars*		*Dr. (₹)*	*Cr.(₹)*
2013				
Aug. 1	Own Debentures A/c	Dr.	28,500	
	Debenture Interest A/c	Dr.	1,200	
	To Bank			29,700
	[Purchase of 300 Debentures of ₹ 100 each at ₹ 95 ex-interest as investments and payment of interest for the expired period of 4 months (i.e., April to July) at 12% p.a.]			

Sep.30	Debenture Interest A/c	Dr.	10,800	
	To Debentureholders A/c			10,200
	To Interest on Own Debentures A/c			600
	(Interest due @ 12% on ₹ 1,70,000 held by outsiders for 6 months and on ₹ 30,000 held by the company for 2 months)			
"	Debentureholders A/c	Dr.	10,200	
	To Bank			10,200
	(Payment made for interest due to outsiders)			
Nov. 1	Own Debentures A/c	Dr.	19,400	
	Debenture Interest A/c	Dr.	200	
	To Bank			19,600
	[Purchase of 200 Debentures of ₹ 100 each at ₹ 98 cum-interest as investments including payment of interest for the expired period of one month (i.e., October) at 12% p.a.]			
2014				
Mar. 31	Debenture Interest A/c	Dr.	11,800	
	To Debentureholders A/c			9,000
	To Interest on Own Debentures A/c			2,800
	(Interest due @ 12% p.a. on ₹ 1,50,000 held by outsiders and out of ₹ 50,000 held by the company on ₹ 30,000 for 6 months and on ₹ 20,000 for 5 months)			
"	Debentureholders A/c	Dr.	9,000	
	To Bank			9,000
	(Payment made for Interest due to outsiders)			
"	Profit and Loss A/c	Dr.	24,000	
	To Debenture Interest A/c			24,000
	(Transfer of Debenture Interest to Profit and Loss Account)			
"	Interest on Own Debentures A/c	Dr.	3,400	
	To Profit and Loss A/c			3,400
	(Transfer of Interest saved on Own Debentures to Profit and Loss Account)			

Ledger Accounts

12% Debentures Account

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
31.3.2014	To Balance c/d	2,00,000	1.4.2013	By Balance c/d	2,00,000
		2,00,000			2,00,000
			1.4.2014	By Balance b/d	2,00,000

Own Debentures Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
1.8.2013	To Bank	28,500	31.3.2014	By Balance c/d	47,900
1.11.2013	To Bank	19,400			
		47,900			47,900
1.4.2014	To Balance b/d	47,900			

Interest on Own Debenture Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
31.3.2014	To Profit and Loss A/c	3,400	30.9.2013	By Debenture Interest A/c	600
			31.3.2014	“ Debenture Interest A/c	2,800
		3,400			3,400

Debenture Interest Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
1.8.2013	To Bank A/c	1,200	31.3.2014	By Profit and Loss A/c	24,000
30.9.2013	To Debentureholders A/c	10,200			
“	” Interest on Own Debentures A/c	600			
1.11.2013	“ Bank	200			
31.3.2014	“ Debentureholders A/c	9,000			
“	” Interest on Own Debentures A/c	2,800			
		24,000			24,000

Balance Sheet of Joy Ltd. as at 31st March, 2014

I. Equities and Liabilities			
(1) Non- current liability			
Long term borrowings	1	2,00,000	

II. ASSETS		
(1) Non –current assets		
Non-Current investment Own Debentures		
(Face value ₹ 50,000)	47,900	

Notes

1. Long term borrowings

   2,000, 12% Debentures of ₹ 100 each fully paid up 2, 00,000

Illustration 20 *(Cancellation of Own Debentures on a subsequent date where Sinking Fund does not exist)*

Continuing Illustration No. 19, if the Debentures held by the company are cancelled on 31st March, 2014, show the necessary journal entries on cancellation and the effect of the same in the Balance Sheet of the company.

Solution:

In addition to the entries made in Illustration No. 19 above, the following entries are required to be passed in the books of the company on cancellation of its Own Debentures:

Journal Entries

Date	*Particulars*		*Dr.* (₹)	*Cr.*(₹)
2014				
Mar. 31	12% Debentures A/c	Dr.	50,000	
	To Own Debentures A/c			47,900
	To Profit on Redemption of Debentures A/c			2,100
	(Cancellation of 500 debentures purchased by the company as its investments at a cost of ₹47,900 resulting into a gain of ₹ 2,100)			
"	Profit on Redemption of			
	Debentures A/c	Dr.	2,100	
	To Capital Reserve A/c			2,100
	(Transfer of capital profit resulting from cancellation of own debentures to Capital Reserve Account)			
"	Profit & Loss Appropriation A/c	Dr.	50,000	
	To Debenture Redemption Reserve A/c			50,000
	(Amount equal to the nominal value of debentures redeemed transferred to DRR)			

Ledger Accounts

12% Debentures Account

Dr.					*Cr.*
Date	*Particulars*	₹	*Date*	*Particulars*	₹
31.3.2010	To Balance c/d	2,00,000	1.4.2009	By Bank	2,00,000
31.3.2014	To Own Debentures A/c	47,900	1.4.2013	By Balance c/d	2,00,000
"	" Profit on Redemption of Debentures A/c	2,100			
"	" Balance c/d	1,50,000			
		2,00,000			2,00,000
			1.4.2014	By Balance b/d	1,50,000

Own Debentures Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
1.8.2013	To Bank	28,500	31.3.2014	By 12% Debentures A/c	47,900
1.11.2013	" Bank	19,400			
		47,900			47,900

Balance Sheet of Joy Ltd. as at 31st March, 2012

I. EQUITIES AND LIABILITIES

	Note	₹
(1) Shareholder's funds		
(a) Reserve and Surplus	1	52,000
(2) Non- current liability		
Long term borrowings	2	1,50,000

Notes

1. Reserve and surplus	
Capital Reserve	2,000
Debenture Redemption Reserve	50,000
	52,000
2. Long term borrowings	
1,500 Debentures of ₹ 100 each fully paid up	1,50,000

Illustration 21 *(When Debentures are purchased as investments of Sinking Fund)*

Confident Ltd. had 2,000 12% Debentures of ₹ 100 each outstanding as on 1st April 2013. The following other balances also appeared in the books of the company on this date:

Debentures Redemption Fund Account	₹ 1,00,000
Debentures Redemption Fund Investments:	

12% Port Trust Bonds (face value ₹ 60,000)	₹ 55,000
Own Debentures (face value ₹ 50,000)	₹ 45,000

Interest on the debentures was payable on 30th September and 31st March and interest on Port Trust Bonds was received on the same dates.

On 1st August, 2013, ₹ 20,000, 12% Port Trust Bonds were sold at ₹ 95 ex-interest and the amount realised was invested in Own Debentures at ₹ 97 cum-interest. During the year a sum of ₹ 5,800 was appropriated for the Sinking Fund which together with the interest received on Sinking Fund during the year was invested in Own Debentures at ₹ 95 each.

You are required to show the journal entries and ledger accounts in the books of the company. Also show how the items will appear in the Balance Sheet of the company. Ignore Income-tax.

Solution:

Journal Entries

Date	*Particulars*		*Dr. (₹)*	*Cr.(₹)*
2013				
Aug. 1	Bank	Dr.	19,800	
	To Debenture Redemption Fund Investment (Bonds) A/c			19,000
	To Interest on Debenture Redemption Fund Investment A/c			800
	[Sale of ₹20,000 12% Port Trust Bonds at ₹95 Ex-interest and receipt of accrued interest for the expired period of 4 months, (April to July) at 12%]			
"	Debenture Redemption Fund Investment			
	(Bonds) A/c	Dr.	667	
	To Debenture Redemption Fund A/c			667
	(Transfer of profit on sale of investments to Debenture Redemption Fund A/c)			
"	Debenture Redemption Fund Investment			
	(Own Debenture) A/c	Dr.	18,600	
	Debenture Interest A/c	Dr.	800	
	To Bank			19,400
	(Purchase of 200 debentures of ₹100 each at ₹ 97 cum- interest as investment of Sinking Fund)			
Sep.30	Debenture Interest A/c	Dr.	11,200	
	To Debenture Redemption Fund A/c			3,400
	To Debentureholders A/c			7,800
	(Interest due on ₹1,30,000 debentures held by			

	outsiders for 6 months at 12% and on ₹70,000 debentures held by the company on ₹50,000 for 6 months at 12% and on ₹20,000 for 2 months at 12%)			
"	Debentureholders A/c	Dr.	7,800	
	To Bank			7,800
	(Payment made for interest due to outsiders)			
"	Bank	Dr.	2,400	
	To Interest on Debenture Redemption Fund Investment A/c			2,400
	(Receipt of interest on balance ₹ 40,000 Port Trust Bonds for 6 months at 12% p.a.)			
2014				
Mar. 31	Debentures Interest A/c	Dr.	12,000	
	To Debenture Redemption Fund A/c			4,200
	To Debentureholders (Interest) A/c			7,800
	(Interest due on ₹ 1,30,000 debentures held by outsiders and ₹ 70,000 debentures held by the company for 6 months at 12% p.a.)			
"	Debentureholders A/c	Dr.	7,800	
	To Bank			7,800
	(Payment made for interest due to outsiders)			
"	Bank	Dr.	2,400	
	To Interest on Debenture Redemption Fund Investment A/c			2,400
	(Receipt of interest on balance ₹ 40,000 Port Trust Bonds for 6 months at 12% p.a.)			
"	Interest on Debenture Redemption Fund Investment A/c	Dr.	5,600	
	To Debenture Redemption Fund A/c			5,600
	(Transfer of interest received on investment to Debenture Redemption Fund Account)			
"	Profit and Loss Appropriation A/c	Dr.	5,800	
	To Debenture Redemption Fund A/c			5,800
	(Transfer of annual profits to Debenture Redemption Fund A/c)			
"	Debenture Redemption Fund Investment (Own Debentures) A/c	Dr.	19,000	

	To Bank			19,000
	(Investment of current year's instalment plus interest received on investment by purchase of 200 own debentures @ ₹ 95)			
"	Profit and Loss A/c	Dr.	24,000	
	To Debenture Interest A/c			24,000
	(Transfer of Debenture Interest to Profit and Loss A/c)			
"	Debenture Redemption Fund A/c	Dr.	667	
	To Capital Reserve			667
	(Transfer of profit on sale of investments)			

Ledger Accounts

Debenture Redemption Fund Account

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
31.3.2014	To Capital Reserve (Profit on sale)	667	1.4.2013	By Balance b/d	1,00,000
"	To Balance c/d (Bond) A/c	1,19,000	1.8.2013	" Debenture Redemption Fund Investment	667
			30.9.2013	" Debenture Interest A/c (Interest on Own Debentures)	3,400
			31.3.2014	" Debenture Interest A/c (Interest on Own Debentures)	4,200
			"	" Interest on Debenture Redemption Fund Investment A/c	5,600
			"	" Profit and Loss Appropriation A/c	5,800
		1,19,667			1,19,667
			1.4.2014	" Balance b/d	1,19,667

6% Debentures Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
31.3.2014	To Balance c/d	2,00,000	1.4.2013	By Balance b/d	2,00,000
		2,00,000			2,00,000
			1.4.2014	By Balance b/d	2,00,000

Debenture Redemption Fund Investment

(Port Trust Bonds) Account

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
1.4.2013	To Balance b/d (face value ₹ 60,000)	55,000	1.8.2013	By Bank (face value ₹ 20,000)	19,000
1.8.2013	To Debenture Redemption Fund A/c (Profit on sale)	667	31.3.2014	By Balance c/d (face value ₹ 40,000)	36,667
		55,667			55,667
1.4.2014	To Balance b/d	36,667			

Debenture Redemption Fund Investment

(Own Debentures) Account)

Date	*Particulars*	₹	*Date*	*Particulars*	₹
1.4.2013	To Balance b/d (face value ₹ 50,000)	45,000	31.3.2014	By Balance c/d (face value ₹ 90,000)	83,000
1.8.2013	To Bank (face value ₹ 20,000)	19,000			
31.3.2014	To Bank (face value ₹ 20,000)	19,000			
		83,000			83,000
1.4.2014	To Balance b/d	83,000			

Interest on Debenture Redemption Fund Investment Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
31.3.2014	To Debenture Redemption Fund A/c	5,600	1.8.2013	By Bank (on ₹ 20,000 for 4 months)	800
			30.9.2013	" Bank (on ₹ 40,000 for 6 months)	2,400
			31.3.2014	" Bank (on ₹ 40,000 for 6 months)	2,400
		5,600			5,600

Debenture Interest Account

Date	Particulars	₹	Date	Particulars	₹
1.8.2013	To Bank	800	31.3.2012	By Profit and Loss A/c	24,000
30.9.2013	" Deb. Red. Fund A/c	3,400			
30.9.2013	" Debentureholders (Interest) A/c	7,800			
31.3.2014	" Deb. Red. Fund A/c	4,200			
"	" Debentureholders (Interest) A/c	7,800			
		24,000			24,000

Balance Sheet of Confident Ltd. as at 31st March, 2014

	Note	₹
I. EQUITY AND LIABILITIES		
1. Shareholders fund		
(a) Reserve and Surplus	1	1,19,667
2. Non-current liabilities		
(a) Long term borrowings	2	2,00,000
II. ASSETS		
(1) Non-current Assets		
(a) Non-current Investment	3	1,19,667

Notes

1. Reserve and surplus		
Capital reserve	667	
Debenture redemption fund	1,19,000	1,19,667
2. Long term borrowings		
2,000 12% Debentures of ₹100 each fully paid-up		2,00,000
3. Non-current investment		
Debenture Redemption Fund Investment A/c	36,667	
Post Trust Bonds (Face value ₹ 40,000)		
Own Debentures		
(Face value ₹90,000)	83,000	1,19,667

Working Notes:

1. Sale proceeds of ₹20,000 Port Trust Bonds:

$$₹\ 20,000 \times \frac{95}{100} = ₹\ 19000$$

2. Interest accrued on 20,000 Port Trust Bonds sold for the expired period of 4 months (i.e., April to July) at 12%

$$= \left(₹\ 20{,}000 \times \frac{12}{100} \times \frac{4}{12}\right) = ₹800$$

3. Profit on sale of 200 Port Trust Bonds: Purchase price of 20,000 Port Trust Bonds

$$\frac{₹\,55{,}000}{60{,}000} \times 20{,}000 = ₹18{,}333$$

Sale proceeds of Port Trust Bonds = ₹19,000

∴ Profit on sale of Port Trust Bonds = ₹ (19,000 - 18,333) = ₹667

4. Cost of 200 Own Debentures purchased on 1st August = 200 x ₹97 = ₹19,400 which includes interest for expired period of 4 months (i.e., April to July) amount to

$$= \left(20{,}000 \times \frac{12}{100} \times \frac{4}{12}\right) = ₹800$$

Actual cost price of 200 debentures = ₹ (19,400 - 400) = ₹19,000

5. Sinking Fund invested on 31.3.2008 = Annual appropriation of Profit + Interest on Investments of ₹1,10,000 (face value) at 12% p.a. i.e. ₹ (5,800 + 13,200) = ₹19,000.

6. Face value of Debentures purchased = ₹19,000 x = ₹20,000

Illustration 22 (Cancellation of Own Debentures on a subsequent date where Sinking Fund exists).

Continuing Illustration No. 21 if Own Debentures held by the company are cancelled on 31st March, 2014, show the necessary journal entries on cancellation and the effect of the same in the Balance Sheet of the Company.

Solution:

In addition to the entries made in Illustration No. 21 above, the following entries are required to be passed in the books of the company on cancellation of its own debentures:

Journal Entries

Date	*Particulars*		*Dr. (₹)*	*Cr.(₹)*
2014				
Mar. 31	12% Debentures A/c	Dr.	90,000	
	To Debenture Redemption Fund Investment (Own Debentures) A/c			83,000
	To Profit on Redemption of Debentures A/c			7,000
	(Cancellation of 900 12% Debentures of ₹ 100 each purchased by the company at a cost of ₹ 83,000 resulting into a gain of ₹ 7,000)			
“	Profit on Redemption of Debentures A/c	Dr.	7,000	
	To Debenture Redemption Fund A/c			7,000

	(Transfer of capital profit resulting from cancellation of own debentures to Debenture Redemption Fund Account)			
"	Debentures Redemption Fund Account	Dr.	97,667	
	To General Reserve A/c			90,000
	To Capital Reserve			7,667
	(Transfer of nominal value of debentures, cancelled during the year to General Reserve A/c and capital profit to Capital Reserve out of Debenture Redemption Fund Account)			

Ledger Accounts

12% Debentures Account

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
31.3.2014	To Debenture Redemption Fund Investment (Own Debentures) A/c	83,000	1.4.2013	By Balance b/d	2,00,000
"	" Profit on Redemption of Debentures A/c	7,000			
"	" Balance c/d	1,10,000			
		2,00,000			2,00,000
			1.4.2014	By Balance b/d	1,10,000

Debenture Redemption Fund Investment (Own Debentures) Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
1.4.2013	To Balance b/d (face value ₹ 50,000)	45,000	31.3.2014	By 12% Debentures A/c	83,000
1.8.2013	To Bank (face value ₹ 20,000)	19,000			
31.3.2014	To Bank (face value ₹ 20,000)	19,000			
		83,000			83,000

Debenture Redemption Fund Account

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
31.3.2014	To General Reserve A/c	90,000	1.4.2013	By Balance b/d	1,00,000
	" Capital Reserve A/c	7,667	1.8.2013	" Debenture Redemption	

	" Balance c/d (Bond) A/c	29,000			Fund Investment	667
			30.9.2013	"	Debenture Interest A/c (Interest on Own Debentures)	3,400
			31.3.2014	"	Debenture Interest A/c (Interest on Own Debentures)	4,200
			"	"	Interest on Debenture Redemption Investment A/c	5,600
			"	"	Profit on Redemption of Debentures A/c	7,000
			"	"	Profit and Loss Appropriation A/c	5,800
		1,26,667				1,26,667
			1.4.2014	By	Balance b/d	29,000

Balance Sheet of Confident Ltd. as at 31st March, 2014

I. EQUITY AND LIABILITIES		
(1) Shareholders fund		
(a) Reserve and Surplus	1	1,26,667
(2) Non-current liabilities		
(a) Long term borrowings	2	1,10,000
II. ASSETS		
(a) Non-current Investment	3	36,667
Notes		
1. Reserve and Surplus		
Capital reserve	7,667	
General reserve	90,000	
Debenture redemption fund	29,000	1,26,667
2. Long term borrowings		
1,100 12% Debentures of ₹ 100 each fully paid-up		1,10,000
3. Non-current investments		
Debenture Redemption Fund Investment A/c		36,667
Post Trust Bonds (Face value ₹ 40,000)		

CONVERSION OF DEBENTURES INTO SHARES

According to the terms of issue of the debentures, the debentureholders may be given the right to exercise the option to convert their debentures into equity shares or preference shares at a stipulated rate within a specified period. If the debentureholders find the offer is beneficial to them, they will exercise their right and opt for shares, otherwise they may not exercise their right. According to section 71 of the Companies Act, 2013, a company may issue debentures with an option to convert debentures into shares either wholly or partly at the time of redemption.

For example, X Ltd. issued 12% Debentures at a discount of 10% and the debentureholders were given the right to exercise the option of converting the debentures into 14% Preference Shares of ₹ 100 each to be issued at a premium of 10%. The holders of ₹ 33,000 debentures expressed their willingness to exercise the option. In such a case, the number of preference shares to be issued in exchange of ₹ 33,000 debentures will be calculated in the following way:

		₹
Face value of debentures to be converted	=	33,000
Less: Discount allowed @ 10% on issue	=	3,300
Actual amount received on issue of the debentures	=	29,700

Now, the issue price of preference shares will be as follows:

	₹
Face value of preference shares	100
Add: Premium @ 10%	10
	110

Therefore, number of preference shares to be issued in exchange of ₹ 33,000 debentures = ₹ 29,700/110 = 270

	₹
Thus, face value of 270 preference shares	27,000
Add: premium @ 10%	2,700
	29,700

In case, the debentures are due for redemption, conversion of debentures into shares, may be made on the basis of terms and conditions mutually agreed upon at the time of redemption. In such a case, even debentures originally issued at a discount can be converted into shares on the basis of the nominal value of the debentures.

Accounting Entry for Conversion

At the time of conversion, new shares can be issued at par or at a premium only. As per Companies Act, 2013 issue of shares at discount is prohibited. The accounting entry for all these cases will be as follows:

1. If shares are issued at par

Debentures A/c	Dr.	with the nominal value of the debentures converted
To Share Capital Account		with the nominal amount of shares issued

2. If shares are issued at a premium

Debentures A/c	Dr.	with the nominal value of the debentures converted

To Share Capital Account	with the nominal amount of shares issued
To Securities Premium Account	with the difference

Note: If the debentures to be converted were issued at a discount, Share Capital A/c should be credited with the amount of cash originally realised on the debentures and Discount on Issue of Debentures A/c should be credited with the amount of discount allowed on those debentures.

Illustration 23

On 1st April, 2013, Green Ltd. issued 2500 12% Debentures of ₹ 100 each at ₹ 95. Holders of these debentures have an option to convert their holdings into 14% Preference Shares of ₹ 100 each at a Premium of ₹ 25 per share at any time within three years.

On 31st March, 2014, holders of 500 Debentures notified their intention to exercise the option.

Show the journal entries relating to the issue and conversion of debentures in the books of the company. Also show how the items affected would appear in the company's balance sheet.

Solution:

Journal Entries

Date	*Particulars*		*Dr. (₹)*	*Cr.(₹)*
2013				
April 1	Bank	Dr.	2,37,500	
	To 12% Debentures Application and Allotment A/c			2,37,500
	(Receipt of application money on 2,500 debentures @ ₹ 95 each)			
"	12% Debentures Application and	Dr.	2,37,500	
	Allotment A/c			
	Discount on Issue of Debentures A/c	Dr.	12,500	
	To 12% Debentures A/c			2,50,000
	(Allotment of 2,500 debentures of ₹100 each issued at a discount of ₹5 each as per Board's resolution dated....)			
2014				
Mar. 31	12% Debentures A/c	Dr.	50,000	
	To Discount on Issue of Debentures A/c			2,500
	To 14% Preference Share Capital A/c			38,000
	To Securities Premium A/c			9,500
	(Conversion of 500 Debentures of ₹ 100 each issued at a discount of 5 each for 380 14% Preference Shares of 100 each at a premium of ₹ 25 each as per Board's resolution dated....)			

Balance Sheet of Green Ltd. as at 31st March, 2014

I. EQUITY AND LIABILITIES			
(1) Shareholders fund			
(a) Share Capital	1	38,000	
(b) Reserve and Surplus	2	9,500	
2. Non- current liabilities			
Long term borrowings	3	2,00,000	
II. ASSETS			
Non-current Assets			
Other non-current assets	4	10,000	
Notes			
1. Share Capital			
14% 380 Preference share of ₹ 100 each		38,000	
2. Reserve and Surplus			
Securities Premium Account		9,500	
3. Long term borrowings			
2,000 12% Debentures of ₹ 100 each fully paid-up		2, 00,000	
4. **Other non-current assets**			
Discount on issue of shares		10,000	
Working Notes:			
Number of 14% Preference Shares has been arrived at as follows:			
			₹
Amount received on issue of 500 debentures (500 x ₹ 100)			50,000
Less: Discount allowed on 500 debentures (500 x ₹ 5)			2,500
Amount actually received			47,500
Issue Price of 14% Preference Shares:			
Face value per share			100
Add: Premium per share			25
Issue price			125
Therefore the number of preference shares issued in exchange of ₹ 50,000 debentures			
= 47,500/125 = 380			
Preference Share Capital = ₹ 380 x 100 = ₹ 38,000			
Securities Premium = 380 x ₹ 25 = ₹ 9,500.			

Note: Whether debentures were issued at discount or at premium becomes irrelevant if conversion into shares takes place at the time of redemption of debenture is due. Suppose in 2008 10,00,000 debentures were issued at a discount of 5% with a term of 6 years. If in 2013, when the redemption is due, debentureholders are allowed to convert the debentures into shares, the relevant amount will be the face value of the debentures (or rather the figure at which they are to be redeemed). If shares are to be issued at par, debentureholders will get shares equal to par value with the amount of the debentures to be converted.

Illustration 24

Swathi Ltd.

Balance Sheet as at 1st April, 2014

I. EQUITY AND LIABILITIES		
(1) Shareholder's fund		
(a) Share Capital	1	5,00,000
(b) Reserve and Surplus	2	12,50,000
(2) Non-current liabilities		
Long term borrowings	3	15,00,000
3. Current Liabilities		
Other current Liability		12,50,000
TOTAL		**45, 00,000**
II. ASSETS		
1. Non-current assets		
(a) Fixed Assets Tangible (net)		18,00,000
(b) Non-current investment	4	4,00,000
2. Current assets		
Cash and cash equivalents		5,00,000
Other current assets		18,00,000
TOTAL		**45,00,000**
Notes		
1. Share Capital		
Share capital of ₹ 10 each		5,00,000
2. Reserve and Surplus		
General reserve	7,50,000	
Debenture redemption fund	5,00,000	12,50,000
3. Long term borrowings		
12% convertible debentures	10,00,000	
Unsecured loans	5,00,000	15,00,000
4. Non-current investment		
Debentures redemption fund investment		4,00,000

The debentures are due for redemption on 1st April, 2014. According to the terms of issue of debentures, they were redeemable at a premium of 5% and also conferred option to the debentureholders to convert 20% of their holdings into equity shares at a predetermined price of ₹ 15.75 per share and the payment in cash.

Assuming that:

(i) Except for 100 debentureholders holding 2,500 debentures, the rest of them exercised the option for maximum conversion.

(ii) The investments realise ₹ 4,40,000 on sale and

(iii) All transactions are put through, on 1st April, 2014.

You are required to redraft the balance sheet of the company as on 1st April, 2014 after giving effect to the redemption. Also show the number of equity shares to be allotted and the cash payment necessary.

Solution:

Working notes:

(i) Calculation of number of shares to be allotted:

Total number of debentures	10,000
Less: Numbers not opting for conversion	2,500
	7,500
20% thereof to be ...... into equity shares	1,500
Amount paid for 1,500 debentures i.e. 1500 x @ ₹ 105	1,57,500

Number of equity shares to be allotted:

1,57,500/15.75 = 10,000 shares of ₹ 10 each.

(ii) Calculation of cash to be paid:

Number of debentures	10,000
Less: Number of debentures to be converted into equity shares	1,500
Number of debentures to be redeemed	8,500

Redemption value = 8,500 x ₹ 105 = ₹ 8,92,500.

(iii) Cash at Bank:

Cash balance	5,00,000
Add: Sale of investment	4,40,000
	9,40,000
Less: Cash paid to debenture holders	8,92,500
	47,500

(iv) Calculation of General Reserve:

Opening of balance	7,50,000
Debenture Redemption Fund (transfer)	5,00,000
	12,50,000

(v) Securities Premium:

Issue of shares on conversion	57,500
Less: Premium on Redemption of Debentures	50,000
	7,500

Swathi Ltd.

Balance Sheet as at 1st April, 2014

I. EQUITY AND LIABILITIES		
(1) Share holder's fund		
(a) Share Capital	1	6,00,000
(b) Reserve and Surplus	2	12,97,500
(2) Non-current liabilities		
Long term borrowings	3	5,00,000
3. Current Liabilities		
Other current Liability		12,50,000
TOTAL		**36,47,500**
II. ASSETS		
1. Non –current assets		
(a) Fixed Assets		
Tangible (net)		18,00,000
2. Current assets		
Cash and cash equivalents		47,500
Other current assets		18,00,000
TOTAL		**36,47,500**
Notes		
1. Share Capital		
Share capital of ₹ 10 each		6,00,000
2. Reserve and Surplus		
Capital reserve	40,000	
General reserve	12,50,000	
Securities premium	7,500	12,97,500
3. Long term borrowings		
Unsecured loans		5,00,000

LESSON ROUND UP

– Debentures may be issued at par, or at a premium, or at a discount.

– Debentures may be issued by a company for cash, for consideration other than cash, and as collateral security.

– The issue of debentures to vendors is known as issue of debentures for consideration other than cash.

– The term 'Collateral Security' implies additional security given for a loan. When a company takes a loan from bank or insurance company, it may issue its own debentures to the lender as collateral security against the loan in addition to any other security that may be offered, such an issue of debentures is known as "Debentures Issued as Collateral Security.

– A company may issue debentures on any specific condition as to its redemption such as: issued at par and redeemable at par, issued at discount redeemable at par, issued at premium redeemable at par, issued at par redeemable at premium, issued at discount, but redeemable at premium.

– When a company issues debentures it undertakes to pay interest thereon at a fixed percentage. The payment of interest on the debt is obligatory on the part of the company issuing them irrespective of the fact whether the company earns profit or not and the interest payable on debentures is a charge against the profits of the company.

– Discount on issue of debentures is a capital loss of the company and it is required to be shown on the assets side of the Balance Sheet under the heading "Other Current or Non Current Asset" until it is written off.

– When a company issues debentures at par or at a discount which are redeemable at a premium, the premium payable on redemption of the debentures is be treated as capital loss.

– Redemption of debentures refers to the discharge of the liability in respect of the debentures issued by a company. Debentures can be redeemed at any time either at par or at a premium or at a discount.

– Debentures may be redeemed by way of : annual drawings, payment in one lump sum at the expiry of a specified period or at the option of the company at a date within such specified period, purchase of debentures in the open market and conversion into shares.

– Interest on debentures is generally paid half-yearly to the holders on certain specified dates. If the purchase price for the debentures includes interest for the expired period, the quotation is said to be "Cum-interest", on the other hand, the purchase price for the debentures excludes the interest for the expired period, the quotation is said to be "Ex-interest".

SELF TEST QUESTIONS

(These are meant for re-capitulation only. Answers to these questions are not to be submitted for evaluation)

1. In April 2009, a company issues 13% ₹ 20, 00,000 debentures at ₹ 96 but redeemable at ₹ 103. Redemption will be carried out by annual drawings of ₹ 4 lacs (face value) commencing at the end of March 2014. What do you recommend as the amount to be charged to the profit and loss account, apart from that of interest?

[Ans.: ₹ 20,000 p.a. from March 2010 to March 2014, ₹ 16,000 in March 2015, ₹ 12,000 in March 2016, ₹ 8,000 in March 2017, ₹ 4,000 March in 2018].

2. 40 lakhs 10% debentures are outstanding in the balance sheet of a company on 31st March, 2013. The company had not paid the six months interest after 30th June, 2013. State the amount of interest on debentures accrued and due as well as interest accrued but not due on 31st March, 2014.

   [Ans.: Interest accrued and due ₹ 2,00,000;

   Interest accrued but not due ₹ 1,00,000].

3. Calculate the amount of discount to be written off each year on the debentures of ₹ 60,00,000 issued on 1.1.2014 at a discount of 5% repayable in annual drawings of ₹ 10,00,000 each year. Accounting period ends on 31st December.

   [Ans.: Ratio - 6 : 5 : 4 : 3 : 2 : 1; Discount Amount : I - ₹ 85,714;

   II - ₹ 71,429; III - ₹ 57,143; IV - ₹ 42,857;

   V - ₹ 28,571 and VI - ₹ 14,286].

4. (a) A company issues 11% ₹ 10,00,000 Debentures, repayable at the end of 10 years at a premium of 5%. It decides to establish a sinking fund to take care of the redemption. Investments in readily marketable securities yield 6% per annum. Sinking Fund Table shows that ₹ 0.075868 annually is required to produce ₹ 1 at the end of 10 years @ 6%. What is the annual amount that has to be set aside and what account will be debited for credit to the Sinking Fund (Debenture Redemption Fund) A/c?

   (b) If investments are made to the nearest ₹ 100, how much will be invested at the end of the 3rd year in the above case?

   [Ans.: (a) ₹ 79,661.40, debit Profit & Loss

   Appropriation A/c; (b) ₹ 89,500].

5. (a) Wye Ltd. has 12% ₹ 10,00,000 Debentures at issue. For the purpose of redemption it maintains a Debenture Redemption Fund with an annual contribution of ₹ 90,000. On 1st April, 2013 the Fund stood at ₹ 4,50,000 represented by 6% ₹ 5,00,000 Government Loan. At what figure would the Debenture Redemption Fund stand at the end of March 2014?

   (b) In the above case, on 1st April, 2014, ₹ 1,00,000 Government Loans was sold @ 93.50 and the proceeds were, utilised to purchase debentures for cancellation @ 85. What is the amount of debentures, face value, that has been cancelled.

   [Ans.: (a) ₹ 5,40,000; (b) ₹ 1,10,000].

6. (a) Zed Ltd. shows in its balance sheet 9% ₹ 30,00,000 Debentures; interest on these is payable on 31st March and 30th September. On 1st June, 2013 the company purchased as investment ₹ 50,000 of the debentures @ 89. What is the profit accruing to the company as a result?

   (b) Continuing the above, at what figure will the debentures appear in the balance sheet?

   [Ans.: (a) Nil; (b) Liabilities side: ₹ 30,00,000; Assets Side; ₹ 44,500 (Own Deb. Ex-interest)
   Cum-interest ₹ 43,750 (44,500 - 750)].

7. (a) Exe Ltd. purchased its own 12% Debentures (interest payable on 30th September and 31st March) as Sinking Fund Investment as shown below:

   (1) 1st August, 2013 ₹ 60,000 @ 94.

   (2) 31st December, 2012 ₹ 40,000 @ 95 cum-interest.

   The total amount of debentures outstanding on 1st April, 2013 was ₹ 10,00,000. How much will be credited to the Sinking Fund in 2013-14 by way of interest resulting from the above two transactions?

(b) On 31st March, 2014 at what figure the investment in Own Debentures stand in the above case?

[Ans.: (a) ₹ 6,000 (b) 93,200].

8. Ess Ltd. pays interest on its 12% Debentures on 30th September and 31st March. To redeem the debentures it has maintained a sinking fund which stood on 31st December, 2013 at ₹ 2,70,000 represented by 6% Government Loan of the nominal value of ₹ 3,00,000 (interest payable on the same dates as for debentures).

   On 1st January, 2014, the company purchased ₹ 1,00,000 of its debentures @ 96, raising the necessary funds by selling Government Loan @ 92.5 (to the nearest ₹ 100). What is the nominal value of the Govt. Loan sold and what is the profit/loss on the sale?

   (Hint: Every ₹ 100 of Debentures requires ₹ 99 i.e. ₹ 96 plus ₹ 3 for interest. Every ₹ 100 of Government Loan will yield ₹ 94 i.e. the price stated plus ₹ 1.50 interest for 3 months).

   [Ans.: ₹ 1,05,300; Profit ₹ 2,632.5].

9. P. Ltd. issued ₹ 10,00,000 13.5% Debentures at a discount of 5%; the debentureholders have an option of converting the amount into ₹ 10 equity shares at a premium of 10%. A debentureholder holding ₹ 40,000 debentures wishes to exercise the option. How many shares will he get?

   [Ans.: 3,454].

10. In 2010 Gee Ltd. issued 10% ₹ 20,00,000 debentures at a discount of 10%; the debentures were redeemable in 2014. In 2014 the company gave the debentureholders the option of converting the debentures into equity shares at a premium of 25%. One debentureholder holding ₹ 1,00,000 Debentures wants to exercise the option. What is the face value of the shares that he will get?

    [Ans.: ₹ 80,000].

Lesson 3

FINAL ACCOUNTS OF COMPANIES

LESSON OUTLINE

- Introduction
- Preparation and presentation of financial statements
- Schedule III of the Companies Act, 2013
- True and fair view of financial statements
- Treatment of special items under companies Act, 2013
- Illustrations
- Profit or loss prior to incorporation
- Preliminary Expenses
- Lesson Round Up
- Self Test Questions

LEARNING OBJECTIVES

The financial statements are the end products of accounting process. They are prepared following the consistent accounting concepts, principles, procedures and also the legal environment in which the business organisations operate. These statements are the outcome of the summarizing process of accounting and therefore, are the sources of information on the basis of which conclusions are drawn about the profitability and the financial position of a company. Hence, they need to be arranged in a proper form with suitable contents so that the shareholders and other users of financial statements can easily understand and use them in their economic decisions in a meaningful way. The objective of this lesson is to make the students understand the statutory provisions regarding preparation of final accounts of companies. After going through this lesson, the one should be able to – Familiarize and understand with the requirements of preparation of statement of Profit and Loss and Balance Sheet, appreciate the importance and modes of making different adjustments in the final account, apportion the profit of a company between pre-incorporation period and post incorporation period etc.

INTRODUCTION

There is no legal obligation for sole proprietorship and partnership firm to prepare final accounts, but companies have statutory obligations to keep proper books of account and to prepare its final accounts every year in the manner as prescribed in the Companies Act. Chapter IX, sections 128 to 138 of the Companies Act, 2013 deals with the legal provisions relating to the Accounts of Companies. These sections including Schedule II and III were brought into force from 1st April 2014. The relevant rules pertaining to these provisions have also been notified. All these relevant provisions/schedules and rules will be applicable for the financial years commencing on or after 1st April 2014. It is clarified that in respect of financial years that commenced earlier than 1st April 2014, shall be governed by the relevant provisions/schedules and rules of the Companies Act, 1956.

Preparation and presentation of financial statements

Section 129 of the Companies Act 2013 governs the preparation and presentation of financial statements of the company.

(1) The financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III.

- the items contained in such financial statements shall be in accordance with the accounting standards.
- nothing contained in this sub-section shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of financial statement has been specified in or under the Act governing such class of company.
- the financial statements shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose –
  a) in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938, or the Insurance Regulatory and Development Authority Act, 1999;
  b) in the case of a banking company, any matters which are not required to be disclosed by the Banking Regulation Act, 1949;
  c) in the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by the Electricity Act, 2003;
  d) in the case of a company governed by any other law for the time being in force, any matters which are not required to be disclosed by that law.

According to the rules for the purposes of sub-section (1) of section 129, the class of companies as may be notified by the Central Government from time to time, shall mandatorily file their financial statements in Extensible Business Reporting Language (XBRL) format and the Central Government may specify the manner of such filing under such notification for such class of companies. The term 'Extensible Business Reporting Language' means a standardized language for communication in electronic form to express, report or file financial information by companies under this rule.

(2) At every annual general meeting of a company, the Board of Directors of the company shall lay before such meeting financial statements for the financial year.

(3) Where a company has one or more subsidiaries, it shall, in addition to financial statements provided under sub-section (2), prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own which shall also be laid before the annual general meeting of the company along with the laying of its financial statement under sub-section (2).

- The company shall also attach along with its financial statement, a separate statement containing the

salient features of the financial statement of its subsidiary or subsidiaries. *According to the rules the statement containing the salient feature of the financial statement of a company's subsidiary or subsidiaries, associate company and joint venture shall be in Form 9.1.*

– *Further as per the rules the Consolidation of financial statements of the company shall be made in accordance with the Accounting Standards, subject however, to the requirement that if under such Accounting Standards, consolidation is not required for the reason that the company has its immediate parent outside India, then such companies will also be required to prepare Consolidated Financial Statements in the manner and format as specified under Schedule III to the Act.*

(4) The provisions of this Act applicable to the preparation, adoption and audit of the financial statements of a holding company shall, mutatis mutandis, apply to the consolidated financial statements.

(5) Without prejudice to sub-section (1), where the financial statements of a company do not comply with the accounting standards referred to in sub-section (1), the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviation.

(6) The Central Government may, on its own or on an application by a class or classes of companies, by notification, exempt any class or classes of companies from complying with any of the requirements of this section or the rules made thereunder, if it is considered necessary to grant such exemption in the public interest and any such exemption may be granted either unconditionally or subject to such conditions as may be specified in the notification.

(7) If a company contravenes the provisions of this section, the managing director, the whole-time director in charge of finance, the Chief Financial Officer or any other person charged by the Board with the duty of complying with the requirements of this section and in the absence of any of the officers mentioned above, all the directors shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees, or with both.

Explanation. – For the purposes of this section, except where the context otherwise requires, any reference to the financial statement shall include any notes annexed to or forming part of such financial statement, giving information required to be given and allowed to be given in the form of such notes under this Act.

SCHEDULE III OF THE COMPANIES ACT, 2013

Introduction

According to Section 129 of the Companies Act 2013, all the companies registered under this Act will have to present its financial statements in Schedule III of the Act. The Schedule III of the Companies Act 2013 has been formulated to keep pace with the changes in the economic philosophy leading to privatization and globalization and consequent desired changes/reforms in the corporate financial reporting practices. It deals with the Form of Balance sheet, Statement of Profit and Loss and disclosures to be made therein and it applies uniformly to all the companies registered under the Companies Act, 2013, for the preparation of financial statements of an accounting year. It has several new features like:

– A vertical format for presentation of balance sheet with classification of Balance Sheet items into current and non-current categories.

– A vertical format of Statement of Profit and Loss with classification of expenses based on nature.

– Elimination the concept of "Schedules" and such information is now to be furnished in terms of "Notes to Accounts".

– It does not contain any specific disclosure for items included in Schedule VI under the head, "Miscellaneous Expenditure". As per AS-16 borrowing cost and discount or premium relating to borrowing could be amortized over loan period. Further, share issue expenses, discount on shares, discount/

premium on borrowing, etc. are excluded from As-26. These items be amortized over period of benefit i.e., normally 3-5 years. The draft guidance note issued by ICAI suggests that unamortized portion of such expenses be shown under the head "Other Current/Non-current Assets" depending on whether the amount will be amortized in the next 12 months or thereafter.

- Debit Balance of Statement of Profit & Loss A/c will be disclosed under the head, Reserves & Surplus as the negative figure.
- No change in the format of cash flow statement as per revised schedule and therefore its preparation continue to be as per AS-3 on cash flow statement.
- It gives prominence to Accounting Standards (AS) i.e. in case of any conflict between the AS and the Schedule, AS shall prevail.

General Instructions for the preparation of balance sheet and profit and loss account

The Schedule III sets out the minimum requirements for disclosure on the face of the Balance Sheet, and the Statement of Profit and Loss (hereinafter referred to as "Financial Statements") and Notes.

Line items, sub-line items and sub-totals shall be presented as an addition or substitution on the face of the Financial Statements when such presentation is relevant to an understanding of the company's 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.

This means new line items or sub items can be added or substituted on the face of the Financial Statements when such presentation is :

- relevant to an understanding of the company's financial position or performance or to cater to industry/sector-specific disclosure requirements
- to cater to industry/sector-specific disclosure requirements or when required for compliance with the amendments to the Companies Act
- under the Accounting Standards

1. Where compliance with the requirements of the Act including Accounting Standards as applicable to the companies require any change in treatment or disclosure including addition, amendment, substitution or deletion in the head or sub-head or any changes, inter se, in the financial statements or statements forming part thereof, the same shall be made and the requirements of this Schedule shall stand modified accordingly.

2. The disclosure requirements specified in this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Accounting Standards prescribed under the Companies Act, 2013. Additional disclosures specified in the Accounting Standards shall be made in the notes to accounts or by way of additional statement unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act shall be made in the notes to accounts in addition to the requirements set out in this Schedule.

3. Notes to accounts shall contain information in addition to that presented in the Financial Statements and shall provide where required

- narrative descriptions or disaggregations of items recognised in those statements; and
- information about items that do not qualify for recognition in those statements.

4. Each item on the face of the Balance Sheet and Statement of Profit and Loss shall 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.

5. Depending upon the turnover of the company, the figures appearing in the Financial Statements may be rounded off as given below: –

Turnover	Rounding off
(a) less than one hundred crore rupees	To the nearest hundreds, thousands, lakhs or millions, or decimals thereof.
(b) one hundred crore rupees or more	To the nearest lakhs, millions or crores, or decimals thereof.

Once a unit of measurement is used, it shall be used uniformly in the Financial Statements.

6. Except in the case of the first Financial Statements laid before the Company (after its incorporation) the corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Financial Statements including notes shall also be given.

7. For the purpose of this Schedule, the terms used herein shall be as per the applicable Accounting Standards.

Presentation of Balance Sheet

A Balance sheet is a statement of the financial position of an enterprise as at a given date, which exhibits its assets, liabilities, capital, reserves and other account balances at their respective book values.

Key features of Balance Sheet

1) The Schedule III permits only Vertical form of presentation.
2) It uses “Equity and Liabilities” and “Assets” as headings.
3) All assets and liabilities classified into current and non-current and presented separately on the face of the Balance Sheet.
4) Number of shares held by each shareholder holding more than 5% shares now needs to be disclosed.
5) Details pertaining to aggregate number and class of shares allotted for consideration other than cash, bonus shares and shares bought back will need to be disclosed only for a period of five years immediately preceding the Balance Sheet date.
6) Any debit balance in the Statement of Profit and Loss will be disclosed under the head “Reserves and surplus.” Earlier, any debit balance in Profit and Loss Account carried forward after deduction from uncommitted reserves was required to be shown as the last item on the asset side of the Balance Sheet.
7) Specific disclosures are prescribed for Share Application money. The application money not exceeding the capital offered for issuance and to the extent not refundable will be shown separately on the face of the Balance Sheet. The amount in excess of subscription or if the requirements of minimum subscription are not met will be shown under “Other current liabilities.”
8) The term “sundry debtors” has been replaced with the term “trade receivables.” ‘Trade receivables’ are defined as dues arising only from goods sold or services rendered in the normal course of business. Hence, amounts due on account of other contractual obligations can no longer be included in the trade receivables.
9) It requires separate disclosure of “trade receivables” outstanding for a period exceeding six months from the date the bill/invoice is due for payment.”
10) “Capital advances” are specifically required to be presented separately under the head “Loans & advances” rather than including elsewhere.
11) Tangible assets under lease are required to be separately specified under each class of asset. In the absence

of any further clarification, the term “under lease” should be taken to mean assets given on operating lease in the case of lessor and assets held under finance lease in the case of lessee.

12) Under the Schedule III, other commitments also need to be disclosed.

The format of balance sheet as given in Part I of Schedule III of the Companies Act 2013 is given below.

Key features Statement of Profit and Loss

1) The name of ‘Profit and Loss Account’ has been changed to “Statement of Profit and Loss”.
2) This format of Statement of Profit and Loss does not mention any appropriation item on its face. Further, ‘below the line’ adjustments to be presented under “Reserves and Surplus” in the Balance Sheet.
3) Any item of income or expense which exceeds one per cent of the revenue from operations or Rs. 100,000 (earlier 1 % of total revenue or Rs. 5,000), whichever is higher, needs to be disclosed separately.
4) In respect of companies other than finance companies, revenue from operations need to be disclosed separately as revenue from (a) sale of products, (b) sale of services and (c) other operating revenues.
5) Net exchange gain/loss on foreign currency borrowings to the extent considered as an adjustment to interest cost needs to be disclosed separately as finance cost.
6) Break-up in terms of quantitative disclosures for significant items of Statement of Profit and Loss, such as raw material consumption, stocks, purchases and sales have been simplified and replaced with the disclosure of “broad heads” only. The broad heads need to be decided based on materiality and presentation of true and fair view of the financial statements.

PART I

BALANCE SHEET

Name of the Company ....

Balance Sheet as at ....

(Rupees in ....)

	Particulars	Note No	Figures as at the end end of current reporting period	Figures as at the end of previous reporting period
	1	**2**	**3**	**4**
(I)	**EQUITY AND LIABILITIES**			
(1)	**Shareholder's Funds**			
	(a) Share Capital			
	(b) Reserves and Surplus			
	(c) Money received against share warrants			
(2)	**Share application money pending allotment**			
(3)	**Non-Current Liabilities**			
	(a) Long-term borrowings			
	(b) Deferred tax liabilities (Net)			

	1	2	3	4
	(c) Other Long term liabilities			
	(d) Long term provisions			
(4)	**Current Liabilities**			
	(a) Short-term borrowings			
	(b) Trade payables			
	(c) Other current liabilities			
	(d) Short-term provisions			
	TOTAL			
II.	**ASSETS**			
(1)	**Non-current assets**			
	(a) Fixed assets			
	i. Tangible assets			
	ii. Intangible assets			
	iii. Capital work-in-progress			
	iv. Intangible assets under development			
	(b) Non-current investments			
	(c) Deferred tax assets (net)			
	(d) Long term loans and advances			
	(e) Other non-current assets			
(2)	**Current assets**			
	(a) Current investments			
	(b) Inventories			
	(c) Trade receivables			
	(d) Cash and cash equivalents			
	(e) Short-term loans and advances			
	(f) Other current assets			
	TOTAL			

General Instructions for preparing the balance sheet of a company

Current Assets :

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 company's normal operating cycle;

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

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

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

All other assets shall be classified as non-current.”

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 company’s normal operating cycle;

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

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

(d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

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 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) 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 that class including restrictions on the distribution of dividends and the repayment of capital;

(f) shares in the company held by its holding company or its ultimate holding company or by its subsidiaries or associates;

(g) shares in the company held by any shareholder holding more than 5 percent shares;

(h) shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts;

(i) Separate particulars for a period of five years following the year in which the shares have been allotted/ bought back, in respect of:

- 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 (Specify the source from which bonus shares are issued).
- Aggregate number and class of shares bought back.

(j) Terms of any security issued along with the earliest date of conversion in descending order starting from the farthest such date.

B. Reserves and Surplus

(i) Reserves and Surplus shall be classified as:

(a) Capital Reserves;

(b) Capital Redemption Reserves;

(c) Securities Premium Reserve;

(d) Debenture Redemption Reserve;

(e) Revaluation Reserve;

(f) Share Options Outstanding Account:

(g) Other Reserves – (specify the nature 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 paid, bonus shares and transfer to/from reserves

(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

– From banks

– From other parties.

(c) Deferred payment liabilities.

(d) Deposits.

(e) Loans and advances from related parties.

(f) Long-term maturities of finance lease obligations

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

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

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

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

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

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

(vii) Period and amount of default in repayment of dues, providing break-up of principal 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

- from banks.
- from other parties.

(b) Loans and advances from subsidiaries/holding company/associates/business ventures.

(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, a mention thereof shall be made and also the aggregate amount of loans under each head.

(iv) Period and amount of default in repayment of dues, providing break-up of principal 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) Income received in Advance;

(d) Interest accrued but not due on borrowings;

(e) Interest accrued and due on borrowings;

(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 & 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 and other movements 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 therefore 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) Licences 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 and other movements and the related amortization and impairment losses/reversals shall be disclosed separately.

(iiii) 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 therefor 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 units, debentures or bonds;

(f) Investments in Mutual Funds;

(g) Investments in partnership firm;

(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;

(d) Aggregate amount of partly paid-up investments;

(e) The names of bodies corporate (indicating separately the names of subsidiaries, associates and other business ventures) in whose securities, investments have been made and the nature and extent of the investments so made in each such body corporate.

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) To the extent secured, considered good;

(b) Others, considered good;

(c) Doubtful.

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

(ii) 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:

(i) (a) secured, considered good;

(b) unsecured, considered good;

(c) Doubtful

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

(iii) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person 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) Investments in Preference shares;

(c) Investments in Government or trust securities;

(d) Investments in units, debentures or bonds;

(e) Investments in Mutual Funds;

(f) Investments in partnership firm;

(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 amount of partly paid-up investments.

(e) Aggregate provision for diminution in value of investments.

O. Inventories

(i) Inventories shall be classified as :

(a) Raw material;

(b) Work-in-progress;

(c) Finished goods;

(d) Stock-in-trade;

(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 should 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 also be classified as:

(a) To the extent secured, considered good;

(b) Others, 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 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) Classification shall be made as:

(a) Bank balances;

(b) Cheques, drafts on hand;

(c) Cash on hand;

(d) Cash equivalents – 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;

(e) Others (specify nature).

(ii) Earmarked bank balances (e.g., unpaid dividend) shall be separately stated.

(iii) Balance with banks to the extent held as 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) To the extent secured, considered good;

(b) Others, 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 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.

S. Other current assets (specify nature).

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

T. Contingencies 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 holders for the period and the related amount per share shall be disclosed separately. Arrears of fixed cumulative dividends 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 the opinion, shall be stated.

PART II

STATEMENT OF PROFIT AND LOSS

Name of Company ....

Profit and loss Statement for the year ended ....

Rupees in ....

	Particulars	Note No.	Figures for the Current reporting period	Figures for the Previous reporting period
I	Revenue from operations			
II	Other Income			
III	Total Revenue (I + II)			
IV	Expenses:			
	Cost of materials consumed			
	Purchases of Stock-in-Trade			
	Changes in inventories of finished goods			
	Work-in-progress and Stock-in Trade			
	Employee benefits expense			
	Finance costs			
	Depreciation and amortization expense			
	Other expenses			
	Total expense			
V	Profit before exceptional and extraordinary items and tax (III-IV)			
VI	Exceptional items			
VII	Profit before extraordinary items and tax (V-VI)			
VIII	Extraordinary items			
IX	Profit before tax (VII-VIII)			
X	Tax expense:			
	(1) Current tax			
	(2) Deferred tax			
XI	Profit (Loss) for the period from continuing operations (IX-X-XIV)			
XII	Profit / (Loss) from discontinuing operations			
XIII	Tax expense of discontinuing operations			
XIV	Profit / (Loss) from discontinuing operations (after tax) (XII-XIII)			
XV	Profit / (Loss) for the period (XI-XIV)			
XVI	Earning per equity share:			
	(1) Basic			
	(2) Diluted			

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 (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 disclosed as:

(a) Interest expense;

(b) Other borrowing costs;

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

4. Other Income

Other income shall be classified as:

(a) Interest Income (in case of a company other than a finace 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 Syock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expense].

(b) Depreciation and amortization expense;

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

(d) Interest Income;

(e) Interest Expense;

(f) Dividend Income;

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

(h) Adjustments to the carrying amount of investments;

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

7. Payments to the auditors as (a) audit, (b) for taxation matters, (c) for company matters, (d) for management services, (e) for other services, (f) for reimbursement of expense;

8. Details of items of exceptional and extraordinary nature;

(i) Prior Period Items;

(ii) (a) In the case of manufacturing companies;

(i) Raw materials under broad heads.

(ii) Goods purchased under broad heads.

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

(iv) (a) The aggregate, if material, of any amounts set aside or propose to be set aside, to reserve , but not including provisions made to meet any specific liability, contingency or commitment known to exit 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 commitment.

(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) Repairs to building

(e) Repairs to Machinery

(f) Insurance

(g) Rates and Taxes, excluding, taxes on income.

(h) Miscellaneous expense,

(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 spareparts;

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 the 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 specific mention of the total number of nonresidents shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related;

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

I. Exports of Goods calculated on F.O.B. basis;

II. Royalty, know-how, professional and consultation fees;

III. Interest and Dividends;

IV. Other Income, indicating the nature thereof

Note:- Broad heads shall be decided taking into account the concept of materiality and presentation of true and fair view of Financial Statements.

General Instructions for the preparation of consolidated financial statements is given in Lesson 5.

TRUE AND FAIR VIEW OF FINANCIAL STATEMENTS

According to section 128 (1) of the Companies Act 2013, 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.

Further section 129(1) of the Companies Act 2013, states that the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 and shall be in the form provided for different class or classes of companies in Schedule III. It also provides also that the financial statements shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose –

(a) in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938, or the Insurance Regulatory and Development Authority Act, 1999;

(b) in the case of a banking company, any matters which are not required to be disclosed by the Banking Regulation Act, 1949;

(c) in the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by the Electricity Act, 2003;

(d) in the case of a company governed by any other law for the time being in force, any matters which are not required to be disclosed by that law.

Thus, the Companies Act requires that the profit and loss account must exhibit a true and fair view of the profit earned or loss suffered by the company during the period for which the account has been prepared. The term true and fair has not been defined nor had it been the subject of any judicial decision. But in order to show a true and fair view financial statement (Statement of Profit and Loss and Balance Sheet) should not mislead the user about the financial health of the oraganisation.

From the accounting point of view, the profit and loss account should be drawn upon the principles stated below:

(a) *Materiality:* All significant factors which will have an impact on the mind of the reader should be disclosed. For example, if a large quantity of raw materials is sold and there is a sizable profit or loss, the sale should not be included in the Sales Account; instead, the cost of the materials should be deducted from materials consumed and the profit or loss on sale of raw materials should be separately disclosed in the profit and loss account. The reader will then know why the profit or loss is and what it is; the reason will not be clear if the sale of raw materials is added to Sales or deduced from materials consumed. If, however, only a small quantity was sold leading to a rather insignificant profit or loss, separate disclosure is not necessary because such a disclosure will not change the impression of the reader about the profit situation.

    What is material and what is not depends upon the judgement of the management. But the materiality of a figure should be judged from the point of view of both the total amount of the item and the amount of the profit or loss. In the above example, materiality has to be seen from the point of view of (i) the amount of materials consumed and (ii) the profit or loss during the year.

(b) *Prior-Period Items:* The rule in India is that once accounts are adopted at the annual general meeting, they cannot be reopened. If any error is discovered, it can be corrected only in the accounts of the subsequent period. Apart from errors, some of the account relating to previous year may come to knowledge or may be ascertained only in the current year. Suppose rates have been revised with effect from October, 2006 but the decision was made only in March, 2008, The increased wages for 2007-08 can certainly be added to the 2007-2008 wages but the increased wages for six months of 2006-2007 will also have to be taken out into account. Errors and other items relating to previous year should be shown separately in the profit and loss account and not clubbed with the item relating to the current year unless the concerned amounts are not material. Preferably, errors and prior year items should be stated below the line i.e. in the Profit and Loss Appropriation Account.

(c) *Extraordinary Items:* If expenses or incomes that do not arise in the ordinary course and are material should be stated separately in the profit and loss account. For example, if a fixed asset is sold, its profit or loss has to be shown separately. Another example would be speculation loss or profit; yet another would be subsidy received from government for operational purposes.

(d) *Change in Accounting Policies:* It is well known that if there is any change in an accounting policy, say method of valuation of inventories or of change in depreciation, there has to be disclosure about the fact of the change and of the fact on profit or loss resulting from such a change.

TREATMENT OF SPECIAL ITEMS UNDER COMPANIES ACT 2013

Although, the general principles for preparing the final accounts of a company are same as that of partnership firms and sole proprietorship concerns, some special points peculiar to a company are described below.

Managerial Remuneration

The section 197(1) of Companies Act 2013 puts a maximum limit on the total managerial remuneration payable

by a public company, to its directors, including managing director and whole-time director, and its manager in respect of any financial year. The remuneration shall not exceed ***eleven per cent of the net profits of that company*** for the financial year computed as laid down in section 198 except that the remuneration of the directors shall not be deducted from the gross profits.

The company in general meeting may, with the approval of the Central Government, authorise the payment of remuneration exceeding eleven per cent of the net profits of the company, subject to the provisions of Schedule V.

Further that, except with the approval of the company in general meeting, –

(i) the remuneration payable to any one managing director; or whole-time director or manager shall not exceed five percent of the net profits of the company

(ii) If there is more than one managing director; or whole-time director or manager remuneration shall not exceed ten per cent of the net profits to all such directors and manager taken together;

(iii) the remuneration payable to directors who are neither managing directors nor whole-time directors shall not exceed one per cent of the net profits of the company, if there is a managing or whole-time director or manager;

(iv) the remuneration payable to directors who are neither managing directors nor whole-time directors shall not exceed three per cent of the net profits of the company, if there is no managing or whole-time director or manager;

(2) The percentages aforesaid shall be exclusive of any fees payable to directors for attending meetings of the Board or Committee thereof or for any other purpose whatsoever as may be decided by the Board.

(3) If in any financial year, a company has no profits or its profits are inadequate, the company shall not pay to its directors, including any managing or whole time director or manager, by way of remuneration except in accordance with the provisions of Schedule V and if it is not able to comply with such provisions, with the previous approval of the Central Government. However, the company can pay fee for attending meetings of the Board or Committee thereof or for any other purpose whatsoever as may be decided by the Board.

(4) The remuneration payable to the directors of a company, including any managing or whole-time director or manager, shall be determined, in accordance with and subject to the provisions of this section, either by the articles of the company, or by a resolution or, if the articles, by a special resolution, passed by the company in general meeting and the remuneration payable to a director determined aforesaid shall be inclusive of the remuneration payable to him for the services rendered by him in any other capacity except for -

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

b) in the opinion of the Nomination and Remuneration Committee, if the company is covered under sub-section (*1*) of section 178, or the Board of Directors in other cases, the director possesses the requisite qualification for the practice of the profession.

(5) A director or manager may be paid remuneration either by way of a monthly payment or at a specified percentage of the net profits of the company or partly by one way and partly by the other.

(6) An independent director shall not be entitled to any stock option and may receive remuneration by way of fees provided under sub-section (*5*), reimbursement of expenses for participation in the Board and other meetings and profit related commission as may be approved by the members. Thus, under the Companies Act 2013, independent directors of a public company can be paid commission other than sitting fees and reimbursement of expenses for attending the meeting provided if the shareholders approval is available for the same.

(7) The net profits for the purposes of this section shall be computed as referred to in section 198.

(8) If any director draws or receives, directly or indirectly, by way of remuneration any such sums in excess of the

limit prescribed by this section or without the prior sanction of the Central Government, where it is required, he shall refund such sums to the company and the company cannot waive it and until such sum is refunded, hold it in trust for the company.

(9) The company shall not waive the recovery of any sum refundable to it under sub-section (*9*) unless permitted by the Central Government.

(10) In cases where Schedule V is applicable on grounds of no profits or inadequate profits, any provision relating to the remuneration of any director which purports to increase or has the effect of increasing the amount thereof, whether the provision be contained in the company's memorandum or articles, or in an agreement entered into by it, or in any resolution passed by the company in general meeting or its Board, shall not have any effect unless such increase is in accordance with the conditions specified in that Schedule and if such conditions are not being complied, the approval of the Central Government had been obtained.

(11) Every listed company shall disclose in the Board's report, the ratio of the remuneration of each director to the median employee's remuneration and such other details as may be prescribed.

(12) Where any insurance is taken by a company on behalf of its managing director, whole-time director, manager, Chief Executive Officer, Chief Financial Officer or Company Secretary for indemnifying any of them against any liability in respect of any negligence, default, misfeasance, breach of duty or breach of trust for which they may be guilty in relation to the company, the premium paid on such insurance shall not be treated as part of the remuneration payable to any such personnel: Provided that if such person is proved to be guilty, the premium paid on such insurance shall be treated as part of the remuneration. Thus any premium paid on the insurance policy to cover the risk for managing director or other directors or Company Secretary shall not form the part of the above limit.

(13) Any director who is in receipt of any commission from the company and who is a managing or whole-time director of the company shall not be disqualified from receiving any remuneration or commission from any holding company or subsidiary company of such company subject to its disclosure by the company in the Board's report.

(14) If any person contravenes the provisions of this section, he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

PART II of Schedule V

1. Remuneration payable by companies having profits: Subject to the provisions of section 197, a company having profits in a financial year may pay remuneration to a managerial person or persons not exceeding the limits specified in such section.

2. Remuneration payable by companies having no profit or inadequate profit without Central Government approval: Where in any financial year during the currency of tenure of a managerial person, a company has no profits or its profits are inadequate, it may, without Central Government approval, pay remuneration to the managerial person not exceeding the higher of the limits under (A) and (B) given below: –

(A) :

Where the effective capital is	Limit of yearly remunerationpayable shall not exceed (Rupees)
1. Negative or less than 5 crores	30 lakhs
2. 5 crores and above but less than 42 lakhs	100 crores
3. 100 crores and above but less than 60 lakhs	250 crores
4. 250 crores and above	60 lakhs plus 0.01% of the effective capital in excess of Rs. 250 crores:

The above limits shall be doubled if the resolution passed by the shareholders is a special resolution and for a period less than one year, the limits shall be pro-rated.

(B) In the case of a managerial person who was not a security holder holding securities of the company of nominal value of rupees five lakh or more or an employee or a director of the company or not related to any director or promoter at any time during the two years prior to his appointment as a managerial person, — 2.5% of the current relevant profit. The above limits shall be doubled if the resolution passed by the shareholders is a special resolution.

Calculation of net profits for determining managerial remuneration

The calculation of net profits of a company in any financial year for the purpose of determining managerial remuneration under section 197 is described in the section 198 of the Companies Act 2013.

According to section 198(2), credit shall be given for the bounties and subsidies received from any Government, or any public authority constituted or authorised in this behalf, by any Government, unless and except in so far as the Central Government otherwise directs.

According to section 198(3), credit shall not be given for the following sums, namely: –

a) profits, by way of premium on shares or debentures of the company, which are issued or sold by the company;

b) profits on sales by the company of forfeited shares;

c) profits of a capital nature including profits from the sale of the undertaking or any of the undertakings of the company or of any part thereof;

d) profits from the sale of any immovable property or fixed assets of a capital nature comprised in the undertaking or any of the undertakings of the company, unless the business of the company consists, whether wholly or partly, of buying and selling any such property or assets:

   Provided that where the amount for which any fixed asset is sold exceeds the written-down value thereof, credit shall be given for so much of the excess as is not higher than the difference between the original cost of that fixed asset and its written down value;

e) any change in carrying amount of an asset or of a liability recognised in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value.

According to section 198(4), the following sums shall be deducted, namely: –

a) all the usual working charges;

b) directors' remuneration;

c) bonus or commission paid or payable to any member of the company's staff, or to any engineer, technician or person employed or engaged by the company, whether on a whole-time or on a part-time basis;

d) any tax notified by the Central Government as being in the nature of a tax on excess or abnormal profits;

e) any tax on business profits imposed for special reasons or in special circumstances and notified by the Central Government in this behalf;

f) interest on debentures issued by the company;

g) interest on mortgages executed by the company and on loans and advances secured by a charge on its fixed or floating assets;

h) interest on unsecured loans and advances;

i) expenses on repairs, whether to immovable or to movable property, provided the repairs are not of a capital nature;

j) outgoings inclusive of contributions made under section 181;

k) depreciation to the extent specified in section 123;

l) the excess of expenditure over income, which had arisen in computing the net profits in accordance with this section in any year which begins at or after the commencement of this Act, in so far as such excess has not been deducted in any subsequent year preceding the year in respect of which the net profits have to be ascertained;

m) any compensation or damages to be paid in virtue of any legal liability including a liability arising from a breach of contract;

n) any sum paid by way of insurance against the risk of meeting any liability such as is referred to in clause (*m*);

o) debts considered bad and written off or adjusted during the year of account.

According to section 198(*5*), in making the computation aforesaid, the following sums shall not be deducted, namely: –

a) income-tax and super-tax payable by the company under the Income-tax Act, 1961, or any other tax on the income of the company not falling under clauses (d) and (e) of sub-section (4);

b) any compensation, damages or payments made voluntarily, that is to say, otherwise than in virtue of a liability such as is referred to in clause (m) of sub-section (4);

c) loss of a capital nature including loss on sale of the undertaking or any of the undertakings of the company or of any part thereof not including any excess of the written-down value of any asset which is sold, discarded, demolished or destroyed over its sale proceeds or its scrap value;

d) any change in carrying amount of an asset or of a liability recognised in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value.

DECLARATION OF DIVIDEND

The term "Dividend" refers to that part of the profits of a company which is distributed by the company among its shareholders by way of return on investments made by the shareholders in the shares, of the company. In other words, dividend is nothing but the distribution of divisible or distributable profits of a company among the holders of its shares. Dividend is paid by a company to its shareholders on the basis of number of shares held by them and the rights attaching to the various classes of shares.

Section 123 of the Companies Act 2013 provides following conditions for the payment of dividend.

a) No dividend shall be declared or paid by a company for any financial year except –

   – out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of Schedule II or out of the profits of the company for any previous financial year or years arrived at after providing for depreciation in accordance with the provisions of Schedule II and remaining undistributed, or out of both; or

   – out of money provided by the Central Government or a State Government for the payment of dividend by the company in pursuance of a guarantee given by that Government.

b) The company has to transfer such percentage of its profits for that financial year as it may consider appropriate to the reserves of the company, before the declaration of any dividend in any financial year.

c) No dividend shall be declared or paid by a company from its reserves other than free reserves.

d) In case of inadequacy or absence of profits in any financial year, any company proposes to declare dividend out of the accumulated profits earned by it in previous years and transferred by the company to the reserves, such declaration of dividend shall not be made except in accordance with the Companies (Declaration and Payment of Dividend) Rules, 2014. In the event of inadequacy or absence of profits in any year, a company may declare dividend out of free reserves subject to the fulfillment of the following conditions, namely: –

   – The rate of dividend declared shall not exceed the average of the rates at which dividend was declared by it in the three years immediately preceding that year: Provided that this sub-rule shall not apply to a company, which has not declared any dividend in each of the three preceding financial year.

   – The total amount to be drawn from such accumulated profits shall not exceed one-tenth of the sum of its paid-up share capital and free reserves as appearing in the latest audited financial statement.

   – The amount so drawn shall first be utilised to set off the losses incurred in the financial year in which dividend is declared before any dividend in respect of equity shares is declared.

   – The balance of reserves after such withdrawal shall not fall below fifteen per cent of its paid up share capital as appearing in the latest audited financial statement.

   – No company shall declare dividend unless carried over previous losses and depreciation not provided in previous year are set off against profit of the company of the current year the loss or depreciation, whichever is less, in previous years is set off against the profit of the company for the year for which dividend is declared or paid.

e) The Board of Directors of a company may declare interim dividend during any financial year out of the surplus in the profit and loss account and out of profits of the financial year in which such interim dividend is sought to be declared.

f) In case the company has incurred loss during the current financial year up to the end of the quarter immediately preceding the date of declaration of interim dividend, such interim dividend shall not be declared at a rate higher than the average dividends declared by the company during the immediately preceding three financial years.

g) The amount of the dividend, including interim dividend, shall be deposited in a scheduled bank in a separate account within five days from the date of declaration of such dividend.

h) No dividend shall be paid by a company in respect of any share therein except to the registered shareholder of such share or to his order or to his banker and shall not be payable except in cash. Provided that nothing in this sub-section shall be deemed to prohibit the capitalization of profits or reserves of a company for the purpose of issuing fully paid-up bonus shares or paying up any amount for the time being unpaid on any shares held by the members of the company. Provided further that any dividend payable in cash may be paid by cheque or warrant or in any electronic mode to the shareholder entitled to the payment of the dividend.

i) A company which fails to comply with the provisions of sections 73 and 74 shall not, so long as such failure continues, declare any dividend on its equity shares.

In the TABLE –F of the Companies Act, following provisions are mentioned for Dividends and Reserve.

– The company in general meeting may declare dividends, but no dividend shall exceed the amount recommended by the Board.

– The Board may from time to time pay to the members such interim dividends as appear to it to be justified by the profits of the company.

– The Board may, before recommending any dividend, set aside out of the profits of the company such sums as it thinks fit as a reserve or reserves which shall, at the discretion of the Board, be applicable for any purpose to which the profits of the company may be properly applied, including provision for meeting contingencies or for equalizing dividends; and pending such application, may, at the like discretion, either be employed in the business of the company or be invested in such investments (other than shares of the company) as the Board may, from time to time, thinks fit.

– The Board may also carry forward any profits which it may consider necessary not to divide, without setting them aside as a reserve.

PROVISION FOR DEPRECIATION

Section 123 of the Companies Act 2013 provides that the depreciation shall be provided out of the profits of the company in accordance with the provisions of Schedule II.

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. The depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less its residual value. The useful life of an asset is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity. The term depreciation includes amortisation

Companies whose financial statements comply with the accounting standards prescribed for such class of companies under section 133, shall have the useful life of an as indicated in Part C of schedule II. In respect of other companies the useful life of an asset shall not be longer than the useful life and the residual value shall not be higher than that prescribed in Part C.

For intangible assets, the provisions of the Accounting Standards shall apply.

The following are the useful lives of various tangible assets:

1. “Factory buildings” does not include offices, godowns, staff quarters.
2. Where, during any financial year, any addition has been made to any asset, or where any asset has been sold, discarded, demolished or destroyed, the depreciation on such assets shall be calculated on a pro rata basis from the date of such addition or, as the case may be, up to the date on which such asset has been sold, discarded, demolished or destroyed.
3. The following information shall also be disclosed in the accounts, namely: –
   (i) depreciation methods used; and
   (ii) the useful lives of the assets for computing depreciation, if they are different from the life specified in the Schedule.
4. Useful life specified in Part C of the Schedule is for whole of the asset. Where cost of a part of the asset is significant to total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately.
5. Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value. Ordinarily, the residual value of an asset is often insignificant but it should generally be not more than 5% of the original cost of the asset.
6. The useful lives of assets working on shift basis have been specified in the Schedule based on their single shift working. Except for assets in respect of which no extra shift depreciation is permitted (indicated

by NESD in Part C above), if an asset is used for any time during the year for double shift, the depreciation will increase by 50% for that period and in case of the triple shift the depreciation shall be calculated on the basis of 100% for that period.

7. From the date this Schedule comes into effect, the carrying amount of the asset as on that date—
   (a) shall be depreciated over the remaining useful life of the asset as per this Schedule;
   (b) after retaining the residual value, shall be recognised in the opening balance of retained earnings where the remaining useful life of an asset is nil.
8. "Continuous process plant" means a plant which is required and designed to operate for twenty-four hours a day.

Illustration 1

Given is the Trial Balance of Marathon Limited as on 31st March, 2014. You are require to prepare the Profit and loss Account and Balance Sheet on 31st March, 2014

Particulars		*Dr.*	*Cr.*
Authorised Share capital divided into 8,000, 6% preference shares of ₹100 each and 20,000 equity shares of ₹100 each			28,00,000
Subscribed Capital			
5,000 6% preference shares of ₹100 each			5,00,000
Equity Share Capital			8,00,000
Capital Reserve			5,000
Purchases	– Coco, Tea, Coffee	58,800	
	– Bakery products	36,200	
Wages and Salary		15,300	
Rent, Rates and Taxes		8,900	
Laundry		750	
Sales	– Coco, Tea and Coffee		82,000
	– Bakery products		44,000
Coal and Firewood		3,290	
Carriage		810	
Sundry Expenses		5,840	
Advertising		8,360	
Repair		4,250	
Rent of Rooms			48,000
Receipt from Billiards			5,700
Miscellaneous Receipts			2,800

Discount Received		3,300
Transfer Fee	700	
Freehold Land and Building	8,50,000	
Furniture and Fittings	86,300	
Stock on hand, 1st April, 2013		
Coco, Tea, Coffee	12,800	
Bakery products	5,260	
Cash in Hand 2,200		
Cash with Bank	76,380	
Preliminary and Formation Expenses	8,000	
2000, 8% debentures of ₹100 each		2,00,000
Profit and Loss Account		41,500
Sundry Creditors		42,000
Sundry Debtors	19,260	
Investment	2,72,300	
Goodwill at Cost	5,00,000	
General Reserve		2,00,000
	19,75,000	**19,75,000**

Additional Information:

– Wages and Salaries outstanding	4,280
– Stock as on 31st march, 2012	
– Coco, Tea, Coffee	22,500
– Bakery Products	16,400

– Provide 5% depreciation on Furniture and Fittings and 2% on Land and Building.

The equity capital on 1st April, 2013 stood at ₹7, 20,000, that is 6,000 shares fully paid and 2,000 shares of ₹60 paid. The directors made a call of ₹ 40 per share on 1st October, 2013. A shareholder could not pay the call on 100 shares and his shares were then forfeited and reissued at ₹90 per share as fully paid. The director proposes a dividend of 8% on equity shares, transferring any amount that may be required from general reserve. Ignore taxation.

Solution

Profit and Loss Account of Marathon and Limited
for the year ended on 31st March, 2012

	Particulars	*Notes*	*Amount (₹)*
I	Revenue from Operations	10	1,79,700
II	Other Receipts	11	6,800
III	Total Revenue (I + II)		**1,86,500**

IV	**Expenses**		
	Purchase of Stock in Trade	12	95,000
	Change in Inventories of Finished Goods	13	(20,840)
	Employee Benefit Expenses	14	19,580
	Other Operating Expenses	15	23,840
	Selling and Administrative Expenses	16	8,360
	Finance Costs	17	16,000
	Depreciation and Amortization Expenses	18	21,315
	Total expenses		1,63,255
V	Profit(Loss) for the period (III-IV)		23,245
	Balance from Previous Years		41,500
	Transfer from General Reserve		29,255
	Less: Proposed Dividend		
	– Preference Share Capital @6%		30,000
	– Equity Share Capital @ 8%		64,000
	Profit (Loss) carried to Balance Sheet		**0**

Balance Sheet of Marathon Limited as on 31st March, 2014

	Particulars	*Notes*	*Amount (₹)*
I	**Equity and Liabilities**		
	1. Shareholders' Fund		
	(a) Share Capital	1	13,00,000
	(b) Reserve and Surplus	2	1,75,745
	2. Non-current liabilities		
	(a) Long term liabilities	3	2,00,000
	3. Current liabilities		
	(a) Trade Payables	4	46,280
	(b) Short Term Provisions	5	1,10,000
	TOTAL		**18,32,025**
II	**Assets**		
	1. Non-Current Assets		
	(a) Fixed assets		
	(i) Tangible Fixed Assets	6	9,14,985
	(ii) Intangible Assets (Goodwill)		5,00,000
	(b) Non – Current Investments		2,72,300

	Note	₹
2. Current Assets		
(a) Inventories	7	38,900
(b) Trade Receivables		19,260
(c) Cash and Cash Equivalents	8	78,580
(d) Other Current Assets	9	8,000
TOTAL		**18,32,025**

Notes to the Financial Statements

1. Share Capital

Equity Share Capital

– Authorised Equity Share Capital : 20,000 Equity Shares of ₹100 each		20,00,000
– Issued and Subscribed8,000 Equity Shares of ₹100 each		8,00,000
Preference share capital		
Authorised Preference Share Capital		
– 8,000, 6% Preference Shares of ₹100 each		8,00,000
– Issued and Subscribed 5,000 6% Preference Shares of ₹100 each		5,00,000
		13,00,000

2. Reserve and Surplus

– Capital Reserve		5,000
– General Reserve	2,00,000	
Less : Amount used to pay dividend on Equity and Preference Share Capital	29,255	1,70,745
		1,75,745

3. Long Term Borrowings

– 2000, 8% Debentures of ₹100 each		2,00,000

4. Trade Payables

– Sundry Creditors		42,000
– Wages and Salaries Outstanding		4,280
		46,280

5. Short term Provisions

– Interest on Debentures		16,000
– Proposed Preference Dividend		30,000
– Proposed Equity Dividend		64,000
		1,10,000

6.	**Tangible Assets**		
	– Freehold Land and Building	8,50,000	
	Less : Depreciation @2%	17,000	8,33,000
	– Furniture and Fitting	86,300	
	Less : Depreciation @5%	4,315	81,985
			9,14,985
7.	**Inventories**		
	– Coco, Tea, Coffee		22,500
	– Bakery Products		16,400
			38,900
8.	**Cash and Cash Equivalents**		
	– Cash at Bank		76,380
	– Cash in Hand		2,200
			78,580
9.	**Other Current Assets**		
	– Preliminary and Formation Expenses		8,000
10.	**Revenue from Operations**		
	Sale of products		
	– Coco, Tea and Coffee	82,000	
	– Bakery Products	44,000	1,26,000
	Sale of services		
	– Rent of Rooms	48,000	
	– Receipt from Billiards	5,700	53,700
			1,79,700
11.	**Other Receipts**		
	– Miscellaneous Receipts		2,800
	– Discount Received		3,300
	– Transfer Fee		700
			6,800
12.	**Purchases of Stock in Trade**		
	– Coco, Tea and Coffee		58,800
	– Bakery Products		36,200
			95,000

13.	**Change in Inventories of Finished Goods**		
	– Coco, Tea, Coffee		
	Opening Stock	12,800	
	Less: Closing Stock	22,500	(9,700)
	– Bakery Products		
	Opening Stock	5,260	
	Less : Closing Stock	16,400	(11,140)
			(20,840)
14.	**Employee Benefit Expenses**		
	Wages and Salaries		15,300
	Add: Outstanding Wages and Salaries		4,280
			19,580
15.	**Other Operating Expenses**		
	– Rent Rates and Taxes		8,900
	– Coal and Firewood		3,290
	– Laundry		750
	– Carriage		810
	– Repair		4,250
	– Sundry Expenses		5,840
			23,840
16.	**Selling and Distribution Expenses**		
	– Advertising		8,360
17.	**Finance Cost**		
	– Interest on Debentures		16,000
18.	**Depreciation and Amortization Expenses**		
	– Land and Building		17,000
	– Furniture and Fittings		4,315
			21,315

Illustration 2

You are required to prepare financial statements from the following trial balance of Mehul Company Ltd. for the year ended 31st March, 2014

Mehul Company Ltd.

Trial Balance as at 31st March, 2014

Particulars	₹	*Particulars*	₹
Stock	68,000	Equity Shares Capital (Shares of ₹10 each)	2,50,000
Furniture & Fixtures	50,000	11% Debentures	50,000
Discount	4,000	Bank Loans	64,500
Loan to Directors	8,000	Bills Payable	12,500
Advertisement	2,000	Creditors	15,600
Bad Debts	3,500	Sales	4,26,800
Commission	12,000	Rent Received	4,600
Purchases	231,900	Transfer Fees	1,000
Plant and Machinery	86,000	Profit & Loss Appropriation Account	13,900
Rentals	2,500	Provision for Depreciation on Plant & Machinery	14,600
Current Account	4,500		
Cash	800		
Interest on Bank Loan	11,600		
Preliminary Expenses	1,000		
Wages	90,000		
Consumables	8,400		
Freehold Land	1,54,600		
Tools and Equipments	24,500		
Goodwill	26,500		
Debtors	28,700		
Bills Receivables	15,300		
Dealer Aids	2,100		
Transit Insurance	3,000		
Trade Expenses	7,200		
Distribution Freight	5,400		
Debentures Interest	2,000		
	8,53,500		**8,53,500**

Additional Information :

- Closing stock as on 31st march, 2014, ₹82,300
- Depreciation on furniture & fixtures @5%, Freehold land @2% and Tools and Equipments @5% to be provided.

Solution

Profit and Loss Account of Mehul Company Ltd.
for the year ended on 31st March, 2014

	Particulars	*Notes*	*Amount (₹)*
I	Revenue from Operations		4,26,800
II	Other Receipts	8	5,600
III	Total Revenue (I + II)		4,32,400
IV	Expenses		
	Purchase of Stock in Trade	9	2,31,900
	Change in Inventories of Finished Goods	10	(14,300)
	Employee Benefit Expenses	11	90,000
	Other Operating Expenses	12	48,100
	Selling and Administrative Expenses	13	2,000
	Finance Costs	14	13,600
	Depreciation and Amortization Expenses	15	6,817
	Total Expenses		3,78,117
V	Profit (Loss) for the Period (III-IV)		54,283
	Balance from Previous Years		13,900
	Profit (Loss) carried to Balance Sheet		**68,183**

Balance Sheet of Mehul Company Ltd.
as on 31st March, 2014

	Particulars	*Notes*	*Amount (₹)*
I	**Equity and Liabilities**		
	1. Shareholders' Fund		
	(a) Share Capital	1	2,50,000
	(b) Reserve and Surplus	2	68,183
	2. Non-Current Liabilities		
	(a) Long Term Liabilities	3	1,14,500
	3. Current liabilities		
	(a) Trade Payables	4	28,100
	TOTAL		**4,60,783**
II	**Assets**		
	1. Non-Current Assets		
	(a) Fixed Assets		
	(i) Tangible Fixed Assets	5	2,93,683
	(ii) Intangible Assets (Goodwill)		26,500
	2. Current Assets		

(a) Inventories		82,300
(b) Trade Receivables		28,700
(c) Cash and Cash Equivalents	6	5,300
(d) Short Term Loan and Advances	7	23,300
(e) Other Current Assets		1,000
TOTAL		**4,60,783**

Notes to the Financial Statements

1. *Share Capital*

– Equity Share Capital	
Authorised Share Capital	
25,000 equity shares of ₹10 each	2,50,000
Issued and Subscribed	
25,000 equity shares of ₹10 each	2,50,000
	2,50,000

2. *Reserve and Surplus*

– Balance as per last Balance Sheet	13,900
Add : Balance in Current Year Profit	54,283

3. *Long Term Borrowings*

	68,183
11% Debentures of ₹100 each	50,000
Bank Loan	64,500
	1,14,500

4. Trade Payables

Sundry Creditors	15,600
Bills Payables	12,500
	28,100

5. Tangible Assets

	Book Value	*Depreciation*	*Net value*
Freehold Land and Building	1,54,600	3,092	1,51,508
Furniture and Fixtures	50,000	2,500	47,500
Plant and Machinery	86,000	14,600	71,400
Tools and Equipments	24,500	1,225	23,275
Total	3,15,100	14,600	2,93,683

6. Cash and Cash Equivalents

Cash at Bank	4,500
Cash in Hand	800
	5,300

7. Short Term Loans and Advances

	Loan to Directors	8,000
	Bills Receivables	15,300
		23,300
8.	Other Income	
	Rent Received	4,600
	Transfer Fee	1,000
		5,600
9.	Purchase of Stock in Trade	
	Purchases	2,31,900
10.	*Change in Inventories of Finished Goods*	
	Closing Stock	82,300
	Less : Opening Stock	68,000
		14,300
11.	Employee Benefit Expenses	
	Wages	90,000
12.	Other Operating Expenses	
	Consumables	8,400
	Bad Debts	3,500
	Discount	4,000
	Rentals	2,500
	Commissions	12,000
	Dealer's Aid	2,100
	Transit Insurance	3,000
	Trade Expenses	7,200
	Distribution Freight	5,400
		48,100
13.	Selling and Administrative Expenses	
	Advertisements	2,000
14.	Finance Costs	
	Interest on Bank Charges	11,600
	Debenture Interest	2,000
		13,600
15.	Depreciation and Amortization Expenses	
	Freehold Land and Building	3,092
	Furniture and Fixtures	2,500
	Tools and Equipments	1,225
		6,817

Illustration 3

The following are the balances from the Ledger of Black Mango Hotel Ltd., on 31st March 2014:

	₹
Share capital - Credit Balance on 1st January, 2014	566,850
Preliminary Expenses	75,000
Freehold Premises	4,68,000
Furniture and Fittings	89,340
Glass and China	11,010
Linen	8,400
Cultery and Plate	3,900
Rates, Taxes and Insurance	17,130
Salaries	24,000
Wages	43,050
Stocks on 31st March, 2013	
Malto ₹ 12,390, Cold drinks ₹ 3780, Frooti ₹ 1650	17,820
Vitamins ₹ 1470, Protiens ₹ 1,140	2,610
Sundry Provision and Stoes ₹ 1,830, Coal ₹ 1500	3,330
Purchases	
Rice ₹ 36,270 Floor ₹ 39,600	75,870
Sundry Provisions and Stores ₹ 52,200	52,200
Malto ₹ 18810 Cold drinks ₹ 21900, Frooti ₹ 11520	52,230
Vitamins ₹ 10500, Protiens ₹ 2400	12,900
Laundry	9,510
Coal and Gas	21,600
Electric Light	11,280
General Expenses	17,100
Sales -	
Malto ₹ 38,700, Cold drinks ₹ 43,350, Frooti ₹ 18,630	100,680
Vitamins ₹ 21,600, Protiens ₹ 3,900	25,500
Meals	238,290
Rooms	93,750
Fires in Bedrooms	5,820
Washing charges	2,190
Repairs, Renewals and Depreciation	

Premises ₹ 3480, Furniture and Fittings ₹ 6600	10,080
Glass and China ₹ 6090, Linen ₹ 3900	9,990
Cultery and Bonchina Plate ₹ 2070	2.070
Cash Book – Debt Balances :	
In Bank	21,480
On Hand	2,190
Visitors Accounts unpaid	4,890
Sundry Creditors	33,900
Stocks on 31st March, 2013	
Malto ₹ 11,970, Cold drinks ₹ 3,330, Frooti ₹ 1,740	
Vitamins ₹ 3570, Protiens ₹ 690	
Sundry Provision and Stores ₹ 1410, Coal ₹ 990	

The Manager is entitled to a commission of 5% of the net profits after charging his commission. The authorized share capital is 100,000 shares of ₹ 10 each of which 57,000 shares were issued, the whole of the amount being called up. The final call on 2100 shares @ ₹ 1.50 per share was unpaid; the directors forfeited these shares at their meeting held on 15th March, 2014.

The tax liability is estimated at ₹ 43,000 and the directors propose to declare a dividend at the rate of 6 per cent. Prepare the Final Accounts for presentation to the shareholders.

Solution:

Balance Sheet of Black Mango Hotel Ltd., as on 31st March, 2014

	Particulars	Note No	₹
	Equity and Liabilities		
1	Shareholders' Funds		
	(a) Share capital	1	5,66,850
	(b) Reserves and Surplus	2	22,823
2	Current Liabilities		
	(a) Trade Payables	3	39,003
	(b) Short-term provisions	4	79,234
	Total		**7,07,910**
	Assets		
1.	Non-current assets		
	(a) Fixed Assets		
	– Tangible assets	5	5,57,340
2.	Current assets		
	(a) Inventories	6	47,010

	(b) Trade receivables		4,890
	(c) Cash and cash equivalents	7	23,670
	(d) Other current assets	8	75,000
	Total		**7,07,910**

Profit and Loss Account of Black Mango Hotel Ltd.
For the year ended 31st March, 2014

	Particulars		Note No	₹
I	Revenue from operations	(A)	9	466,230
II	Expenses :			
	Cost of materials consumed		10	75,870
	Purchase of Stock-in Trade		11	1,17,330
	Changes in inventories of finished goods work-in-progress and stock-in-Trade		12	60
	Employee benefits expenses		13	29,103
	Other operating expenses		14	1,07,580
	Administrative and general expense		15	34,230
	Total Expenses	(B)		364,173
III	Profit before tax (VII - VIII)	(A -- B)		102,057
IV	Provision for tax			43,000
V	Profit (Loss) for the period			59,057
VI	Proposed Dividend			32,940
	Dividend Distribution tax (3.294 x 0.10)			3,294
VII	Profit (Loss) carried forward to Balance Sheet			22,823

Notes to accounts

			₹
1.	Share Capital		
	Authorised		
	100,000 equity shares of ₹ 10 each		10,00,000
	Issued & subscribed & called up		
	54,900 Equity Shares of ₹ 10 each	549,000	
	Forfeited Shares	17,850	566,850
			5,66,850
2	**Reserve and Surplus**		
	Surplus (Profit & Loss) A/c		22,823
			22,823
3	**Trade Payables**		
	Sundry Creditors		33,900

Note	Particulars		
	Manager's Commission Outstanding		5,103
			39,003
4	**Short-term provisions**		
	Provision for taxation		43,000
	Proposed Dividend		32,940
	Dividend Distribution tax		3,294
			79,234
5	**Tangible assets**		
	Freehold Premises	471,480	
	Less: Depreciation	(3,480)	4,68,000
	Furniture & Fittings	95,940	
	Less: Depreciation	(6,600)	89,340
			5,57,340
6	**Inventories**		
	Raw Material		
	Malto, Cold drinks and Frooti	17,040	
	Vitamins and Protiens	4,260	
	Sundry Provisions & Stores	2,400	23,700
	Loose tools		
	Linen	12,300	
	Less: Depreciation	(3,900)	8,400
	Cutlery & Plate	5,970	
	Less: Depreciation	(2,070)	3900
	Glass and China	17,100	
	Less : Depreciation	(6,090)	11,010
			47,010
7	**Cash and Cash equivalents**		
	Cash at Bank	21,480	
	Cash in hand	2,190	**23,670**
8	**Other current assets**		
	Preliminary expenses	75,000	**75,000**
9	**Revenue from operations**		
	Sale of products		
	Malto, Cold drinks and Frooti	100,680	
	Vitamins and Protiens	25,500	1,26,180
	Sale of services		
	Meals	2,38,290	
	Rooms	93,750	
	Fires in Bed Rooms	5,820	
	Washing charges	2,190	3,40,050

			4,66,230
10	**Cost of materials consumed**		
	Rice, Floor		**75,870**
11	**Purchase of Stock-in-Trade**		
	Malto, Cold drinks and Frooti		52,330
	Vitamins, Protiens		12,900
	Sundry Provisions & Stores		52,220
			1,17,330
12	**Changes in inventories of finished goods work-in-progress and stock-in-Trade**		
	Opening Stock		
	Malto, Cold drinks and Frooti	17,820	
	Vitamins, Protiens	2,610	
	Sundry Provisions & Stores	3,330	23,760
	Less: Closing stock		
	Malto, Cold drinks and Frooti	(17,040)	
	Vitamins, Protiens	(4,260)	
	Sundry Provisions & Stores	(2400)	(23,700)
			60
13	**Employee benefits expenses**		
	Salaries	24,000	
	Manager's commission (on ₹ 102060 @ 5%)	5,103	29,103
			29,103
14	**Other operating expenses**		
	Wages		43,050
	Coal and Gas		21,600
	Laundry		95,100
	Electricity Light		11,280
	Repairs, Renewals and Depreciation		
	Premises	3,480	
	Furniture and Fittings	6,600	
	Glass and China	6,090	
	Linen	3,900	
	Cutlery & Plate	2,070	22,140
			1,07,580
15	**Administration and general expenses**		
	Rates, Taxes and Insurances	17,130	
	General expenses	17,100	34,230
			34,230

PROFIT OR LOSS PRIOR TO INCORPORATION

Generally, it happens with a newly formed company that an existing business is taken over as a going concern as at a date prior to the date of incorporation of the company. The profit or loss of the business, thus acquired, the period from the date of purchase till the date of incorporation* is called Profit or Loss Prior to Incorporation. Unless the agreement with the vendors provides otherwise, such a profit or loss belongs to the company. But profit or loss prior to incorporation should not be regarded as trading profit or loss of the company since the company cannot earn profit or incur loss before it comes into existence. In fact, such profit or loss increases or decreases the net assets acquired by the company on its formation and comes to it not as revenue but as capital. Thus, profit or loss prior to incorporation is of capital nature and as such it is necessary to ascertain such profit or loss as accurately as possible.

The profit or loss prior to incorporation should be treated in the books of accounts in the following manner:

(i) *Profit prior to incorporation:* Such a profit, being of capital nature, cannot be credited to the Profit and Loss Account and thus it cannot ordinarily be used for the purpose of payment of dividend. Hence, such a profit should be credited to Capital Reserve Account which can be utilised in writing off capital losses like preliminary expenses, discount on issue of shares or debentures or in writing down the value of fixed assets including goodwill. Until it is fully utilized, Capital Reserve Account has to be shown in the liabilities side of the Balance Sheet under the heading “Reserve and Surplus”.

(ii) *Loss prior to incorporation:* Such a loss, being of capital nature, should be debited to a separate account called “Loss Prior to Incorporation Account” which can be written off against other capital profits of the company. It can also be written off against the profit revenue profit of the company.

METHODS TO ASCERTAIN PROFIT OR LOSS PRIOR TO INCORPORATION

Profit or loss prior to incorporation can be ascertained in any of the following methods:

Preparation of Trading and Profit and Loss Account for the period upto the date of incorporation

Under this method, a trial balance has to be prepared as on the date of incorporation of the company by balancing off of the books and the value of stock has to be ascertained as on that date. Then, a Trading and Profit and Loss Account has to be prepared for the period which will disclose the profit or loss prior to incorporation. Profit or Loss prior to incorporation can be ascertained accurately under this method. All transactions thereafter would naturally relate exclusively to the post-incorporation period and thus give post-incorporation profit or loss.

But stock-taking and the balancing off of the books in the intervening period is often very inconvenient as the same will adversely affect the normal functioning of the business. In view of this difficulty, this method is not generally adopted in actual practice.

Preparation of Profit and Loss Account by apportionment of items of income and expenses into pre-incorporation and post-incorporation periods

Under this method, a trial balance is prepared only at the end of the accounting period and the profit or loss for the pre and post incorporation period is ascertained by preparing Profit and Loss Account. The profit or loss is ascertained by apportioning items of income and expenses between the two periods, i.e., the pre-incorporation and the post-incorporation periods on some basis. Thus under this method, profit or loss for the two periods, cannot be ascertained as accurately as under the first method, this method can only give an estimate of the profit or loss of the two periods. As the first method involves a lot of inconvenience, there is no other alternative than to depend on this method.

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*The date of commencement of business is of no consequence for this purpose.

The apportionment of profit or loss, in such a case, between the pre-incorporation and post-incorporation periods can be done on any one of the following basis:

Time basis

The profit or loss for the whole accounting period is apportioned between the periods prior to and after incorporation on the basis of time i.e., in proportion of the time of the respective periods. For example, if the time of the pre-incorporation and post-incorporation period be 3 months and 9 months respectively, the profit or loss for the whole period would be apportioned between the two periods in the ratio 3 : 9, i.e. 1 : 3. Thus, 1/4th of the profit would be treated as pre-incorporation profit while 3/4th of the profit would be treated as post-incorporation profit.

This principle is based on the assumption that profits are earned by the business evenly throughout the year. But in reality since no business can be expected to earn its profits evenly throughout the year, apportionment of profit or loss solely on the basis of time is not at all satisfactory.

Turnover basis

The profit or loss for the whole accounting period is apportioned between the periods prior to and after incorporation on the basis of turnover, i.e., in proportion of the turnover of the respective periods. For example, if the turnover of the pre-incorporation and post-incorporation periods be ₹ 1,00,000 and ₹ 4,00,000 respectively, the profit or loss for the whole period would be apportioned between the two periods in ratio of 1 : 4. Thus, 1/5th of the profit would be treated as pre-incorporation profit while 4/5th of the profit would be treated as post-incorporation profit.

This principle is also based on the assumption that turnover is spread evenly throughout the year. But in reality, this may not be always true. Besides, all the expenses of business need not necessarily depend on the turnover. As such, apportionment of profit or loss solely on the basis of turnover is also not satisfactory.

Equitable basis

The manner of apportionment of profit or loss between the pre-incorporation and the post-incorporation periods actually depends upon the nature of each particular item. The most equitable method is normally to apportion the gross profit or gross loss of the whole accounting period on the basis of the turnover and the expenses on their respective merits, those, varying with turnover being apportioned on that basis and those which do not vary with the turnover being apportioned on the basis of time.

What is actually to be done in this case is to prepare a Trading Account for the whole period and to find out the gross profit or gross loss in the usual way. The Profit and Loss Account is split up into the two periods (i.e., pre-incorporation and post- incorporation periods) and all the items appearing in the Profit and Loss Account are then apportioned on the basis of their respective merits. For this, following principles are, generally followed:

	Nature of the item	*Basis of apportionment*
1.	Gross Profit or Gross Loss	On the basis of turnover in the respective periods. OR In the absence of turnover in the respective periods, on the basis of expenses which are directly related to turnover in the respective periods. OR In the absence of any such information, on the basis of time in the respective periods.
2.	All fixed or standing charges, such as rent, rates, taxes, insurance, general expenses, salaries, printing and stationery, telephone,	On the basis of time in the respective periods.

	postage, and telegrams, depreciation, audit fees, etc.	
3.	All variable expenses directly varying with the turnover, such as, commission, discount, brokerage, salesmen's salaries, advertisement carriage outwards, etc.	On the basis of turnover in the respective periods.
4.	All expenses wholly applicable to the period prior to incorporation like vendors' salary, interest on vendors' capital, interest on purchase consideration upto the date of incorporation, etc.	Exclusively to be shown in the pre-incorporation period.
5.	All expenses wholly applicable to the post-incorporation period like, directors' fees, debenture interest, discount on issue of debentures, preliminary expenses or formation expenses, etc.	Exclusively to be shown in the post-incorporation period.

Illustration 4

Smart Ltd. was incorporated on 1st August, 2011 with an authorised capital of 5,00,000 equity shares of ₹ 10 each to acquire the business of Mr. Smart with effect from 1st April, 2011.

The purchase consideration was agreed at ₹ 7,00,000 to be satisfied by the issue of 40,000 equity shares of ₹ 10 each as fully paid-up and 3,000, 9% debentures of ₹ 100 each as fully paid-up.

The entries relating to the transfer were not made in the books which were carried on without a break until 31st March, 2012. On 31st March, 2012 the trial balance extracted from the books showed the following:

	₹	₹
Sales		10, 43,700
Purchases	7,76,580	
Advertising	37,800	
Postage and Telegram	8,820	
Rent and Rates	18,420	
Packing Expenses	16,800	
Office Expenses	12,540	
Opening Stock as on 1.4.2010	1,05,220	
Directors' fees	20,000	
Debenture Interest	18,000	
Land and Buildings	3,00,000	
Plant and Machinery	1,80,000	
Furniture and Fixture	20,000	
Sundry Debtors	1,39,500	

Cash at Bank	40,000	
Cash-in-hand	4,900	
Bills Payable		30,000
Sundry Creditors		53,240
Preliminary Expenses	7,360	
Smart's Capital Account		5, 89,000
Smart's Drawings Account	10,000	
	17,15,940	17,15,940

You are also given the following additional information:

(i) Stock on 31st March, 2012 amounted to ₹ 98,920.

(ii) The average monthly sales for April, May and June were one half of those for the remaining months of the year and the gross profit margin was constant throughout the year.

You are required to calculate the profit prior and post incorporation as on 31st March, 2012

Solution:

M/s Smart Ltd.

Trading Account for the year ended 31st March, 2012

Dr. Cr.

Particulars	₹	Particulars	₹
To Opening Stock	1,05,220	By Sales	10,43,700
To Purchases	7,76,580	By Closing Stock	98,920
To Gross Profit c/d	2,60,820		
	11,42,620		11,42,620

Profit and Loss Account for the year ended 31st March, 2012

	Pre-incorporation period, i.e., 1.4.2011 to 31.7.2011 ₹	*Post-incorporation period, i.e., 1.8.2011 to 31.3.2012* ₹		*Pre-incorporation period, i.e., 1.4.2011 to 31.7.2011* ₹	*Post-incorporation period, i.e., 1.8.2011 to 31.3.2012* ₹
To Advertising (5 : 16)	9,000	28,800	By Gross Profit b/d (5 : 16)	62,100	1,98,720
To Postage and Telegram (1 : 2)	2,940	5,880			
To Rent and Rates (1 : 2)	6,140	12,280			
To Packing Expenses (5 : 16)	4,000	12,800			

To Office Expenses (1 : 2)	4,180	8,360			
To Directors' fees		20,000			
To Debenture Interest		18,000			
To Preliminary Expenses		7,360			
To Pre-Incorporation profit	35,840				
To Net Profit c/d		85,240			
	62,100	**1,98,720**		**62,100**	**1,98,720**

Working Notes:

1. Ratio of Time between pre-incorporation period and post-incorporation period = 4 months : 8 months = 1 : 2
2. Ratio of turnover between pre-incorporation period and post-incorporation period -

   Let the turnover for the months of April, May and June be 1, turnover for the remaining months will be 2.

   Now, turnover for the pre-incorporation period

   (i.e. 1.4.2010 to 31.7.2010 = 1+1+1+2 = 5

   and turnover for the post-incorporation period

   (i.e., 1.8.2010 to 31.3.2010 = 8 x 2 = 16

   Ratio of turnover between the two periods = 5 : 16
3. As the amount of preliminary expenses is negligible. it has been assumed that the same has to be written off against the revenue.

Illustration No. 5

A company, incorporated on 1st May, 2012 acquired a business as a going concern with effect from 1st January, 2012. The first accounts were drawn up to September 30, 2012.

The gross profit is₹ 2,24,000. The general expenses are ₹ 56,880, directors remuneration ₹ 4,000 p.m.; formation expenses amounted to ₹ 6,000, rent which till June 30, 2012 was ₹ 400 p.m. was increased to ₹ 12,000 per annum from July 1, 2012.

The manager of the earlier firm whose salary was ₹ 2,000 p.m. was made as director upon the incorporation and his remuneration thereafter is included in the figure of Directors' remuneration given earlier.

Prepare Profit and Loss Account for the period and find out the profits available for dividends and the profit prior to incorporation.

Solution:

Profit and Loss Account for the period of 9 months ended 30th September, 2012

Dr. Cr.

	Pre-incorporation period, i.e., 1.1.2012 to 30.4.2012 ₹	*Post-incorporation period, i.e., 1.5.2012 to 31.9.2012* ₹		*Pre-incorporation period, i.e., 1.1.2012 to 30.4.2012* ₹	*Post-incor poration period, i.e., 1.5.2012 to 30.9.2012* ₹
To General Expenses (4 : 5)	25,280	31,600	By Gross Profit b/d	99,556	1,24,444
To Rent	1,600	3,800			
To Salary to Manager	8,000				
To Directors' Remuneration		20,000			
To Pre-incorporation profit transferred to Capital Reserve A/c	64,676				
To Net Profit c/d		69,044			
	99,556	**1,24,444**		**99,556**	**1,24,444**

1. Profit available for dividend = ₹ 69,044.
2. Profit prior to incorporation ₹ 64,676 being capital profits transferred to Capital Reserve Account which can be utilised in writing off formation expenses of ₹ 6,000. Then the Capital Reserve Account will show a balance of ₹ 58,676.

Working Notes:

1. As the information is available about the turnover in the respective periods, gross profit has been apportioned between the pre-incorporation and post-incorporation periods on the basis of time, i.e., in the ratio 4 : 5
2. Directors' remuneration for the period 1st May, 2012 to September, 2012, i.e., for 5 months = ₹ 4,000 x 5 = ₹ 20,000.
3. Rent for the period prior to incorporation = ₹ 400 x 4 = ₹ 1,600

   For the post incorporation period

   ₹ 400 x 2 + = ₹ (800 + 3,000) = ₹ 3,800
4. Salary to manager for the period prior to incorporation = ₹ 2,000 x 4 = ₹ 8,000.
5. General expenses have been apportioned on the basis of time, i.e., in the ratio 4 : 5.
6. It is assumed that the formation expenses are not be written off.

Illustration No. 6

Vijay Ltd. was incorporated on 1st March, 2012 and received its certificate of commencement of business on 1st April, 2012. The company bought the business of M/s Small and Co. with effect from 1st November, 2011. From the following figures relating to the year ending October, 2012, find out the profit available for dividends:

(i) Sales for the year were ₹ 6,00,000 out of which sales upto 1st March were ₹ 2,50,000.

(ii) Gross profit for the year was ₹ 1,80,000.

(iii) Expenses debited to the Profit and Loss account were:

	₹
Rent	9,000
Salaries	15,000
Directors' fees	4,800
Interest on debentures	5,000
Audit fees	1,500
Discount on sales	3,600
Depreciation	24,000
General expenses	4,800
Advertising	18,000
Stationery and printing	3,600
Commission on sales	6,000
Bad debts	1,500*
Interest to vendor on purchase consideration upto May 1, 2012	3,000

* *₹ 500 relates to debts created prior to incorporation.*

Solution:

Statement showing profit prior to and after incorporation

	Basis of Allocation	*Prior to incorporation (₹)*	*After incorporation (₹)*
Gross profit	Sales	75,000	1,05,000
Less: Expenses:			
Rent	Time	3,000	6,000
Salaries	Time	5,000	10,000
Directors' fees	Actual	-	4,800
Interest on debentures	Actual	-	5,000
Audit fees	Time	500	1,000
Discount on sales	Sales	1,500	2,100
Depreciation	Time	8,000	16,000

General expenses	Time	1,600	3,200
Advertising	Sales	7,500	10,500
Stationery and printing	Time	1,200	2,400
Commission on sales	Sales	2,500	3,500
Bad debts	Actual	500	1,000
Interest to vendor	Time	2,000	1,000
Total Expenses		33,300	66,500
Profit (gross profit – expenses)		41,700	38,500

Working Notes:

(i) The ratio of sales is ₹ 2,50,000 : ₹ 3,50,000 i.e. 5 : 7.

(ii) The ratio of time is 4 months (upto 1st March) to 8 months or 1 : 2 except in case of interest to vendor.

(iii) Interest paid to vendor is for 6 months out of which interest for four months (upto 1st March) is charged to the period prior to incorporation.

(iv) Bad debts have been allocated as per the instruction.

(v) Directors' fees and interest on debentures, arising only on formation of the company, have been charged wholly to the post incorporation period.

PRELIMINARY EXPENSES

Preliminary expenses refer to those expenses which are incurred in forming a joint stock company. These comprise the expenses incidental to the creation and floatation of a company and the following items are usually included therein:

(i) Stamp duty and fees payable on registration of the company and stamp papers purchased for preliminary contracts of the company.

(ii) The legal charges for preparing the Prospectus, Memorandum and Articles of Association and contracts and of the registration of the company.

(iii) Accountants' and Valuers' fees for reports, certificates, etc.

(iv) Cost of printing the Memorandum and Articles of Association, printing, advertising and issuing the prospectus.

(v) Cost of preparing, printing and stamping letters of allotment and share certificates.

(vi) Cost of preparing printing and stamping Debenture Trust Deed, if any.

(vii) Cost of company's seal and books of account, statutory books and statistical books.

But preliminary expenses should not include the following expenses which are incurred before commencement of business:

(i) Cost of preparation of the feasibility report.

(ii) Cost of preparation of the project report.

(iii) Cost of conducting market survey or any other survey necessary for the business of the company.

(iv) Consultancy fees payable for engineering services in connection with the business.

Generally, a limit is prescribed in the Articles or Prospectus or the Statement in lieu of Prospectus upto which any amount would be spent on preliminary expenses. But sanction of the shareholders is necessary if the amount spent on preliminary expenses exceeds the said limit. The accounting for preliminary expenses will be as follows:

Preliminary Expenses A/c Dr. with the amount of expenditure

To Cash or Bank A/c

Strictly speaking preliminary expenses are of capital nature and as such should be shown on the assets side of the Balance Sheet under the heading "Miscellaneous Expenditure".

Although, there is no legal compulsion to write off the amount of preliminary expenses, it is prudent to write it off as soon as possible since it is unrepresented by assets. Preliminary expenses being of capital nature, may be written off against capital profits.

Alternatively, such expenses may be treated as deferred revenue expenditure and written off gradually over a number of years by transfer to Profit and Loss Account. For income-tax purposes, such expenses can be written off over a period of 10 years. Until completely written off, Preliminary expenses have to be shown on the assets side of the Balance Sheet under the heading 'Miscellaneous Expenditure'.

LESSON ROUND-UP

– Final accounts of a company consist of balance sheet as at the end of the accounting period and profit and loss account for that period.

– Section 129 of the Companies Act, 2013 prescribes the form and contents of balance sheet and profit and loss account of a company.

– Balance sheet of a company shall be prepared according to Schedule III of the Companies Act, 2013.

– The term managerial remuneration includes remuneration payable to managing director, whole-time directors, part-time directors and manager.

– The total managerial remuneration payable by a public company or a private company which is a subsidiary of a public company to its directors including any managing or whole-time director or manager is limited to 11% of the net profits.

– Dividend refers to that part of the profits of a company which is distributed by the company among its shareholders by way of return on investments made by the shareholders in the shares, of the company.

– Companies declaring distributing or paying dividends are liable to pay tax on the same at prescribed rate which is known tax on distributed profit.

– Interim dividend means a dividend paid to the shareholders of a company in anticipation of profits of a period before the accounts of the company for that period have been prepared.

– When a company accumulates huge reserves out of its profits which is much in excess of the needs of the company, the excess amount can be distributed among the existing shareholders of the company by way of bonus shares.

SELF-TEST QUESTIONS

(*These are meant for re-capitulation only. Answers to these questions are not to be submitted for evaluation*)

1. State how you will treat the following while preparing the final accounts of the company concerned for the year ending 31.3.2014.

(i) Land and Buildings (Cost ₹ 5,00,000 depreciation provided ₹ 80,000) sold for ₹ 7,50,000.

(ii) It was discovered in September 2013 that the purchase invoice of ₹ 50,000 dated 11.2.2012 was not entered in the book at all; accounts for 2011-12 were passed at the AGM in August, 2013.

(iii) While preparing the accounts for 2012-2013 closing stock was valued at market price ₹ 6,20,000 instead of cost which was ₹ 6,50,000.

(iv) In June, 2012 post manufacturing excise duty totaling ₹ 6,00,000 was paid in respect of 2011-12 and 2012-2013.

(v) The market value of the quoted investments is ₹ 2,25,000 as against the cost of ₹ 2,50,000.

(vi) Interest received 13,500 after tax being deducted at 10%.

(vii) Railway claim for goods lost in transit in 2011-12 costing ₹ 40,000 settled in 2012-13 for ₹ 30,000. No entry was passed in 2011-12.

(viii) Sales tax, collected from customers ₹ 1,50,000 against which amount paid is ₹ 1,20,000.

(ix) Subsidy, ₹ 1,00,000 received from Government for installation of generating set.

(x) Balance held in the Bank of Iraq, Baghdad, ₹ 25,000.

[Ans.: (i) ₹ 2,50,000 capital reserve; 80,000 revenue income; (ii) Debit Profit and Loss Appropriation Account for 2009-10; (iii) No Special treatment; the method of valuation should be disclosed in the balance sheet; (iv) Debit Profit and Loss Appropriation Account for 2009-10; (v) Disclose the market value in the balance sheet - no provision need be made for the fall in the value; (vi) Either show gross income in profit and loss account of ₹ 15,000 or net ₹ 13,500 indicating ₹ 1,500, tax deducted at source; (vii) ₹ 30,000, income, should be shown as a separate item, preferably below the line; (viii) ₹ 30,000 should be shown as a current liability; (ix) Should be shown as a capital reserve or as a deduction from the cost of the generating set; (x) The name of the bank should be disclosed in the balance sheet along with the maximum balance held at any time during the year.]

Lesson 4

Corporate Restructuring

LESSON OUTLINE

- Meaning of Corporate Restructuring
- Need and Scope of Corporate Restructuring
- Kinds of Restructuring
- Meaning of Amalgamation
- Types of Amalgamation
- Methods of Accounting for Amalgamations
- Accounting for Amalgamations
- Acquisition of Business
- Internal Reconstruction
- Methods of Internal Reconstruction
- Lesson Round UP
- Self Test Questions

LEARNING OBJECTIVES

Corporate restructuring is a very hot topic now a days. Various companies are using the restructuring mode for different-different reasons. Corporate restructuring provides a mode for the companies to survive in the fierce competition. The objective of this lesson is to get students aware about the accounting aspects for different forms of Corporate Restructuring. After going through, this lesson, the student will able to :

- Understand the meaning of Corporate restructuring, its need, scope and different forms
- Understand the accounting concepts relating to amalgamation in the nature of merger and acquisitions.
- Understand the accounting entries in the books of transferor and transferee company
- Understand the accounting entries on acquisition of business by a company

Pooling of Interest Method of accounting is followed in case of an amalgamation in the nature of merger. In this method, the amalgamation is accounted for as if the separate business of the amalgamating companies were intended to be continued by the transferee (amalgamated) company. Accordingly, only minimal, changes are made in aggregating the individual financial statements of the amalgamating companies.

MEANING OF CORPORATE RESTRUCTURING

Restructuring as per Oxford dictionary means, "to give a new structure to, rebuild or rearrange". Corporate Restructuring thus implies rearranging the business for increased efficiency and profitability.

The meaning of the term 'Corporate Restructuring' is quite wide and varied. Depending upon the requirements of a company, it is possible to restructure its business, financial and organizational transactions in different forms. Restructuring is a method of changing the organizational structure in order to achieve the strategic goals of the organization or to sharpen the focus on achieving them. The essentials of Corporate Restructuring are efficient and competitive business operations by increasing the market share, brand power and synergies.

Simply stated, Corporate Restructuring is a comprehensive process, by which a company can consolidate its business operations and strengthen its position for achieving its short-term and long-term corporate objectives - synergetic, dynamic and continuing as a competitive and successful entity.

The expression 'Corporate Restructuring' implies restructuring or reorganizing a company or its business (or one of its businesses) or its financial structure, in such a way as to make it operate more effectively. This is not a legal term and has no precise meaning nor can it be defined with precision.

NEED AND SCOPE OF CORPORATE RESTRUCTURING

Corporate Restructuring is concerned with arranging the business activities of the corporate as a whole so as to achieve certain predetermined objectives at corporate level. Such objectives include the following:

- orderly redirection of the firm's activities;
- deploying surplus cash from one business to finance profitable growth in another;
- exploiting inter-dependence among present or prospective businesses within the corporate portfolio;
- risk reduction; and
- development of core competencies.

When we say corporate level it may mean a single company engaged in single activity or an enterprise engaged in multi activities. It could also mean a group having many companies engaged in related or unrelated activities. When such enterprises consider an exercise for restructuring their activities they have to take a wholesome view of the entire activities so as to introduce a scheme of restructuring at all levels. However such a scheme could be introduced and implemented in a phased manner. Corporate Restructuring also aims at improving the competitive position of an individual business and maximizing it's contribution to corporate objectives. It also aims at exploiting the strategic assets accumulated by a business i.e. natural monopolies, goodwill, exclusivity through licensing etc. to enhance the competitive advantages. Thus restructuring would help bringing an edge over competitors.

The scope of Corporate Restructuring encompasses enhancing economy (cost reduction) and improving efficiency (profitability). When a company wants to grow or survive in a competitive environment, it needs to restructure itself and focus on its competitive advantage. The survival and growth of companies in this environment depends on their ability to pool all their resources and put them to optimum use. A larger company, resulting from merger of smaller ones, can achieve economies of scale. If the size is bigger, it enjoys a higher corporate status. The status allows it to leverage the same to its own advantage by being able to raise larger funds at lower costs. Reducing the cost of capital translates into profits. Availability of funds allows the enterprise to grow in all levels and thereby become more and more competitive.

SOME EXAMPLES OF CORPORATE RESTRUCTURING

– Assume ABC Limited has surplus funds but it is not able to consider any viable project. Whereas XYZ Limited has identified viable projects but has no money to fund the cost of the project. Assume the merger of both the said companies. A viable solution emerges resulting in mutual help and benefit and in a competitive environment, it offers more benefits than what meets your eyes.

– Take the case of a company secretary in practice. His income may not be as regular as would be the case of a company secretary in employment. Assume he marries a company secretary in employment. The merger will help them meet the requirements of practice and enable the practice to grow without getting affected by the irregularity in cash flow.

Thus going by the above simple illustrations, one should be able to understand that Corporate Restructuring aims at different things at different times for different companies and the single common objective in every restructuring exercise is to eliminate the disadvantages and combine the advantages.

WHY CORPORATE STRUCTURING EXERCISE IS CARRIED OUT ?

The various needs for undertaking a Corporate Restructuring exercise are as follows:

(i) to focus on core strengths, operational synergy and efficient allocation of managerial capabilities and infrastructure.

(ii) consolidation and economies of scale by expansion and diversion to exploit extended domestic and global markets.

(iii) revival and rehabilitation of a sick unit by adjusting losses of the sick unit with profits of a healthy company.

(iv) acquiring constant supply of raw materials and access to scientific research and technological developments.

(v) capital restructuring by appropriate mix of loan and equity funds to reduce the cost of servicing and improve return on capital employed.

(vi) Improve corporate performance to bring it at par with competitors by adopting the radical changes brought out by information technology.

KINDS OF RESTRUCTURING

Restructuring may be of the following kinds:

Financial restructuring which deals with the restructuring of capital base and raising finance for new projects. This involves decisions relating to acquisitions, mergers, joint ventures and strategic alliances.

Technological restructuring which involves, inter alia, alliances with other companies to exploit technological expertise.

Market restructuring which involves decisions with respect to the product market segments, where the company plans to operate based on its core competencies.

Organizational restructuring which involves establishing internal structures and procedures for improving the capability of the personnel in the organization to respond to changes. This kind of restructuring is required in order to facilitate and implement the above three kinds of restructuring. These changes need to have the cooperation of all levels of employees to ensure that the restructuring is successful.

The most commonly applied tools of corporate restructuring are amalgamation, merger, demerger, slump sale, acquisition, joint venture, disinvestment, strategic alliances and franchises.

After a brief overview of corporate restructuring now we would confine our discussion to the accounting for different types of restructuring.

AMALGAMATION OF COMPANIES

MEANING OF AMALGAMATION

The term "amalgam" means to unite or to combine. Generally, the term 'amalgamation' is used when two or more existing companies go into liquidation and a new company is formed to take over their business and the term 'absorption' is used when one or more existing companies go into liquidation and one existing company takes over or purchases the businesses of all companies. However, the difference between amalgamation and absorption has been dispensed with by the Accounting Standard (AS-14) - Accounting for Amalgamations issued by the ICAI. Thus the term amalgamation includes absorption.

Therefore, amalgamation means liquidation of two or more companies to form a new company or liquidation of one or more company by takeover by one of the existing company.

Accounting Standard (AS) 14 -Accounting for Amalgamations

AS 14 issued by the ICAI, deals with the procedure of accounting for amalgamations and the treatment of any resultant goodwill or reserves.

This standard does not deal with cases of acquisitions which arise when there is a purchase by one company (referred to as the acquiring company) of the whole or part of the shares, or the whole or part of the assets, of another company (referred to as the acquired company) in consideration for payment in cash or by issue of shares or other securities in the acquiring company or partly in one form and partly in the other. The distinguishing feature of an acquisition is that the acquired company is not dissolved and its separate entity continues to exist. As per AS – 14,

(a) Amalgamation means an amalgamation pursuant to the provisions of the Companies Act, 1956 or any other statute which may be applicable to companies.

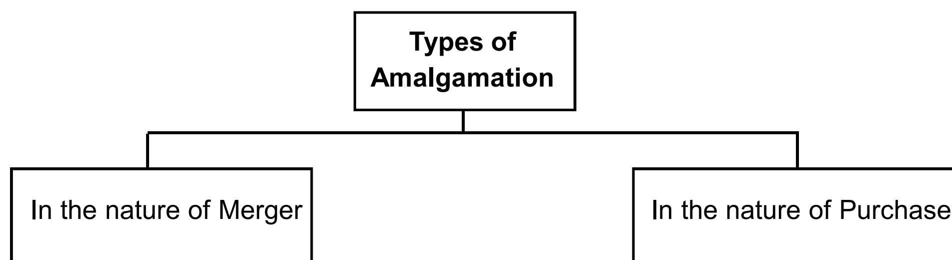
(b) Transferor Company means the company which is amalgamated into another company. It is also called Vendor Company.

(c) Transferee Company means the company into which a transferor company is amalgamated. It is also called Vendee Company.

(d) Reserve means the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability.

Types of Amalgamation

Generally speaking, there are two basic methods under which companies can unite together.



Amalgamation in the Nature of Merger

The amalgamations where there is a genuine pooling not merely of the assets and liabilities of the amalgamating companies but also of the shareholders' interests and of the businesses of these companies. Such amalgamations

are amalgamations which are in the nature of 'merger' and the accounting treatment of such amalgamations should ensure that the resultant figures of assets, liabilities, capital and reserves more or less represent the sum of the relevant figures of the amalgamating companies. An amalgamation is classified as an 'amalgamation in the nature of merger' when all of the following five conditions are satisfied.

(i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

(ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

(iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agrees to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

(iv) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

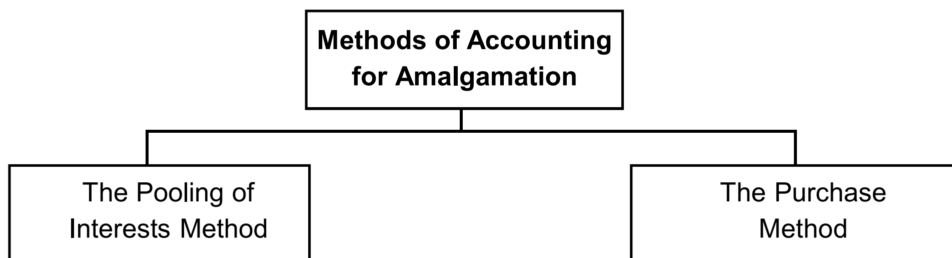
(v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

Amalgamation in the Nature of Purchase

The amalgamations which are in effect a mode by which one company acquires another company and, as a consequence, the shareholders of the company which is acquired normally do not continue to have a proportionate share in the equity of the combined company, or the business of the company which is acquired is not intended to be continued. Such amalgamations are amalgamations in the nature of purchase.

If any one or more conditions listed in the amalgamation in the nature of merger is not satisfied, it is amalgamation in the nature of purchase.

Methods of Accounting for Amalgamations



The Pooling of Interests Method

The Pooling of Interests Method is for an amalgamation in the nature of merger. Following are the three salient features of this method:

- Under the Pooling of Interests Method, the assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts and in the same form as at the date of amalgamation.

For example, the machinery of the transferor company should be clubbed with the machinery of the transferee company and shown at a combined figure. Similarly, general reserve of the transferor company should be clubbed with the general reserve of the transferee company. This reflects the facts that the entries are simply merged together.

- If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies is adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies are reported in accordance with Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.
- The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company should be adjusted in the reserves of the transferee company. Accordingly no goodwill or capital reserve will arise out of amalgamation by way of merger.

The Purchase Method

The object of the purchase method is to account for the amalgamation by applying the same principles as are applied in the normal purchase of assets. This method is used in accounting for amalgamations in the nature of purchase. Following rules are adopted in this method:

- The assets and liabilities of the transferor company should be incorporated either at their existing carrying amounts or the purchase consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation in the books of the transferee company.
- Identity of statutory reserves whether capital or revenue or arising on revaluation of the transferor company is not preserved and hence these reserves should not be included in the transferee company.
- If purchase consideration is more than the value of net assets of the transferor company, it should be treated as goodwill arising on amalgamation and should be debited to Goodwill Account. On the other hand, if the consideration is lower than the value of net assets acquired, the difference should be credited to Capital Reserve Account.
- The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life. The amortisation period should not exceed five years unless a somewhat longer period can be justified.
- The statutory reserves of the transferor company which are required to be maintained for legal compliance e.g, Export Profit Reserve should be included in financial statements of the transferee company by crediting the relevant Statutory Reserve Account and corresponding debit should be given to ‘Amalgamation Adjustment Account’.

The Amalgamation Adjustment Account should be disclosed as a part of Miscellaneous Expenditure in the balance sheet. Where the identity of the Statutory Reserve is no longer required to be maintained, both statutory Reserve Account and Amalgamation Adjustment Account should be reversed.

CONSIDERATION

The consideration for the amalgamation may consist of securities, cash or other assets. In determining the value of the consideration, an assessment is made of the fair value of its elements. A variety of techniques is applied in arriving at fair value. For example, when the consideration includes securities, the value fixed by the statutory authorities may be taken to be the fair value. In case of other assets, the fair value may be determined by reference to the market value of the assets given up. Where the market value of the assets given up cannot be reliably assessed, such assets may be valued at their respective net book values.

Many amalgamations recognise that adjustments may have to be made to the consideration in the light of one or more future events. When the additional payment is probable and can reasonably be estimated at the date

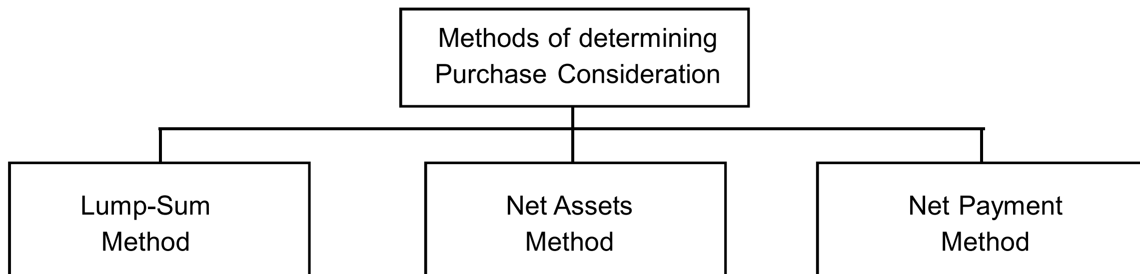
ACCOUNTING FOR AMALGAMATIONS

A. Computation of purchase consideration

B. Accounting in the books of transferor company

C. Accounting in the books of transferor company

Computation of purchase consideration



(i) Lump Sum Method: The amount to be paid by the transferee company as consideration may be stated in the problem as a lump sum. In such a case, no calculation is required.

(ii) Net Assets Method: The amount of consideration or the amount of net assets is ascertained under this method in the following manner:

Assets taken over (at their revalued figures, if any, otherwise at their book figures).

Less: Liabilities taken over (at their agreed values, if any, otherwise at their book figures).

While determining the amount of consideration under this method care should be taken of the following:

1. The term "Assets" will always include cash in hand and cash at bank, unless otherwise stated but shall not include any fictitious asset like preliminary expenses, underwriting commission, discount on issue of shares or debentures, profit and loss account (debit balance), etc.
2. If any particular asset is not taken over by the transferee company, the same should not be included while computing purchase consideration.
3. If there is any goodwill or pre-paid expenses, the same should be included in the assets taken over unless otherwise stated.
4. The term "Liabilities" will mean all liabilities to third parties (the company being the first party and shareholders being the second party).
5. The term "Trade Liabilities" will mean trade creditors and bills payable and shall not include other liabilities to third parties, such as, bank overdraft, debentures, outstanding expenses, taxation liability, etc.
6. The term "Liabilities" shall not include any past accumulated profits or reserves, such as general reserve, reserve fund, sinking fund, dividend equalisation fund, capital reserve, securities premium account, capital redemption reserve account, profit and loss account etc. These are payable to the shareholders and not to the third parties.

7. If any fund or portion of any fund denotes liability to third parties, the same must be included in liabilities, such as, staff provident fund, workmens' savings bank account, workmens' profit sharing fund, workmens' compensation fund (up to the amount of claim, if any), etc.
8. If any liability is not taken over by the transferee company, the same should not be included.
9. The term "business" will always mean both the assets and the liabilities of the company.

(iii) Net Payment Method: The amount of consideration under this method is ascertained by adding up the total value of shares and other securities issued and the payments made in the form of cash and other assets by the transferee company to the transferor company in discharge of consideration. So the consideration constitutes the total payment in whatever form either in shares, debentures, or in cash to the liquidator of the transferor company for payment to the shareholders of the transferor company. Significantly, the total payments made by the transferee company to discharge the claims of preference shareholders and/or equity shareholders of the transferor company may be construed as consideration. In fact they can be satisfied by issuing preference shares/equity shares or debentures, at par, premium or discount and partly by cash. Now the question arises, suppose the transferee company has agreed to discharge the debentures of the transferor company by issuing its own debentures whether it is possible to include the debentures issued to the debentureholders as part of consideration. In this case, according to AS-14, any payments made by the transferee company to other than the shareholders of the transferor company cannot be treated as part of consideration. Moreover, consideration implies the value agreed upon for the net assets taken over by the transferee company, hence payments made to discharge the liabilities of the transferor company may be excluded from consideration. Therefore payments made to the debentureholders should not be considered as part of consideration and they should treated separately and discharged as per the terms of agreement. The same principles may apply to the cost of amalgamation paid by the transferee company since such payment will not form part of purchase consideration and hence ignored. A separate entry will be made by the transferee company in this regard.

It may be noted that in this study material, by consideration, under net payment method we shall mean the total payments made by the transferee company to the shareholders of the transferor company for the value of net assets taken over which would have been available to the shareholders of the transferor company had there been no merger. Therefore, any payments made to debentureholders or to discharge the liabilities of the transferor company by the transferee company are excluded from the calculation of consideration. The practical problems in this study material are also worked out accordingly.

While determining the amount of consideration under this method, care should be taken of the following:

1. The value of assets and liabilities taken over by the transferee company are not to be considered in calculating the consideration.
2. The payments made by the transferee company for shareholders, whether in cash or in shares or in debentures must to be taken into account.
3. Where the liabilities are taken over by the transferee company and subsequently discharged such amount should not be added to consideration.
4. When liabilities are taken over by the transferee company they are neither deducted nor added to the amount arrived at as consideration.
5. Any payments made by the transferee company to some other party on behalf of the transferor company are to be ignored.

6. If the liquidation expenses of the transferor company are paid by the transferee company, the same should not be taken as a part of the consideration.

(iv) Shares Exchange Method: In this method, the consideration is ascertained on the basis of the ratio in which the shares of the transferee company are to be exchanged for the shares of the transferor company. This exchange ratio is generally determined on the basis of the value of each company's shares.

Illustration 1

Following is the balance sheet of A Ltd. as on 31st March, 2014:

	Particulars		*Amount (₹)*
I	**EQUITIES AND LIABILITIES**		
1	**Shareholders' funds**		
	(a) Share Capital		
	Authorised, Issued subscribed and paid up capital		
	14% Preference shares of Rs. 100 each	7,50,000	
	Equity shares of Rs. 10 each, fully called up and paid up	15,00,000	22,50,000
	(b) Reserve and surplus		
	General reserve		9,00,000
2	**Non-current liabilities**		
	15% Debentures		7,00,000
3	**Current Liabilities**		
	Current liabilities		5,00,000
	TOTAL		**43,50,000**
II	**ASSETS**		
1	**Non-current Assets**		
	(a) Fixed Assets		
	Tangible Assets & intangible Assets		32,50,000
	(b) Investment		6,00,000
2	**Current Assets**		
	Misc Current Assets		5,00,000
	TOTAL		**43,50,000**

X Ltd agreed to take over the assets and liabilities on the following terms and conditions:

(i) When consideration calculated under Net Assets method

(a) Discharge 15% debentures at a premium of 10% by issuing 15% debentures of X Ltd.

(b) Fixed assets 10% above the book value.

(c) Investments at par value.

(d) Current assets at a discount of 10%.

(e) Current liabilities at book value.

(ii) When consideration calculated under Net Payment method

(a) Discharge the debenture holders of A Ltd. at 10% premium by issuing 15% debentures of X Ltd.

(b) Preference shareholders are discharged at a premium of 10% by issuing 15% preference shares of ₹ 100 each.

(c) Issue 3 equity shares of ₹ 10 each for every 2 equity shares in X Ltd. and pay cash @ ₹ 3 per equity share.

Calculate consideration under:

(i) Net assets method; and (ii) Net payment method respectively.

Solution

Calculation of Purchase Consideration

(i) Net Asset Method:

		(₹ in '000's)
Value of assets taken over:		
Fixed assets		35,75
Investments		6,00
Current assets		4,50
Total assets		46,25
Less: Liabilities taken over :		
15% debentures	7,70	
Current liabilities	5,00	12,70
		33,55

(ii) Net Payment Method:

	(₹ in '000's)	Mode of Payment
For preference shareholders	8,25	15% Pref. Shares in X Ltd.
For equity shareholders:		
3 equity shares for every		
2 shares =	22,50	Equity shares
₹ 3 per share=	4,50	Cash
Consideration	35,25	

NB: Consideration for debentureholders has not been included. These debentures are assumed to be taken over and discharged by X Ltd. by issuing 15% debentures.

ACCOUNTING ENTRIES IN THE BOOKS OF TRANSFEROR COMPANY

It involves the closing of accounts in the books of the transferor company. The following procedures are followed:

1. Open a Realisation Account and transfer all the assets except any fictitious assets like preliminary expenses, underwriting commission, discount on issue of shares or debentures, profit and loss account (Dr.) balance, etc., to it at their book value:

Realisation A/c	Dr.	(with the total)
To Sundry Assets A/c		(with their books value)
(Individually)		

Notes:

(i) If cash in hand and cash at bank are not taken over by the transferee company, do not transfer them to Realisation Account. But, if it is taken over, then it must be transferred to the Realisation Account.

(ii) The asset not taken over by the transferee company has also to be transferred to the Realisation Account.

(iii) Goodwill and other intangible assets like trade marks, patent rights, etc. are also transferred to Realisation Account provided they have realisable value or they are taken over by the transferee company.

2. Similarly, transfer the liabilities taken over by the transferee company to the Realisation Account at their book figures:

Sundry Liabilities A/c (individually)	Dr	(with their book figure)
To Realisation A/c		(with the total)

3. On the consideration becoming due from the transferee company:

Transferee Company	Dr	(with the amount of
To Realisation A/c		consideration)

4. If any assets (other than fictitious assets) is not taken over by the transferee company, the same has to be realised by the transferor company itself:

Bank	Dr	(with the realised value)
To Realisation A/c		

5. On receiving the consideration from the transferee company:

Shares in Transferee Company	Dr	(as the case may be
Debentures in Transferee Company	Dr	according to the terms of
Bank	Dr	discharge of the consi-
To Transferee Company		deration)

6. If the liquidation expenses or realisation expenses are borne by the transferor company itself:

Realisation A/c	Dr	(with the amount of
To Bank		expenditure)

7. If the liquidation expenses or realisation expenses are borne by the transferee company:

In such a case, it is better not to pass any entry in the books of the transferor company. Alternatively, the following two entries may be passed, the effect of which will be practically nil:

(i) Transferee Company	Dr	(with the amount of
To Bank		expenditure)
(ii) Bank	Dr	(with the amount of
To Transferee Company		expenditure)

Entry (i) is passed when the expenditure is incurred, and entry (ii) when it is reimbursed

8. If any liability is not taken over by the transferee company, the same need not be transferred to the Realisation Account. On payment, the liability account should be debited and Bank Account is credited with the actual amount paid. But, if there is any profit or loss on redemption of the liability, the same must be shown in the Realisation Account. The entry for this will be:

(a) In case of Profit:		
Respective Liability A/c	Dr	(with the profit, i.e
To Realisation A/c		difference between the amount due and the amount payable)
(b) In case of Loss:		
Realisation A/c	Dr	(with the loss, i.e,difference
		To Respective Liability A/c between the amount payable and the amount due)

9. Now pay off the outside liabilities, if any, not taken over by the transferee company:

Respective Liability A/c	Dr	(with the amount paid)
To Bank		

10. When the debentures are discharged: (not assumed or discharged by transferee company)

(a) Debentures A/c	Dr	(with the book value)
To Debentureholders A/c		
(b) Debentureholders A/c	Dr	(with the amount paid)
To Bank		

11. Now, pay off the preference shareholders, if any

(a) Preference Share Capital A/c	Dr	(with the book figures)
To Preference Shareholders A/c		
(b) Preference Shareholders A/c	Dr	(with the amount payable)
To Preference Shares in Transferee Company		
To Equity Shares in Transferee Company		(as the case may be)
To Debentures in Transferee Company		
To Bank		

12. Now, close the Realisation Account and transfer the profit or loss on realisation to Equity Shareholders Account:

(a) In case of profit:		
Realisation A/c	Dr	(with the amount of profit)
To Equity Shareholders A/c		
(b) In case of loss:		
Equity Shareholders A/c	Dr	(with the amount of loss)
To Realisation A/c		

13. Before the equity shareholders are paid off, transfer equity share capital and the past accumulated profits and reserves to Equity Shareholders Account:

Equity Share Capital A/c	Dr	(with the paid up value)
General Reserve A/c	Dr	
Reserve Fund A/c	Dr	(with their figures as the
Capital Reserve A/c	Dr	case may be)
Profit and Loss A/c	Dr	
To Equity Shareholders A/c		(with the total)

14. Similarly, transfer the past accumulated losses and fictitious assets, if any, to Equity Shareholders Account:

Equity Shareholders A/c	Dr	(with the total)
To Profit and Loss A/c		
To Preliminary Expenses A/c		
To Underwriting Commission A/c		(as the case may be)
To Discount on Issue of Shares A/c		
To Discount on Issue of Debentures A/c		

15. Now, pay off the equity shareholders:

Equity Shareholders A/c	Dr	(with the amount payable)
To Equity Shares in Transferee Co A/c		
To Preference Shares in Transferee Co A/c		(as the case may be)
To Debentures in Transferee Co A/c		
To Bank		

Notes:

1. If preference shareholders or debentureholders are paid more or less than the amount due to them as per balance sheet, the difference be transferred Equity Shareholders Account through Realisation Account.
2. After the equity shareholders are paid off, all the accounts in the book of the transferor company will be closed and not a single account will show any balance.

3. The net amount payable to the equity shareholders, after adjustment of accumulated profits and reserves, fictitious assets and profit or loss on realisation, must be equal to the amount of shares and debentures in transferee company and cash received from the transferee company left after discharge of all liabilities and preference share capital.

ACCOUNTING ENTRIES IN THE BOOKS OF TRANSFEREE COMPANY

A. In case the Amalgamation is in the nature of Merger: (Pooling of Interest Method)

1. On amalgamation of the business:

Business Purchase Account	Dr	(with the amount of consideration)
To Liquidator of Transferor Company		

2. When assets, liabilities and reserves are taken over from the transferor company and incorporated in the books:

Sundry Assets (Individually)	Dr	(with the book value)
To Sundry Liabilities (Individually)		(with the book value)
To Profit and Loss A/c		(with the book balance)
To Reserves		(with the book balance)
To Business Purchase A/c		(with the consideration)

Amalgamation in the nature of merger, all the assets, written off expenses, debit balance of Profit and Loss Account, outside liabilities and reserves of the transferor company have to be recorded in the books of the transferee company in the form and at the book values as they were appearing in the books of the transferor company on the date of amalgamation. However, if there is a conflict in the accounting policies of the transferee and transferor companies, changes in the book values may be made to ensure uniformity.

While passing the above journal entry, the difference between the amount of consideration payable by the transferee company to the transferor company and the amount of the share capital of the transferor company is adjusted in the general reserve or other reserves.

3. When consideration is satisfied:

Liquidator of Transferor Company	Dr.	(with the purchase consideration)
To Equity Share Capital		(with the paid-up value of
To Preference Share Capital		shares allotted)
To Bank		(with cash paid)

The shares may be allotted at premium or at discount, in which case share premium account and discount on issue of shares account should be stated. In the case of mergers the consideration receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares. However, the transferee company may issue preference shares to the preference shareholders of the transferor company. Moreover, the transferee company may allot securities other than equity shares and give cash and other assets to satisfy the dissenting shareholders of the transferor company.

4. On discharge of liability, say, the debentures of the transferor company by the transferee company directly, say, by allotment of its own debentures, the journal entry will be:

Debentures in Transferor Company	Dr.	(with the paid-up value of
To Debentures		debentures allotted)

5. If the liquidation expenses of the transferor company are borne by the transferee company it may be adjusted in the General Reserve:

General Reserve A/c	Dr.	(with the amount of expenses)
To Bank		

6. For the formation expenses of the transferee company:

Preliminary Expenses Account	Dr.	(with the amount of expenditure)
To Bank		

B. In case the Amalgamation is in the nature of Purchase:

1. On acquisition of the business from the transferor company:

Business Purchase A/c	Dr.	(with the amount of consideration)
To Liquidator of Transferor Company		

2. When the assets and liabilities are taken over from transferor company:

Sundry Assets A/c (Individually excluding goodwill)	Dr.	(with their revalued figures, if any, otherwise at their book figures)
To Sundry Liabilities A/c (Individually)		(with the figures at which they are taken over)
To Business Purchase A/c		(with the amount of consideration)

Notes:

(a) If the debit total is greater than the credit total, the difference has to be treated as capital profit and as such the same should be credited to Capital Reserve Account.

(b) Similarly, if the credit total is greater than the debit total, the difference should be debited to Goodwill Account.

3. When the consideration is satisfied:

Liquidator of Transferor Company	Dr.	(with the amount of consideration)
To Preference Share Capital A/c		
To Equity Share Capital A/c		(with the face value of shares allotted)
To Debentures A/c		(with the face value of debentures allotted)
To Bank		(with the amount paid)

The shares or debentures may be allotted at a premium or at a discount.

4. Normally when an amalgamation is in the nature of purchase, the identity of the reserves of the transferor company is not maintained. However, in order to get the advantage of provision of some statute, it is necessary to retain the identity of statutory reserves of the transferor company in the books of the transferee company. In

order to record the statutory reserves of the transferor company in the books of the transferee company, the following entry will be passed:

Amalgamation Adjustment A/c	Dr	(with the amount of statutory
To Statutory Reserve A/c		reserve)

It may be noted that latter, when the identity of statutory reserves of transferor company is no longer required to be maintained, the above mentioned entry will be reversed.

5. If the liquidation expenses of the transferor company are borne by the transferee company, the same is to be debited to Goodwill Account and the following entry is to be passed:

Goodwill Account	Dr.	(with the amount of expenditure)
To Bank		

6. With the formation expenses of the transferee company, if any:

Preliminary Expenses A/c	Dr.	(with the amount of expenditure)
To Bank		

7. If there are both goodwill and capital reserve, Goodwill may be written off against Capital Reserve:

Capital Reserve A/c	Dr.	(with the amount written off)
To Goodwill A/c		

Note: Either Goodwill Account or Capital Reserve Account whichever is greater will appear in the balance sheet.

8. If any liability is discharged by the transferee company:

Respective Liability A/c	Dr.	(with the amount payable)
To Share Capital A/c		
To Debentures A/c		(as the case may be)
To Bank		

9. If fresh issue of shares or debentures is made to raise further capital:

(a) Bank	Dr.	(with the money received
To Share Application and Allotment A/c		on application)
To Debenture Application and Allotment A/c		
(b) Share Application and Allotment A/c	Dr.	(with the money received on
Debenture Application and Allotment A/c	Dr.	shares or debentures allotted)
To Share Capital A/c		
To Debentures A/c		

Illustration 2

(Amalgamation in the nature of merger)

The following are the Balance Sheet of A Co. Ltd. and B Co. Ltd. as on 30th September, 2013

A Co. Ltd.

	Particulars	*Amount (₹)*	*Amount (₹)*
I	**EQUITIES AND LIABILITIES**		
1	**Shareholders' funds**		
	(a) Share Capital		
	Authorised, Issued subscribed and paid up capital 50,000 Equity shares of ₹ 10 each, fully called up and paid up		5,00,000
	(b) Reserve and surplus		
	General reserve		1,70,000
	Profit and Loss account		30,000
2	**Non-current liabilities**		
	12% Debentures		1,00,000
	Employee provident fund		15,000
3	**Current Liabilities**		
	Trade Payables		50,000
	TOTAL		**8,65,000**
II	**ASSETS**		
1	**Non-current Assets**		
	(a) Fixed Assets		
	Tangible Assets		
	Building	1,50,000	
	Machinery	5,50,000	7,00,000
2	**Current Assets**		
	Stock	80,000	
	Trade receivables	70,000	
	Cash	15,000	1,65,000
	TOTAL		**8,65,000**

B Co. Ltd.

I.	**EQUITIES AND LIABILITIES**	**Amount (₹)**	**Amount (₹)**
1	**Shareholders' funds**		
	(a) Share Capital		
	Authorised, Issued subscribed and paid up capital		

	30,000 Equity shares of ₹ 10 each, fully called up and paid up			3,00,000
2	**Current Liabilities**			
	Trade Payables			40,000
	TOTAL			**3,40,000**
II	**ASSETS**			
1	**Non-current Assets**			
	(a) Fixed Assets			
	Tangible Assets			
	Machinery			2,50,000
2	**Current Assets**			
	Stock		40,000	
	Trade receivables	50,000		
	Less: Provision for doubtful debts	5,000	45,000	
	Cash and cash equivalents		5,000	90,000
	TOTAL			**3,40,000**

The two companies agree to amalgamate and form a new company called C Co. Ltd. which takes over all the assets and liabilities of both the companies on 1st October, 2013.

The purchase consideration is agreed at ₹ 6,61,500 and ₹ 3,15,000 for A Co. Ltd. and B Co. Ltd. respectively.

The entire purchase price is to be paid by C Co. Ltd. in fully paid equity shares of ₹ 10 each. The debentures of A Co. Ltd. will be converted into equivalent number of debentures of C Co. Ltd.

Give journal entries to close the books of A Co. Ltd. and B Co. Ltd. and show the opening entries in the books of C Co. Ltd. Also prepare the opening Balance Sheet in the books of C Co. Ltd. as on 1st October, 2013. The authorised capital of C Co. Ltd. is 2,00,000 equity shares of ₹ 10 each.

Solution:

Journal Entries in the Books of A Co. Ltd.

			Dr.	*Cr.*
Date	*Particulars*		*Amount (₹)*	*Amount (₹)*
2013,	Realisation A/c	Dr.	8,65,000	
Oct 1	To Buildings A/c			1,50,000
	To Machinery A/c			5,50,000
	To Stock A/c			80,000
	To Trade receivables A/c			70,000
	To Cash A/c			15,000
	(Being the transfer of sundry assets at their book values)			

	12% Debentures A/c	Dr.	1,00,000	
	Trade Payables A/c	Dr.	50,000	
	Employees' Provident Fund A/c	Dr.	15,000	
	To Realisation A/c			1,65,000
	(Being the transfer of sundry liabilities at their book-figures)			
	C Co. Ltd.	Dr.	6,61,500	
	To Realisation A/c			6,61,500
	(Being the consideration due as per agreement dated.....)			
	Equity Shareholders A/c	Dr.	38,500	
	To Realisation A/c			38,500
	(Being transfer of loss on realisation)			
	Equity Shares in C Co. Ltd.	Dr.	6,61,500	
	To C Co. Ltd.			6,61,500
	(Being the receipt of consideration)			
	Equity Share Capital A/c	Dr.	5,00,000	
	General Reserve A/c	Dr.	1,70,000	
	Profit and Loss A/c	Dr.	30,000	
	To Equity Shareholders A/c			7,00,000
	(Being the transfer of share capital and past accumulated profits and reserves)			
	Equity Shareholders A/c	Dr.	6,61,500	
	To Equity Shares in C Co. Ltd.			6,61,500
	(Being the final payment to equity shareholders)			

Journal of B Co. Ltd.

2013, Oct 1	Realisation A/c	Dr.	3,45,000	
	To Machinery A/c			2,50,000
	To Stock A/c			40,000
	To Trade receivables A/c			50,000
	To Cash A/c			5,000
	(Being the transfer of sundry assets at their book-values)			

	Provision for Doubtful Debts A/c	Dr.	5,000	
	Trade Payables A/c	Dr.	40,000	
	To Realisation A/c			45,000
	(Being the transfer of sundry liabilities at their book-figures)			
	C Co. Ltd.	Dr.	3,15,000	
	To Realisation A/c			3,15,000
	(Being the consideration due as per agreement dated.....)			
	Realisation A/c	Dr.	15,000	
	To Equity Shareholders A/c			15,000
	(Being the transfer of profit on realisation)			
	Equity Shares in C Co. Ltd.	Dr.	3,15,000	
	To C Co. Ltd.			3,15,000
	(Being the receipt of consideration)			
	Equity Share Capital A/c	Dr.	3,00,000	
	To Equity Shareholders A/c			3,00,000
	(Being the transfer of share capital)			
	Equity Shareholders A/c	Dr.	3,15,000	
	To Equity Shares in C Co. Ltd.			3,15,000
	(Being the final payment to equity shareholders)			

Journal of C Co. Ltd.

2013, Oct 1	Business Purchase A/c	Dr.	9,76,500	
	To Liquidator of A Co. Ltd.			6,61,500
	To Liquidator of B Co. Ltd.			3,15,000
	(Being the amalgamation of business of A Co. Ltd. and B Co. Ltd. as per agreement dated.....)			
	Buildings A/c	Dr.	1,50,000	
	Machinery A/c	Dr.	5,50,000	

Particulars		Dr.	Cr.
Stock A/c	Dr.	80,000	
Trade receivables A/c	Dr.	70,000	
Cash A/c	Dr.	15,000	
General Reserve A/c	Dr.	1,61,500	
To General Reserve			1,70,000
To Profit and Loss A/c			30,000
To 12% Debentures in A Co. Ltd.			1,00,000
To Trade Payables A/c			50,000
To Employees Provident Fund			15,000
To Business Purchase A/c			6,61,500
(Being the assets, liabilities, general reserve and profit and loss account of A Ltd. transferred and the difference between consideration and share capital debited general reserve account)			
Machinery A/c	Dr.	2,50,000	
Stock A/c	Dr.	40,000	
Trade receivables A/c	Dr.	50,000	
Cash A/c	Dr.	5,000	
General Reserve A/c	Dr.	15,000	
To Trade Payables A/c			40,000
To Provision for Doubtful Debts A/c			5,000
To Business Purchase A/c			3,15,500
(Being the assets and liabilities of B Ltd. transferred and the difference between consideration and share capital debited to general reserve account)			
Profit and Loss A/c	Dr.	6,500	
To General Reserve A/c			6,500
(The debit balance in general reserve account is transferred to the profit and loss account)			
Note: The above three journal entries may be clubbed and one compound entry may be passed as under:			
" Buildings A/c	Dr.	1,50,000	
Machinery A/c	Dr.	8,00,000	
Stock A/c	Dr.	1,20,000	

Trade receivables A/c	Dr.	1,20,000	
Cash A/c	Dr.	20,000	
To Provision for Doubtful Debts			5,000
To 12% Debentures in A Co. Ltd.			1,00,000
To Trade Payables			90,000
To Employees Provident Fund			15,000
To Profit and Loss A/c [note]			23,500
To Business Purchase A/c			9,76,500
(Being the assets, liabilities, reserve and profit and loss account of A Ltd. and B Ltd. transferred and the difference between consideration and equity capital of transferor companies adjusted against the general reserve and profit and loss account)			
Liquidator of A Co. Ltd.	Dr.	6,61,500	
Liquidator of B Co. Ltd.	Dr.	3,15,000	
To Equity Share Capital			9,76,500
(Being the allotment of 97,650 equity shares to transferor companies as fully paid up for consideration other than cash)			
12% Debentures in A Co. Ltd.	Dr.	1,00,000	
To 12% Debentures A/c			1,00,000
(Being the debentures issued in place of 12% Debentures in A Ltd.)			

Note: Profit and Loss Account balance is arrived as follows:

	A Ltd. ₹	B Ltd. ₹
Amount of share capital	5,00,000	3,00,000
Less : Purchase consideration	6,61,500	3,15,000
	(1,61,500)	(15,000)

This total difference of ₹ 1, 76,500 should be adjusted against the reserves and profit and loss account.

	Combined ₹	Adjustment ₹	Balance ₹
General Reserve	1,70,000	1,70,000	–
Profit and Loss Account	30,000	6,500	23,500
	2,00,000	1,76,500	23,500

Balance Sheet of C Co. Ltd.
as on 1st October, 2013

	Particular		Amount in (₹)	Amount in (₹)
I	**EQUITIES AND LIABILITIES**			
1	**Shareholders' funds**			
	(a) Share Capital			
	Authorised Capital – 2,00,000 equity shares of ₹ 10 each			20,00,000
	Issued subscribed and paid up capital			
	96,750 Equity shares of ₹ 10 each, issued to transferors as fully paid-up for consideration other than cash			9,76,500
	(b) Reserve and surplus			
	Profit and Loss account			23,500
2	**Non-current liabilities**			
	12% Debentures of ₹100 each			1,00,000
	Employee provident fund			15,000
3	**Current Liabilities**			
	Trade Payables			90,000
	TOTAL			**12,05,000**
II	**ASSETS**			
1	**Non-current Assets**			
	(a) Fixed Assets			
	(i) Tangible Assets			
	Building		1,50,000	
	Plant & machinery		8,00,000	9,50,000
2	**Current Assets**			
	Stock		1,20,000	
	Trade recievables	1,20,000		
	Less: Provision for Doubtful Debt	5,000	1,15,000	
	Cash and Cash equivalents : Cash in hand		20,000	2,55,000
	TOTAL			**12,05,000**

Illustration 3 (Amalgamation in the nature of merger)

Thin & Co. Ltd. was absorbed by Thick & Co. Ltd., as on 30th June, 2013. All the assets and liabilities of Thin & Co. Ltd. were taken over by Thick & Co. Ltd. The consideration was agreed at ₹ 3,36,600 and was paid in so many fully paid equity shares of Thick & Co. Ltd. to be distributed to the equity shareholders of Thin & Co. Ltd. The following are the balance sheets of both the companies as on 30.6.2013.

Balance Sheet
as on 30th June, 2013

	Particular	Thick & Co Ltd.		Thin & Co Ltd.	
I	**EQUITIES AND LIABILITIES**				
1	**Shareholders' funds**				
	(a) Share Capital				
	Authorised, Issued subscribed and paid up capital				
	Equity shares of ₹ 10 each, fully called up and paid up		7,50,000		2,00,000
	(b) Reserve and surplus				
	General reserve	1,50,000		50,000	
	Profit and Loss account	20,502	1,70,502	12,900	62,900
2	**Non-current liabilities**				
	Workman compensation fund	12,000		9,000	
	Employee provident fund	10,000	22,000	4,000	13,000
3	**Current Liabilities**				
	Trade Payables	58,567		30,456	
	Provision for taxation	12,000	70,567	5,000	35,456
	TOTAL		**10,13,069**		**3,11,356**
II	**ASSETS**				
1	**Non-current Assets**				
	(a) Fixed Assets				
	(i) Tangible Assets				
	Plant & machinery	3,12,000		1,00,000	
	(ii) Intangible Assets				
	Goodwill	2,00,000	5,12,000	60,000	1,60,000
2	**Current Assets**				
	Stock	2,65,000		80,000	
	Debtor	2,21,200		56,000	
	Cash and Cash equivalents : Cash in hand	869		356	
	: Cash at bank	14,000	5,01,069	8,300	1,44,656
	Other current Assets				
	Prepaid Insurance				700
	Income Tax Refund claim				6,000
	TOTAL		**10,13,069**		**3,11,356**

You are required to:

(i) Show the necessary ledger accounts in the books of Thin & Co. Ltd.;

(ii) Show the necessary journal entries in the books of Thick & Co. Ltd.; and

(iii) Prepare the Balance Sheet of Thick & Co. after the amalgamation.

Solution:

Ledger of Thin & Co. Ltd.

Realisation Account

Dr. *Cr.*

Particulars	*Amount ₹*	*Particulars*	*Amount ₹*
To Goodwill	60,000	By Sundry Trade Payables	30,456
To Plant and Machinery	1,00,000	By Staff Provident Fund	4,000
To Stock-in-Trade	80,000	By Provision for Taxation	5,000
To Trade receivables	56,000	By Thick & Co. Ltd.	3,36,600
To Income-tax Refund Claim	6,000		
To Prepaid Insurance	700		
To Cash in Hand	356		
To Cash at Bank	8,300		
To Equity Shareholders (Profit)	64,700		
	3,76,056		3,76,056

Thick & Co. Ltd.

Particulars	*Amount ₹*	*Particulars*	*Amount ₹*
To Realisation A/c	3,36,600	By Equity Shares in Thick & Co. Ltd.	3,36,600

Equity Shares in Thick & Co. Ltd.

Particulars	*Amount ₹*	*Particulars*	*Amount ₹*
To Thick & Co. Ltd.	3,36,600	By Equity Shareholders A/c	3,36,600

Equity Shareholders Account

Particulars	*Amount ₹*	*Particulars*	*Amount ₹*
To Equity Shares in Thick & Co. Ltd. A/c	3,36,600	By Equity Share Capital A/c	2,00,000
		By General Reserve A/c	50,000
		By Profit and Loss A/c	12,900
		By Workmen Compensation Fund	9,000
		By Realisation A/c	64,700
	3,36,600		3,36,600

Journal Entries in the Books of Thick & Co. Ltd.

Particulars		*Dr. (₹)*	*Cr.(₹)*
Business Purchase A/c	Dr.	3,36,600	
To Liquidator of Thin & Co. Ltd.			3,36,600.
(Being the amalgamation of business of Thin & Co. Ltd. as per agreement dated......			
Goodwill	Dr.	60,000	
Plant and Machinery	Dr.	1,00,000	
Stock in Trade	Dr.	80,000	
Trade receivables	Dr.	56,000	
Prepaid Insurance	Dr.	700	
Income tax Refund Claim	Dr.	6,000	
Cash in Hand	Dr.	356	
Cash at Bank	Dr.	8,300	
General Reserve	Dr.	73,700	
To Workman Compensation Fund			9,000
To Trade Payables			30,456
To Staff Providend Fund			4,000
To Provision for Taxation			5,000
To Business Purchase A/c			3,36,600
(Being the assets, liabilities and reserves of Thin Ltd. at book value transferred and the difference in consideration and equity share capital being adjusted against in the general reserve of Thin Ltd.)			
Liquidator of Thin & Co. Ltd.	Dr.	3,36,600	
To Equity Share Capital			3,36,600
(Being the allotment of 33,360 equity shares of ₹ 10 each to the transferor company as consideration)			

Illustration 4

Under given is the balance sheet of Rajbhasha & Co as on 31st March, 2014

	Particular	Amount (₹)	Amount (₹)
I	**EQUITIES AND LIABILITIES**		
1	**Shareholders' funds**		
	(a) Share Capital		
	Authorised, Issued subscribed and paid up capital		
	12,500 9% preference shares of ₹ 8 each	1,00,000	
	1,50,000 equity shares of ₹ 1 each	1,50,000	2,50,000
	(b) Reserve and surplus		
	Profit and Loss account		(98,000)
2	**Non-current liabilities**		
	10% debentures		60,000
3	**Current Liabilities**		
	Trade Payables	50,000	
	Bank overdraft (Secured by Land and building)	20,000	
	Debentures interest	4,200	74,200
	TOTAL		**2,86,200**
II	**ASSETS**		
1	**Non-current Assets**		
	(a) Fixed Assets		
	Freehold Land and building	34,000	
	Plant	96,000	
	Tools and dies	27300	1,57,300
	(b) Other non-current expenses		
	Research and development expenses		18,000
2	**Current Assets**		
	Stock		42,500
	Trade receivables		53,400
	Investment		15,000
	TOTAL		**2,86,200**

The scheme of re-organisation detailed below has been agreed by all the parties approved by the Court. You are required to prepare:

(a) Journal entries recording the transactions in the books, including cash;

(b) The balance sheet of the company as on 1st April, 2014 after the completion of the scheme.

(i) The following assets are to be revalued as shown below: plant ₹ 59,000 tools and dies ₹ 15,000; stock ₹ 30,000 and debtors ₹ 48,700.

(ii) The research and development expenditure and debit balance of profit and loss account are to be written off.

(iii) Price of land recorded in the books at ₹ 6,000 is valued at ₹ 14,000 and is to be taken over by the debenture holders in part repayment of principal. The remaining freehold land and buildings are to be revalued at ₹ 40,000.

(iv) A creditor for ₹ 18,000 has agreed to accept a second mortgage debenture of 11% per annum secured on plant for ₹ 15,500 in settlement of his debt. Other creditors totaling ₹ 10,000 agreed to accept a payment of ₹ 0.85 in the rupee for immediate settlement.

(v) The investment at a valuation of ₹ 22,000 is to be taken over by the bank.

(vi) The ascertained loss is to be met by writing down the equity shares to ₹ 1 each and preference shares to ₹ 8 each. The authorised share capital is to be increased immediately to the original amount.

(vii) The equity shareholders agree to subscribe for two new ordinary shares at par for every share held. This cash is all received.

(viii) The costs of the scheme are ₹ 3,500. These have been paid and are to be written off. The debenture interest has also been paid.

Solution

Journal Entries in the books of Rajbhasha & Co

	Particulars		Amount Dr. ₹	Amount Cr. ₹
1	Freehold Land and Building A/c	Dr.	20,000	
	Investment A/c	Dr.	7,000	
	To Reconstruction A/c			27,000
	(Book value of assets raised to their revalued worth)			
2	Trade Payables	Dr.	28,000	
	To 11% Second Mortgage Debentures			15,500
	To Bank			8,500
	To Reconstruction A/c			4,000
	(The discharge of part of the creditors)			
3	10% Debentures A/c	Dr.	14,000	
	To Debenture holders A/c			14,000
	(Redemption of part of the debentures)			

			Dr. (₹)	Cr. (₹)
4	Debenture holders A/c	Dr.	14,000	
	To Freehold Land and Building			14,000
	(The discharge of amount due to debenture holders)			
5	Equity Share Capital A/c (₹ 10)	Dr.	1,50,000	
	Preference Share Capital A/c (₹ 10)	Dr.	1,00,000	
	To Equity Share Capital A/c (Re. 1)			15,000
	To Preference Share Capital A/c (₹ 8)			80,000
	To Reconstruction A/c			1,55,000
	(The writing down of equity and preference shares)			
6	Bank	Dr.	30,000	
	To Equity Share Capital A/c			30,000
	(The subscription of 30,000 equity shares)			
7	Bank	Dr.	22,000	
	To Investments			22,000
	(Investments taken over by bank)			
8	Reconstruction A/c	Dr.	3,500	
	Outstanding Interest on Debentures A/c	Dr.	4,200	
	To Bank			7,700
	(Payment of reorganisation expenses and outstanding interest)			
9	Reconstruction A/c	Dr.	1,82,500	
	To Plant			37,000
	To Tool and Dies			12,300
	To Stocks			12,500
	To Provision for Bad Debts A/c			4,700
	To Reserve and Development Expenditure A/c			18,000
	To Profit and Loss A/c			98,000
	(Writing down of various assets and elimination of fictitious assets)			

Balance Sheet of Rajbhasha & Co.

as at 1st April, 2014

	Particular	Amount (₹)	Amount (₹)
I	**EQUITIES AND LIABILITIES**		
1	**Shareholders' funds**		
	(a) Share Capital		
	Authorised Capital		
	12,500 9% preference shares of ₹ 8 each	1,00,000	
	1,50,000 equity shares of ₹ 1 each	1,50,000	2,50,000
	Issued subscribed and paid up capital		
	10,000 9% preference shares of ₹ 8 each	80,000	
	45,000 equity shares of ₹ 1 each	45,000	1,25,000
2	**Non-current liabilities**		
	10% 1st Mortgage debentures	46,000	
	11% 2nd mortgage debentures	15,500	61,500
3	**Current Liabilities**		
	Trade Payables		22,000
	TOTAL		**2,08,500**
II	**ASSETS**		
1	**Non-current Assets**		
	(a) Fixed Assets		
	Freehold Land and building	28,000	
	Add: Amount of Appreciation made under scheme of reconstruction	12,000	40,000
	Plant	96,000	
	Less: Amount written off under scheme of reconstruction	37,000	59,000
	Tools and dies	27,300	
	Less: Amount written off under scheme of reconstruction	12,300	15,000
2	**Current Assets**		
	Stock		30,000
	Trade receivables	53,400	
	Less: Provision for bad debts	4,700	48,700
	Cash and Cash equivalents		15,800
	TOTAL		**2,08,500**

ACQUISITION OF BUSINESS

Acquisition of business by a limited company, generally, refers to the purchase of a non-corporate business like sole- proprietorship or partnership form of business by a company. This does not necessarily mean that a limited company cannot acquire the business of a corporate body, i.e., another limited company. But strictly speaking, the acquisition of business of a limited company by another limited company comes under the purview of "Amalgamation, Absorption and Reconstruction of Companies".

Such an acquisition of business by a limited company may take any of the following two forms:

(i) An existing company may purchase an existing business of a sole-proprietor or a partnership firm, or

(ii) A new company may be formed to take over an existing business of a sole proprietor or a partnership firm, i.e., the existing business unit may be converted into a limited company. If the object is to retain the control of the sole-proprietor or the partners in the company, a private limited company may be formed. On the other hand, if the object of conversion is to supplement the resources for carrying out various expansion programmes, a public limited company may be formed for the purpose.

Important Points to be noted in Connection with Acquisition of a Business

1. Consideration: Consideration refers to the price payable by the company for the business acquired. Generally, an agreement is made between the company and the vendor containing the terms and conditions of the acquisition of business, the basis for determining the consideration and the mode of payment of the consideration.

Consideration is usually, determined by taking into consideration the following facts:

(i) the present value of the net tangible assets acquired, i.e., the present value of gross tangible assets acquired less liabilities, if any, acquired by the company;

(ii) the amount payable, if any, for goodwill of the business acquired; and

(iii) the liability to be taken over by the purchasing company.

In case, for determining the present value of the assets, revaluation is made and the re-valued figures should be taken as their present values; otherwise, book-values should be taken. In case the business is purchased for a lump sum, the difference between the consideration to be paid and the value of net tangible assets will be the goodwill. On the other hand, if the value of net tangible assets exceeds the consideration the difference will be treated as 'Capital Reserve'.

As the terms and conditions of acquisition of business may vary in different circumstances, the basis for determining the consideration also varies from case to case. As for example, it may so happen that only the fixed assets of an existing business may be taken over by a company or only the tangible assets may be taken over by the company or both the assets and the liabilities may be taken over by the company. However, in most of the cases, the consideration is given in the problem itself.

2. Mode of payment of the consideration by the company: After the consideration is determined, the next question that arises is how to satisfy the consideration. The consideration may be satisfied by the company in any of the following ways:

(i) the entire consideration may be paid in cash;

(ii) the entire consideration may be paid by the issue of shares of the company;

(iii) the entire consideration may be paid by the issue of debentures of the company; or

(iv) the consideration may be paid partly in cash and partly by the issue of shares and/or debentures of the company.

Generally the last method is adopted by a company to satisfy the consideration.

It is important to note here that the shares or debentures may be issued to the vendors either at par or at a premium or at a discount.

3. Interest payable to vendors on the purchase consideration: If the payment of consideration to the vendors is unnecessarily delayed, the question of payment of interest to vendors for the period of the delay, naturally, arises. In such a case, the vendors can legitimately claim interest on the amount due to them for the period of delay, i.e., from the date of purchase to the date of payment. Hence, the agreement must mention about the payment of interest to vendors specifying the rate of interest.

4. Realisation expenses of the vendor borne by the purchasing company: Sometimes, the purchasing company may agree to bear the cost of realisation of the vendor and the fact must be contained in the agreement. Such expenses are to be treated as capital expenditure of the company and should be debited to Goodwill Account.

5. Whether to open a new set of books by the company on acquisition of business or to continue the books of the vendor: On acquisition of business, the company may either open a new set of books for recording its transactions or continue the same set of books of the vendor. A decision has to be taken by the company in this respect.

6. Collection of debtors and payment to creditors of the vendor on behalf of the vendor: Sometimes, the debtors and the creditors of the vendor are not taken over by the purchasing company. In such a case, the purchasing company may agree to collect the debtors of the vendor and to pay the creditors of the vendor as agent of the vendor in exchange of certain commission at fixed rate.

Accounting Entries in the Books of the Purchasing Company on Acquisition

When new set of books are opened:

1. When the business is acquired –

Business Purchase A/c	Dr.	with the amount of consideration
To Vendors		

2. When the assets and liabilities taken over by the company are recorded –

Sundry Assets A/c (Individually)	Dr.	with the re-valued figure if any; otherwise, at book value
To Sundry Liabilities A/c (Individually)		with the values at which they are taken over
To Business Purchase A/c		with the consideration

Alternatively, instead of passing the above two entries the following entry may also serve the purpose:

Sundry Assets A/c (Individually)	Dr.	with the revalued figures, if any, otherwise, at book figures
To Sundry Liabilities (Individually)		with the values at which they are taken over
To Vendors		with the consideration

Notes: (i) If the credit total is greater than the debit total, the difference should be debited to Goodwill Account.

(ii) If the debit total is greater than the credit total, the difference has to be treated as capital gain and as such, Capital Reserve Account should be credited.

Goodwill or Capital Reserve should be ascertained only as indicated above - the amount appearing in the

vendors, balance sheet is not relevant.

3. When the payment is made to vendors –

Vendors	Dr.	with the amount due
To Share Capital A/c		with the value of shares allotted, if any
To Debentures A/c		with the value of debentures allotted, if any
To Cash or Bank A/c		with the amount of cash, if any

Notes: (i) Shares capital or Debentures should be credited only with their nominal value.

(ii) If the shares or debentures are issued at a premium, Securities Premium Account should be credited with the amount of the premium.

(iii) Similarly, if the shares or debentures are issued at a discount, Discount on Issue of Shares Account or Discount on Issue of Debentures Account should be debited with the discount.

4. If interest is payable to vendors on the purchase consideration for delayed payment –

Interest to Vendors	Dr.	with the amount of interest payable
To Vendors		

Note: This entry would be made before the payment is made to vendors and the amount of interest would be included in the payment.

5. If the realisation expenses of the vendor are borne by the company and acquisition expenses are incurred by the company, the same has to be treated as capital loss and the entry for this will be as follows –

Goodwill A/c	Dr.	with the amount of expenditure
To Cash/Bank A/c		

6. If any item of expenses or losses can be adjusted against Securities Premium Account u/s 52 of Companies Act, 2013 the same should be adjusted to the extent possible and for this the entry will be as follows –

Securities Premium A/c	Dr.	with the amount of adjustment
To Preliminary Expenses A/c		
Or To Discount on Issue of Shares A/c		
Or To Discount on Issue of Debentures A/c		

Illustration 5 (Where consideration is given in the problem).

Snow View Ltd., was registered with an authorised capital of 1,00,000 Equity Shares of ₹10 each and it acquired the business of Mr. Bansal of Mr. Bansal at an agreed price of ₹2,50,000.

The Balance Sheet of Mr. Bansal at the date of acquisition was as follows:

Liabilities	*Amonut ₹*	*Assets*	*Amonut ₹*
Capital	2,00,000	Freehold Premises	1,00,000
Reserve	20,000	Plant and Machinery	80,000
Trade Payables	50,000	Stock	20,000

Bills Payable	30,000	Trade receivables	27,500	
		Less: Provisions	2,500	25,000
		Cash at Bank		75,000
	3,00,000			3,00,000

The consideration was to be discharged by the issue of 20,000 equity shares of ₹10 each as fully paid-up and the balance in cash.

You are asked to journalise the transactions in the books of Snow View Ltd. Also prepare the opening balance sheet of the company.

Solution:

Journal Entries

Particulars		*Dr.* *Amonut (₹)*	*Cr.* *Amonut (₹)*
Business Purchase A/c	Dr.	2,50,000	
To Bansal			2,50,000
(Consideration due to vendor on purchase of the business as per agreement dated...)			
Freehold Premises A/c	Dr.	1,00,000	
Plant and Machinery A/c	Dr.	80,000	
Stock A/c	Dr.	20,000	
Trade receivables A/c	Dr.	27,500	
Bank	Dr.	75,000	
Goodwill A/c	Dr.	30,000	
To Provision for Bad Debts A/c			2,500
To Trade Payables A/c			50,000
To Bills Payable A/c			30,000
To Business Purchase A/c			2,50,000
(Taking over the assets and the liabilities of the vendor debiting the difference to Goodwill Account)			
Bansal	Dr.	2,50,000	
To Equity Shares Capital A/c			2,00,000
To Bank			50,000
(Allotment of 20,000 Equity Shares of ₹10 each to vendor as fully paid-up for consideration other than cash and payment of the balance ₹50,000 in cash as per Board's resolution)			

Balance Sheet of Snow View Ltd. as at.....

	Amonut ₹	Amonut ₹
I EQUITIES AND LIABILITIES		
1 Shareholders' funds		
(a) Share Capital		
Authorised Capital		
1,00,000 equity shares of ₹ 10 each		10,00,000
Issued subscribed and paid up capital		
20,000 Equity shares of ₹ 10 each		2,00,000
2 Current Liabilities		
Bills Payable	30,000	
Trade Payables	50,000	80,000
TOTAL		**2,80,000**
II ASSETS		
1 Non-current Assets		
(a) Fixed Assets		
(i) Tangible Assets		
Freehold Premises	1,00,000	
Plant & Machinery	80,000	1,80,000
(ii) Intangible Assets		
Goodwill		30,000
2 Current Assets		
Stock		20,000
Trade receivables	27,500	
Less: Provision for bad debts	2,500	25,000
Cash and Cash equivalents		25,000
TOTAL		**2,80,000**

Illustration 6 (Where consideration is not given in the problem).

Woodlands Ltd., registered with a capital of ₹10,00,000 in equity shares of ₹10 each acquired the business of M/s A and B, the Balance Sheet of whom at the date of acquisition was as follows:

Liabilities	*Amonut ₹*	*Assets*	*Amonut ₹*
Bills Payable	16,000	Cash at Bank	29,000
Trade Payables	30,000	Bills Receivable	13,000
Reserve	14,000	Trade receivables	48,000

Capital Accounts:		Stock	18,000
A - 70,000		Furniture and Fixtures	2,000
B - 70,000	1,40,000	Plant and Machinery	40,000
		Land and Buildings	50,000
	2,00,000		2,00,000

The assets and liabilities were subject to the following revaluation:

Plant and Machinery to be depreciated by 10%

Furniture and Fittings to be depreciated by 15%

Land and Buildings to be appreciated by 20%

A provision to be made for bad debts on debtors @ 2-1/2%

Goodwill of the firm was valued at ₹24,000.

The consideration was to be discharged as follows:

(i) Allotment of 10,000 Equity Shares of ₹10 each at ₹12 each.

(ii) Allotment of 500, 14% Debentures of ₹100 each at a discount of 10%.

(iii) Balance in cash.

The cost of acquisition of the company amounted to ₹ 5,000.

You are required to show the journal entries in the books of the company and prepare the opening balance sheet of the company after the acquisition.

Solution:

Particulars	*Amonut ₹*	*Amonut ₹*
Calculation of consideration:		
Assets taken over:		
Cash and Cash equivalents		29,000
Bills Receivable		13,000
Trade receivables	48,000	
Less: Provision for Bad Debts @ 2-1/2%	1,200	46,800
Stock		18,000
Furniture and Fixtures	2,000	
Less: Depreciation @ 15%	300	1,700
Plant and Machinery	40,000	
Less: Depreciation @ 10%	4,000	36,000
Land and Buildings	50,000	
Add: Appreciation @ 20%	10,000	60,000
Goodwill		24,000
Gross Assets taken over		2,28,500

Less: Liabilities taken over:		
Bills Payable	16,000	
Trade Payables	30,000	46,000
Net Assets acquired or consideration		1,82,500

Journal Entries

		Dr. ₹	*Cr.* ₹
Business Purchase A/c	Dr.	1,82,500	
To M/s A and B			1,82,500
(Consideration due to vendors on purchase of the business as per agreement dated...)			
Bank	Dr.	29,000	
Bills Receivable A/c	Dr.	13,000	
Trade receivables A/c	Dr.	48,000	
Stock A/c	Dr.	18,000	
Furniture and Fixture A/c	Dr.	1,700	
Plant and Machinery A/c	Dr.	36,000	
Land and Buildings A/c	Dr.	60,000	
Goodwill A/c	Dr.	24,000	
To Provision for Bad Debts A/c			1,200
To Bills Payable A/c			16,000
To Trade Payables A/c			30,000
To Business Purchase A/c			1,82,500
(Taking over the various assets and the liabilities of the vendor)			
M/s A and B	Dr.	1,82,500	
Discount on Issue of Debentures A/c	Dr.	5,000	
To Equity Share Capital A/c			1,00,000
To Securities Premium A/c			20,000
To 14% Debentures A/c			50,000
To Bank			17,500
(Allotment of 10,000 Equity Shares of ₹10 each at a premium of ₹2 per share and 500 debentures of ₹100 each at a discount of 10% to vendors for consideration other than cash and the balance of ₹17,500 paid in cash as per Board resolution dated.....)			
Goodwill	Dr.	5,000	

To Bank			5,000
(Payment of cost of acquisition; added to goodwill since it increases the cost of acquiring the business)			
Securities Premium A/c	Dr.	5,000	
To Discount on Issue of Debentures A/c			5,000
(Writing off of capital losses against Securities Premium Account as per Section 52)			

Balance Sheet of Woodlands Ltd. as at.....

	₹	₹
I EQUITIES AND LIABILITIES		
1 **Shareholders' funds**		
(a) Share Capital		
Authorised Capital : 1,00,000 equity shares of ₹ 10 each		10,00,000
Issued subscribed and paid up capital		
10,000 Equity shares of ₹ 10 each		1,00,000
(b) **Reserve & Surplus**		
Securities Premium		15,000
2 **Non-current liabilities**		
500, 14% Debentures of ₹100 each		50,000
3 **Current Liabilities**		
Bills Payable	16,000	
Trade Payables	30,000	46,000
TOTAL		**2,11,000**
II ASSETS		
1 **Non-current Assets**		
(a) Fixed Assets		
(i) Tangible Assets		
Freehold Premises	60,000	
Furniture and fixture	1,700	
Plant & Machinery	36,000	97,700
(ii) Intangible Assets		
Goodwill		29,000
2 **Current Assets**		
Stock		18,000
Trade receivables	48,000	
Less: provision for bad debts	1,200	46,800
Cash and Cash equivalents		6,500
Bills receivable		13,000
TOTAL		**2,11,000**

INTERNAL RECONSTRUCTION

INTRODUCTION

When a company has been making losses for a number of years and the financial position does not present a true and fair view of the state of the affairs of the company. In such a company the assets are overvalued, the assets side of the balance sheet consists of fictitious assets, useless intangible assets and debit balance in the profit and loss account. Such a situation does not depict a true picture of financial statements and shows a higher net worth than what the real net worth ought to be. In short the company is over capitalized. Such a situation brings the need for reconstruction.

Reconstruction is a process by which affairs of a company are reorganized by revaluation of assets, reassessment of liabilities and by writing off the losses already suffered by reducing the paid up value of shares and/or varying the rights attached to different classes of shares. It means reconstruction of a company's financial structure. Reconstruction of company's financial structure can take place either with or without the liquidation of the company.

External Reconstruction

If the company going into reconstruction is liquidated it is called as External Reconstruction. A new company is formed with the same name in order to take over the business of the existing company. Such external reconstruction is essentially covered under the category 'amalgamation in the nature of merger' in AS-14.

Internal Reconstruction

Internal reconstruction is carried out without liquidating the company and forming a new one. It necessarily involves the reduction of share capital. There is no transfer of assets and liabilities, because there is not a formation of new company.

Meaning of Internal Reconstruction

When the company reconstructs its financial structure internally without undergoing liquidation, it is internal reconstruction. Under this scheme company continues its legal existence. A scheme of re-organisation is prepared in which all parties sacrifice. It also means the reduction of capital to cancel any paid up share capital which is lost or not represented by available assets. This is done to write off the losses of the company.

Significance of internal reconstruction

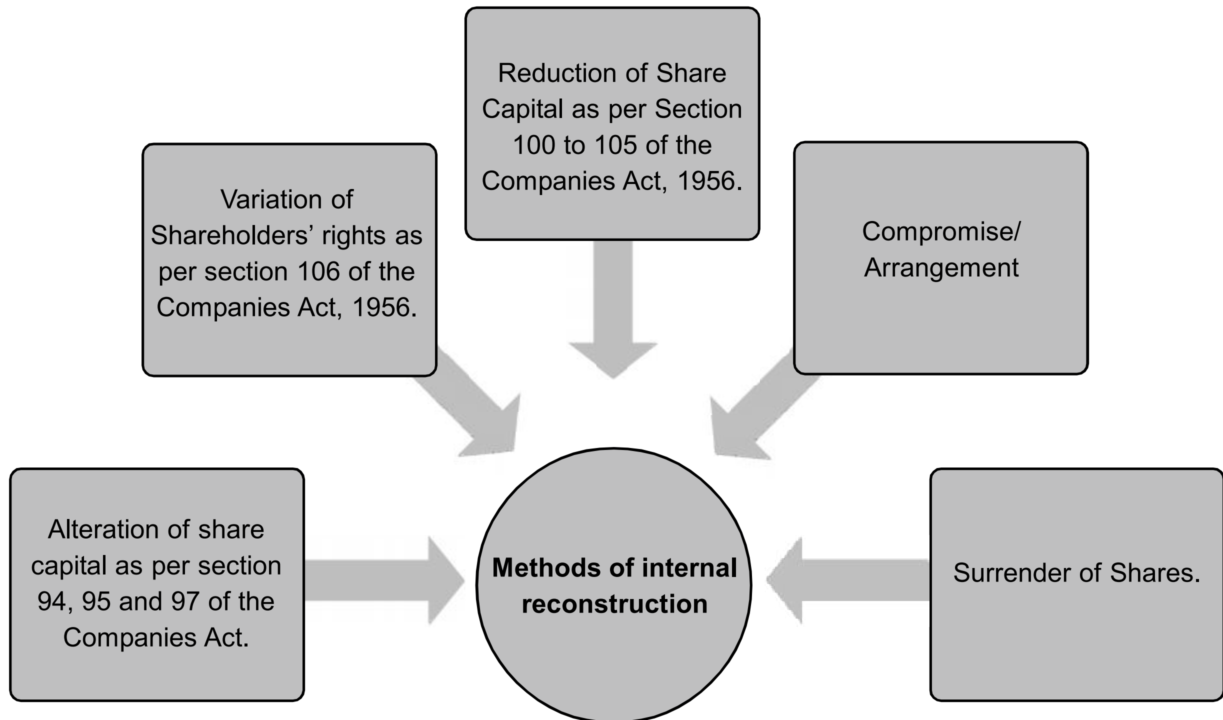
Internal reconstruction is done by the company when:

– there is an overvaluation of assets and undervaluation of liabilities.

– there is a difficulty to meet the financial crisis and there are continuous losses.

Methods of internal reconstruction

There are various steps of internal reconstruction which is defined in financial accounting. For properly deploying the process of internal reconstruction, following methods are generally employed or used simultaneously.



Alteration of share capital as per section 94, 95 and 97 of the Companies Act, 1956

A limited company having a share capital, may by passing an ordinary resolutions in general meeting without the approval of court, if so authorised by its articles, alter the conditions of its memorandum as follows:

1. Increase its share capital by such amount as it thinks necessary by issuing new shares; accounting entries are the same as are made at the time of issue of shares.
2. Consolidate and divide all or any of its share capital into shares of larger amount than its existing shares; it does not bring any change in the total amount of share capital
3. Convert all or any of its fully paid up shares into stock, and reconvert that stock into fully paid up shares of any denomination; Partly paid up shares can never be converted into stock.
4. Subdivide its shares, or any of them, into shares of smaller amount than is fixed by the memorandum. In the sub- division the proportion between the amount paid and the amount, if any, unpaid on each reduced share shall be the same as it was in the case of the share from which the reduced share is derived; sub division also does not bring any change in the amount of share capital. It only increases the number of shares.
5. Cancel shares which have not been taken or agreed to be taken by any person on the date of passing the resolution, and diminish the amount of its share capital by the amount of the shares so cancelled. A cancellation of shares in pursuance of this section shall not be deemed to be a reduction of share capital. The company can cancel only those shares which are not so far taken by public. Since cancellation of unissued capital does not affect the paid up capital in any way, no entry is required at the time of cancellation.

Accounting Entries

1.	**For increase in share capital** Bank account Dr. To equity share capital a/c (Being the amount received on shares of ₹ each)
2.	**For consolidation of shares** Equity share capital A/c Dr. To equity share capital A/c (Being conversion of shares of ₹ each into ....shares of ₹ each)
3.	**For sub-division of shares** Equity share capital A/c Dr. To equity share capital (Being conversion of shares of ₹ each into shares of ₹ each)
4.	**For conversion of share into stock or vice versa** Equity share capital A/c Dr. To equity stock a/c (Being conversion of fully paid equity shares of ₹ each into equity stock) Equity stock A/c Dr. To equity share capital A/c (Being conversion of equity stock into equity shares of ₹ each)
5.	**For cancellation of unissued capital** No entry is passed for cancellation of capital

Variation of Shareholders' rights

Where the share capital of a company is divided into different classes of shares, the rights attached to the shares of any class may be varied with the consent in writing of not less than three- fourths of the issued shares of that class or with the sanction of a special resolution passed at a separate meeting of the holders of the issued shares of that class if provided in the memorandum or articles of the company, or if such variation is not prohibited by the terms of issue of the shares of that class.

Accounting Entries

1.	**For changing rate of dividend of preference shares** (Old) % Cum preference share capital A/c Dr. To (New) % Cum preference share capital A/c (Being rate of dividend on preference shares changed)
2.	**For converting cumulative preference shares into non cumulative preference shares without changing the amount of share capital** Cum preference share capital A/c Dr. To Non Cum preference share capital A/c (Being cumulative preference converted into shares into non cumulative preference shares)

Reduction of Share Capital as per Section 100 to 105 of the Companies Act, 1956

Capital Reduction refers to the cancellation of that part of paid up capital which is lost in operations or which is not represented by existing assets. It is generally resorted to write off the past accumulated loss of the company. It is unlawful except when sanctioned by the court because conservation of capital is one of the main principles of the company law.

A company limited by shares or a company limited by guarantee and having a share capital if so authorised by its articles, by special resolution, can reduce its share capital in any way subject to confirmation by the Court-

(i) By reducing the uncalled liability of the members.

(ii) By writing off the part of paid up capital which is lost in the operations or which is not represented by available assets.

(iii) By returning the part of capital which is in the excess of the need of the company.

A company may reduce its share capital if all of the following conditions are satisfied:

(i) If a company is authorised by its articles to do so.

(ii) If special resolution is passed at a general meeting.

(iii) If the court's order in confirming the reduction of share capital is obtained.

Procedure for reducing share capital

(i) The company cannot reduce its share capital unless it is authorised by its articles. However, if the articles do not permit capital reduction, they may be altered by special resolution to enable the company to reduce its share capital.

(ii) The company must pass a special resolution for reduction of capital.

(iii) The company must apply to the court for an order confirming the capital reduction. The court must look after the interests of creditors and shareholders' before giving an order confirming the capital reduction.

(iv) The court may make an order confirming the capital reduction. The court may make an order confirming the capital reduction on such terms and conditions as it thinks proper, if it is satisfied that every creditor of the company entitled to object capital reduction has consented to the reduction or that his debt has been discharged or secured by the company.

(v) The court may also order the company to add the words "and reduced" to the name of the company for such period as it deems fit. The court may also order the company to publish reasons for reduction and all other information in regard thereto for public information.

(vi) The order of the court confirming the reduction must be produced before the registrar and a certified copy of the order and of the minutes of reduction should be filed with the registrar for registration.

Note: In the following cases, procedure of reduction of capital is not called for:

(i) Where redeemable preference shares are redeemed in accordance with the provisions of section 80.

(ii) Where any shares are forfeited for non-payment of calls.

(iii) Where there is surrender of shares or a gift is made to a company of its own shares.

(iv) Where the nominal share capital of a company is reduced by cancelling any shares which have not been taken or agreed to be taken by any person.

Accounting procedure

(i) In case of internal reconstruction by reducing capital, a "capital reduction account" is to be opened, which is credited with the amount sacrificed by the shareholders, debenture holders and creditors.

(ii) Then the amount of capital reduction is utilised for writing off fictitious assets, past losses and excess value of other assets.

(iii) If there is any balance of capital reduction account left after writing off the above losses, then it is to be transferred to capital reserve account.

(iv) The amount to be written off cannot exceed the amount credited to the capital reduction amount. But if any reserve appears on the liabilities side of the balance sheet, the same may be utilised in writing off the accumulated losses and assets.

(v) Write off all fictitious assets (including Goodwill and Patents) and eliminate all overvaluation of assets by crediting the accounts concerned and debiting the Capital Reduction (or Reconstruction) Account. For this purpose, any reserve appearing in the books of the company may be used. If any balance is left in the Capital Reduction (or Reconstruction) Account it should be transferred to the Capital Reserve Account.

(vi) If there is any contingent liability (like arrears of preference dividend etc.) and if the same is forgone for the claimant, then no entry will be passed.

(vii) If any contingent liability or unrecorded liability (like reconstruction expenses) is to be paid, then it will be paid out of capital reduction a/c.

(viii) In case there are any profits or gain occurs during the process of internal reconstruction then such profits or gains must be credited to capital reduction account.

(ix) In case of surrender of shares, shareholders surrender part of their holdings to the company, which are utilised to repay debenture holders, preference shareholders and other creditors of the company. Balance of unused shares surrendered is to be cancelled by transferring to capital reduction account.

Accounting Entries

1.	**Entry for share capital reduced without changing the face value of the shares**		
	Share Capital A/c	Dr.	
	To Capital Reduction/Reconstruction/ Reorganization Account) A/c		*(with the amount of the reduction made)*
2.	**Entry if face value of the shares is also changed on reduction of capital a new category of share capital is created**		
	Share Capital A/c (Old)	Dr.	
	To Share capital A/c (New) To Capital reduction A/c		*(with the amount treated as paid up)(with the difference amount)*
3.	**Entry When debenture holder and creditors are also ready to reduce their claim against company**		
	Debenture A/c	Dr.	
	Creditors A/c	Dr.	
	To Capital reduction A/c		
4.	**Entry in case of appreciation in the value of any asset**		
	Assets A/c	Dr.	
	To Capital reduction A/c		

5.	**Entry if any contingent liability matures and is to be paid immediately the following entry is passed** Capital reduction A/c Dr. To Liability payable A/c Liability Payable A/c Dr. To cash/ Bank/ share capital A/c
6.	**Entry for utilising the amount of capital reduction to write off accumulated losses.** Capital Reduction A/c Dr. To Profit & Loss A/c To Preliminary Expenses A/c To Discount on Shares /Debentures A/c To Goodwill A/c To Trade Assets A/c To Patents/Copy rights To Assets A/c
7.	**For transferring any balance left in the capital reduction account to capital reserve account** Capital reduction A/c Dr. To capital reserve A/c *(with the balance left)*

While preparing the balance sheet of a reconstructed company, the following points are to be kept in mind:

(i) After the name of the company, the words "and Reduced" should be added only if the Court so orders.

(ii) In case of fixed assets, the amount written off under the scheme of reconstruction must be shown for five years.

Compromise/ Arrangements

A scheme of compromise and arrangements involve sacrifices by the shareholders, debenture holders, creditors etc. when the company faces financial problems.

Accounting Entries

1.	**When shareholders give up their claim to reserves and accumulated profits** Reserves A/c Dr. To Reconstruction A/c
2.	**When outside liabilities is settled at lesser amount** Outside liabilities A/c Dr. To Reconstruction A/c

Surrender of Shares

The shareholders are made to surrender their shares. The shares are then allotted to debenture holders and creditors. Unutilized shares are cancelled.

Illustration 1

A Mills Ltd., decided to have internal reconstruction. The Balance Sheet of the Company as on 31st March, 2013 was as follows:

A Mills Ltd.

Balance Sheet as at 31st March, 2013

Particulars		Note No.	Amount ₹
I. Equity and Liabilities			
(1) Shareholders' Funds			
(a) Share Capital			
Authorized, Issued and Subscribed : 10,000 10% Cumulative Preference Shares of ₹10 each			1,00,000
25,000 Equity Shares of ₹10 each			2,50,000
(b) Reserves and Surplus			
Securities Premium Reserves			25,000
General Reserve	Nil		
Less: P& L A/c Dr. Balance	1,10,000		(1,10,000)
(2) Share Application Money pending allotment			0
(3) Non – Current Liabilities			
(a) Long Term Borrowing			
10%, 800 Debentures of ₹100 each			
(Secured on freehold property)			80,000
(4) Current Liabilities			
Trade Payables			30,000
Creditors for Expenses			11,000
Interest Accrued on Debentures			4,000
	Total		3,90,000
II. ASSETS			
(1) Non-current Assets			
(a) Fixed Assets			
(i) Tangible Assets			
Freehold Property			75,000
Leasehold Property			1,00,000
Plant and Machinery			60,000
(ii) Intangible Assets			

Goodwill		50,000
(b) Non-Current Investments		25,000
(2) Current Assets		
Other Current Assets		60,000
Share Issue Expenses		20,000
Total		**3,90,000**

Preference dividends are in arrears for two years. A scheme for reduction of capital was sanctioned by the court as follows:

- *10% cumulative preference shares of ₹10 each to be reduced to ₹8 per share.*
- *Equity shares of ₹10 each to be reduced to ₹4 per share.*
- *After reduction, both the shares are to be consolidated into shares of ₹10.*
- *The authorized capital to be restored to ₹1,00,000 in 10% cumulative preference shares of ₹10 each and ₹2,50,000 in equity shares of ₹10 each.*
- *One (new) equity share of ₹10 each is to be issued for every ₹40 of gross preference dividend in arrears.*
- *The debenture holders agreed to take over the freehold property at ₹1,30,000 and paid the balance to the company after satisfying their claim.*
- *Fictitious and intangible assets are to be written off.*
- *The value of assets is to be as follows:*

Leasehold Property	₹80,000
Plant and Machinery	₹50,000
Current Assets	₹40,000

- *Investments realized ₹10,000.*
- *Securities premium reserve balance is allowed to be utilized.*

The scheme as sanctioned by the court was implemented.

You are required to prepare

(i) Journal entries for reduction of share capital and consolidation of preference shares and equity shares.

(ii) Capital Reduction Account

(iii) Cash Account

(iv) Balance Sheet after reduction.

Solution

Journal Entries

Particulars		Debit Amount ₹	Credit Amount ₹
10% Cumulative Preference Share Capital (₹10) A/c	Dr.	1,00,000	
To Capital Reduction A/c			20,000
To 10% Cumulative Preference Share Capital (₹8) A/c			80,000
(Being reduction of 10,000 10% cumulative preference shares of ₹10 each to shares of ₹8 each as per scheme of capital redemption sanctioned by the court).			
Equity Share Capital (₹10) A/c	Dr.	2,50,000	
To Capital Reduction A/c			1,50,000
To Equity Share Capital (₹4) A/c			1,00,000
(Being reduction of 25,000 10% equity shares of ₹10 each into shares of ₹4 each as per scheme of capital reduction sanctioned by the court).			
10% Cumulative Preference Share Capital (₹8) A/c	Dr.	80,000	
To 10% Cumulative Preference Share Capital(New ₹10) A/c			80,000
(Being consolidation of 10,000, 10% preference shares of ₹8 each into 8,000 10% Cumulative Preference Shares of ₹10 each)			
Equity Share Capital (₹4) A/c	Dr.	1,00,000	
To Equity Share Capital (New ₹10) A/c			1,00,000
(Being consolidation of 25,000 10% equity shares of ₹4 each into 10,000 equity shares of ₹10 each)			

CAPITAL REDUCTION ACCOUNT

Particulars	₹	Particulars	₹
To Equity Share Capital (New ₹10) each (See note)	5,000	By 10% Cumulative Preference Share Capital (₹10) A/c	20,000
To Leasehold Property	20,000	By Equity Share Capital (₹10) A/c	1,50,000
To Plant and Machinery	10,000	To Securities Premium Rserve	25,000
To Current Assets	20,000	By Freehold Property A/c (Profit)	55,000
To Loss on Sale of Investments	15,000		
To Goodwill written off	50,000		
To Share Issue Expenses	20,000		
To Profit & Loss A/c Dr. Balance	1,10,000		
	2,50,000		2,50,000

Note:

Arrears of Preference Dividend = 2 x 10% of ₹1,00,000 = ₹ 20,000

To be discharged in equity shares for arrears of every ₹40 = ₹20,000/₹40 = 500 shares of ₹10 each = ₹5,000

CASH ACCOUNT

Particulars		₹	Particulars	₹
To Freehold Property	1,30,000		By Balance c/d	56,000
Less : Debenture holders	84,000	46,000		
To Investments A/c		10,000		
		56,000		56,000

BALANCE SHEET OF A Mills Ltd. (and Reduced)

As on 31st March, 2013

Particulars		Note No.	Amount ₹
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds			
(a) Share Capital			
Authorized :			
10,000 10% Cumulative Preference			
Shares of ₹10 each			1,00,000
25,000 Equity Shares of ₹10 each			2,50,000
Issued Subscribed and Paid-up:			
8,000 10% Cumulative Preference Shares of ₹10 each			80,000
10,500 Equity Shares of ₹10 each (of the above 10,500 equity shares 500 equity shares were issued for consideration other than cash)			1,05,000
(2) Share Application Money pending allotment			0
(3) Non – Current Liabilities			
(4) Current Liabilities			
Trade Payables	11,000		
Creditors for Expenses	30,000		
	Total		2,26,000
II. ASSETS			
(1) Non-current Assets			
(a) Fixed Assets			
(i) Tangible Assets			
Leasehold Property 1,00,000			

Less : Written off under reconstruction			
Scheme dated……….	20,000		80,000
Plant and Machinery	60,000		
Less : Written off under reconstruction scheme dated…….	10,000		50,000
(2) Current Assets			
Cash			56,000
Other Current Assets			40,000
	Total		2,26,000

ILLUSTRATION 2

Balance Sheet of SII Ltd.

As on 31st March, 2013 appears as below

Particulars		Note No.	Amount ₹
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds			
(a) Share Capital			
1,50,000 Equity Shares of ₹10 each fully paid			15,00,000
5,000 11% preference shares of ₹100 each fully paid			5,00,000
(b) Reserves and Surplus			
General Reserve	Nil		
Less: Debit balance of P&L a/c	16,40,000		(16,40,000)
(2) Share Application Money pending allotment			0
(3) Non – Current Liabilities			
11% Debentures			5,00,000
Unsecured loans			5,00,000
(4) Current Liabilities			
Bank Overdraft			6,30,000
Interest accrued on loans			1,50,000
Interest Accrued and due on debentures			1,10,000
Other current liabilities			5,00,000
	Total		27,50,000

II. ASSETS		
(1) Non-current Assets		
(a) Fixed Assets		
Tangible Asset 20,00,000		
Less : Depreciation Reserve 15,00,000		5,00,000
(2) Current Assets		
Stock and Stores		6,00,000
Trade Receivables		14,50,000
Other Current Assets		2,00,000
Total		27,50,000

A scheme of reconstruction has been agreed amongst the shareholders and the creditors with the following salient features:

(a) Interest due on unsecured loans is waived.

(b) 50% of the interest due on the debentures is waived

(c) The 11% preference shareholders' rights are to be reduced to 50% and converted into 15% Debentures of ₹10 each.

(d) Current liabilities would be reduced by ₹50,000 on account of provision no longer required.

(e) The banks agree to the arrangement and to increase the cash credit/overdraft limits by ₹1,00,000 upon the shareholders agreeing to bring in a like amount by way of new equity.

(f) Besides additional subscription as above, the equity shareholders agree to convert the existing equity shares into new 10 rupees shares of total value ₹5,00,000.

(g) The debit balance in the Profit & Loss Account is to be wiped out, ₹2,60,000 provided for doubtful debts and the value of fixed assets increased by ₹4,00,000.

Redraft the Balance Sheet of the company based on the above scheme of reconstruction.

Solution

Balance Sheet of SII Ltd. (and reduced)

As on 31st March, 2013

Particulars	Note No.	Amount ₹
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds		
(a) Share Capital		
60,000 Equity Shares of ₹10 each fully paid		6,00,000
(b) Reserves and Surplus		
Capital Reserve		5,000

(2) Share Application Money pending allotment			0
(3) Non-Current Liabilities			
11% Debentures			5,00,000
15% Debentures			2,50,000
Unsecured loans			5,00,000
(4) Current Liabilities			
Bank Overdraft (6,30,000-1,00,000)			5,30,000
Interest Accrued and due on debentures			55,000
Other current liabilities (5,00,000-50,000)			4,50,000
Total			28,90,000
II. ASSETS			
(1) Non-current Assets			
(a) Fixed Assets			
(i) Tangible Assets	24,00,000		
Less : Depreciation Reserve	15,00,000		9,00,000
(2) Current Assets			
Stock and Stores			6,00,000
Receivables	14,50,000		
Less: Provision for doubtful debts	2,60,000		11,90,000
Other Current Assets			2,00,000
Total			28,90,000

Working Note 1:

CAPITAL REDUCTION ACCOUNT

Particulars	₹	Particulars	₹
To General Reserve	16,40,000	By Interest Accrued and Due on:	
To Provision for Doubtful Debts	2,60,000	Unsecured Loans	1,50,000
To Capital Reserve		Debentures	55,000
(Balancing figure)	5,000	By 11% Preference Share Capital A/c	2,50,000
		By Current Liabilities	50,000
		By Equity Share Capital A/c	10,00,000
		By Fixed Assets	4,00,000
	19,05,000		19,05,000

ILLUSTRATION 3

Balance Sheet of JAY Co. Ltd.

As on 31st March, 2013 is given below:

Particulars		Note No.	Amount ₹
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds			
(a) Share Capital			
2,000 6% Cumulative Preference Shares of ₹100 each fully paid-up			2,00,000
75,000 equity shares of ₹10 each fully paid-up			7,50,000
(b) Reserves and Surplus			
General Reserve	Nil		
Less: Debit balance of P&L a/c	3,50,000		(3,50,000)
(2) Share Application Money pending allotment			0
(3) Non – Current Liabilities			
6% Debentures (Secured by Freehold Property)			3,75,000
Directors loan			2,00,000
(4) Current Liabilities			
Trade Payables			12,500
Interest Accrued and due on debentures			22,500
	Total		12,10,000
II. ASSETS			
(1) Non-current Assets			
(a) Fixed Assets			
Freehold Property			3,50,000
Plant			50,000
(b) Non Current Investments (At Cost)			60,000
(2) Current Assets			
Stock and Stores			2,00,000
Trade Receivables			4,00,000
Deferred Advertising Expenditure			1,50,000
	Total		12,10,000

The Court approved a scheme of reorganization to take effect on 1.4.2013 whereby:

– Preference shares to be written down to ₹75 each and equity shares to ₹2 each.

– Preference Dividends-in-arrears for 4 years, 75% to be waived and equity shares of ₹2 each to be allotted for the remaining quarter.

- Accrued Debenture Interest to be paid in cash.
- Debenture holders agreed to take over Freehold Property (Book Value ₹1,50,000) at a valuation of ₹1,50,000 in part repayment of their holdings and to provide additional cash of ₹1,30,000 secured by a floating charge on the company's assets at an interest rate of 10% p.a.
- Deferred Advertising to be written off.
- Stock to be written off fully.
- ₹2,33,000 to be provided as Bad Debts.
- Investments sold out for ₹1,50,000.
- In settlement of their loans, Directors are to accept equity shares of ₹2 each for 90% of their loans, waving 10% of the balance of their loan amount.
- Capital commitments contracts totaling ₹3,00,000 are to be cancelled by payment of penalty @ 5% of Contract Value.
- Taxation and Cost of Scheme are to be ignored.

Show Journal entries, reflecting the effect of the above transactions (including cash transactions) and draw up the Balance Sheet after affecting the Scheme.

Solution

JOURNAL OF A Co. LTD

Particulars		Debit Amount ₹	Credit Amount ₹
6% Preference Share Capital A/c	Dr.	50,000	
To Capital Reduction A/c			50,000
(Being Preference Shares of ₹100 each reduced to ₹75 as per reconstruction scheme)			
Equity Share Capital A/c	Dr.	6,00,000	
To Capital Reduction A/c			6,00,000
(Being equity shares of ₹10 reduced to ₹ 2 as per reconstruction scheme)			
Capital Reduction A/c	Dr.	12,000	
To Equity Share Capital A/c			12,000
(Being arrears of Preference Share Dividend ₹48,000 are to be satisfied by issue of ₹ 12,000 equity shares to the extent of 25% of ₹48,00)			
Accrued Debentures Interest A/c	Dr.	22,500	
To Bank			22,500
(Being Accrued debentures interest paid)			
6% Debentures A/c	Dr.	1,50,000	
To Freehold Property A/c			1,50,000
(Being claim of debenture holders settled in part in respect of principal amount by transfer of freehold property as per reconstruction scheme)			

Particulars		Dr. (₹)	Cr. (₹)
Bank A/c	Dr.	1,30,000	
To 10% Debentures A/c			1,30,000
(10% Debentures issued for Cash)			
Capital Reduction A/c	Dr.	9,33,000	
To Profit & Loss A/c			3,50,000
To Deferred Advertising Expenses A/c			1,50,000
To Stock A/c			2,00,000
To Bad Debts A/c			2,33,000
(Being various assets written off as per Reconstruction scheme)			
Freedom Property A/c	Dr.	2,00,000	
To Capital Reduction A/c			2,00,000
(Being appreciation in the value of property i.e.,₹ 4,00,000 – (₹3,50,000 – ₹1,50,000)			
Bank A/c	Dr.	1,50,000	
To Trade Investments			60,000
To Capital Reduction A/c			90,000
(Trade investment sold and profit credited to Capital Reduction A/c)			
Directors' Loan A/c	Dr.	2,00,000	
To Equity Share Capital A/c			1,80,000
To Capital Reduction A/c			20,000
(Being Directors' Loan discharged by issue of Share Capital and the balance transferred to Capital Reduction A/c)			
Capital Reduction A/c	Dr.	15,000	
To Bank			15,000
(Being payment of 5% penalty for cancellation of capital commitments of ₹3,00,000)			

The Balance Sheet of A & Co. (After Reconstruction)

As on 1st April, 2013

Particulars	Note No.	Amount ₹
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds		
(a) Share Capital		
1,71,000 Equity Shares of ₹2 each		3,42,000
(Of the above 90,000 shares have been issued for consideration other than cash)		
2,000 6% Cumulative preference shares of ₹75 each fully paid		1,50,000
(2) Share Application Money pending allotment		0
(3) Non – Current Liabilities		
6% Debentures		2,25,000
10% Debentures		1,30,000
(4) Current Liabilities		
Trade Payables		12,500
Total		8,59,500
II. ASSETS		
(1) Non-current Assets		
(a) Fixed Assets		
Freehold Property (Including ₹2,00,000 appreciation in value due to reconstruction)		4,00,000
Plant		50,000
(2) Current Assets		
Trade Receivables (₹4,00,000– ₹2,33,000)		1,67,000
Cash at Bank (₹1,30,000 + ₹1,50,000 – ₹22,500 – ₹15,000)		2,42,500
Total		8,59,500

ILLUSTRATION 4

Balance Sheet of KING Co. Ltd.

As on 31st March, 2013 is given below:

Particulars		Note No.	Amount ₹
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds			
(a) Share Capital			
2,00,000 Equity Shares of ₹10 each, ₹5 paid up			10,00,000
6,000 8% Preference shares of ₹100 each			6,00,000
(b) Reserves and Surplus			
General Reserve	Nil		
Less: Debit balance of P&L a/c	4,08,000		(4,08,000)
(2) Share Application Money pending allotment			0
(3) Non – Current Liabilities			
9% Debentures			6,00,000
(4) Current Liabilities			
Trade Payables			69,000
Interest Accrued and due on debentures			1,08,000
Bank overdraft			1,50,000
Interest accrued on bank overdraft			15,000
Total			21,34,000
II. ASSETS			
(1) Non-current Assets			
(a) Fixed Assets			
(i) Tangible Assets			11,40,000
(ii) Intangible Assets			
Patents and copyrights			80,000
(b) Non Current Investments (At Cost)			65,000
(2) Current Assets			
Stock and Stores			4,00,000
Trade Receivables			4,39,000
Bank			10,000
Total			21,34,000

- Preference dividend is in arrear for one year. Preference shareholders to give up their claims, inclusive of dividends, to the extent of 30% and desire to be paid-off.
- Debenture-holders agree to give up their claims to interest in consideration of their interest being enhanced to 12%.
- Bank agrees to give up 50% of its interest outstanding in consideration of its being paid off at once.
- Creditors would like to grant a discount of 5% if they are paid immediately.
- Balance of Profit & Loss Account, Patents and Copyrights and Debtors of ₹30,000 to be written off.
- Fixed Assets to be written down by ₹34,000.
- Investments are to reflect their market value.
- To the extent not specifically stated, equity shareholders suffer on reduction of their rights. Cost of reconstruction is ₹3,350.

Draft journal entries in the books of the company assuming that the scheme has been put through fully with the equity shareholders bringing in necessary cash to pay off the parties and to leave a working capital of ₹30,000 and prepare the Balance Sheet after reconstruction.

Solution

In the Books of KING Co. Ltd.

JOURNAL ENTRIES

Particulars		Debit Amount ₹	Credit Amount ₹
8% Preference Share Capital A/c	Dr.	6,00,000	
To Preference Shareholders A/c			4,20,000
To Capital Reduction A/c			1,80,000
(30% of claim given up by preference shareholders as per reconstruction scheme dated…………….)			
Capital Reduction A/c	Dr.	33,600	
To Preference Shareholders A/c			33,600
(70% of arrear preference dividend payable to preference Shareholders as per reconstruction scheme)			
Preference Shareholders A/c	Dr.	4,53,600	
To Bank A/c			4,53,600
(Amount due to preference shareholders discharged)			
9% Debentures A/c	Dr.	6,00,000	
Interest Accrued on Debentures A/c	Dr.	1,08,000	
To 12% Debentures A/c			6,00,000
To Capital Reduction A/c			1,08,000
(9% debentures converted into equivalent number of 12% debentures and the accrued debenture interest sacrificed as per reconstruction scheme)			

Particulars		Dr. (₹)	Cr. (₹)
Bank Overdraft A/c	Dr.	1,50,000	
Interest Accrued on Bank Overdraft A/c	Dr.	15,000	
To Bank A/c			1,57,500
To Capital Reduction A/c			7,500
(Bank overdraft paid-off including 50% of accrued interest as per reconstruction scheme, the interest sacrificed credited to Capital Reduction A/c)			
Creditors A/c	Dr.	69,000	
To Bank A/c			65,550
To Capital Reduction A/c			3,450
(Creditors claim discharged to the extent of 95% as per reconstruction scheme, the balance of the claim sacrificed)			
Capital Reduction A/c	Dr.	5,62,000	
To Profit & Loss A/c			4,08,000
To Patents & Copyrights A/c			80,000
To Debtors A/c			30,000
To Investments A/c			10,000
To Fixed Assets A/c			34,000
(Writing off debit balance of profit and loss account, patents & copy rights and writing down the value of debtors, investments and fixed assets as per reconstruction scheme)			
Equity Share capital A/c (W. Note 1)	Dr.	3,00,000	
To Capital Reduction A/c			3,00,000
(Equity shareholders rights reduced to a share of ₹3.5 vide Board Resolution No. …. Dated…, the amount of sacrifice credited to Capital Reduction Account)			
Bank A/c (W. Note 2)	Dr.	7,00,000	
To Equity Share Capital A/c			7,00,000
(Amount received on 2,00,000 equity shares @ ₹3.50 per share as per reconstruction scheme)			
Capital Reduction A/c	Dr.	3,350	
To Bank A/c			3,350
(Reconstruction expenses paid)			

Balance Sheet of KING Co. Ltd. (and reduced)

As on 31st March, 2013

Particulars	Note No.	Amount ₹
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds		
(a) Share Capital		
Issued and Paid-up : 2,00,000 Equity Shares of ₹10 each, ₹7 paid		14,00,000
(2) Share Application Money pending allotment		0
(3) Non – Current Liabilities		
12% Debentures		6,00,000
(4) Current Liabilities		0
Total		20,00,000
II. ASSETS		
(1) Non-current Assets		
Fixed Assets (₹11,40,000 – ₹34,000 written off under Reconstruction Scheme)		11,06,000
Non Current Investments		55,000
(2) Current Assets		
Stock and Stores		4,00,000
Trade Receivables		4,09,000
Bank		30,000
Total		20,00,000

Working Notes:

1. Statement Showing Liabilities and Equity Sacrificed and their uses as per Scheme

Liabilities and Equity Sacrificed	₹	Uses	₹
Preference Shareholders:		Writing off :	
30% of ₹6,00,000	1,80,000	Reconstruction Expenses	3,350
Debenture holders:		Profit & Loss Account Balance	4,08,000
Interest on Debentures	1,08,000	Patients & Copyrights	80,000
Bank Overdraft:		Arrear Preference Dividend	33,600
Interest on Bank Overdraft (50%)	7,500	(70% of ₹48,000)	
Creditors :		Writing down :	
5% of ₹69,000	3,450	Debtors	30,000
Equity Shareholders :		Investments	10,000

Sacrifice @ ₹1.50 per share (Balancing figure)	3,00,000	Fixed Assets	34,000
	5,98,950		5,98,950

2. Cash to be brought in by Equity Shareholders:

	₹
Payment to:	
Preference shareholders (including arrear preference dividend) 70% of ₹6,48,000	4,53,000
Bank Overdraft (including interest on bank overdraft) (₹1,50,000 + ₹7,500)	1,57,500
Creditors (95% of ₹69,000)	65,550
Others:	
Reconstruction expenses	3,350
Additional cash required for working capital of ₹30,000 to be maintained (₹30,000 – ₹10,000 cash in hand)	20,000
	7,00,000

No. of equity shares = 2,00,000

Therefore, contribution per equity share = ₹ 7,00,000/2,00,000 = ₹ 3.50

ILLUSTRATION 5

The following is the Balance Sheet as at 31st March, 2013 of JINX Prospects Ltd.

Particulars	Note No.	Amount ₹
I. EQUITY AND LIABILITIES		
(1) Shareholders' Funds		
(a) Share Capital		
7,500 Equity Shares of ₹100 each fully paid up		7,50,000
3,000 8% Preference shares of ₹100 each		3,00,000
(b) Reserves and Surplus		
Securities Premium		12,000
General Reserve		80,000
(2) Share Application Money pending allotment		0
(3) Non – Current Liabilities		0
(4) Current Liabilities		
Trade Payables		3,75,000
Total		15,17,000

II. **ASSETS**		
(1) Non-current Assets		
(a) Fixed Assets		
(i) Tangible Assets		9,80,000
(ii) Intangible Assets		
Goodwill		1,00,000
(b) Non Current Investments (At Cost)		20,000
(2) Current Assets		
Stock and Stores		2,00,000
Trade Receivables		1,54,500
Bank		62,500
Total		15,17,000

Contingent liability:

Preference Dividends in arrears ₹66,000.

The Board of Directors of the company decided upon the following scheme of reconstruction:

- The preference shares are to be converted into 13% unsecured debentures of ₹100 each in regard to 80% of the dues (including arrears of dividend) and for the balance equity shares of ₹50 paid-up would be issued. The authorized capital of the company permitted the issue of additional shares.
- Equity shares would be reduced to shares of ₹50 each paid-up.
- All equity holders agree to pay the balance in cash.
- Goodwill has lost its value and is to be written off fully. Investments are to reflect their market value of ₹30,000. Obsolete items in stock of ₹50,000 are to be written off. Bad debts to the extent of 5% of the total debtors would be provided for. Fixed assets to be written down by ₹1,50,000.
- The scheme was duly approved and put into effect.

The Company carried on trading for six months and after writing off depreciation at 20% p.a. on the revised value of fixed assets, made a net profit of ₹80,000. The half-yearly working resulted in an increase of Sundry Debtors by ₹60,000, Stock by ₹80,000 and cash by ₹40,000.

Show the journal entries necessary in the Company's books to give effect to the scheme and draw the Balance Sheet as at 30th September, 2013.

Solution

In the Books of JINX Prospects Ltd.

JOURNAL ENTRIES

Particulars		Debit Amount ₹	Credit Amount ₹
Cumulative Preference Share Capital A/c	Dr.	3,00,000	
Capital Reduction A/c	Dr.	66,000	
To Cumulative Preference Shareholders A/c			3,66,000
(Being the cumulative preference shares & arrear Dividend transferred to cumulative preference shareholders account in accordance with the resolution of The Board dated………………..)			
Cumulative Preference Shareholders A/c	Dr.	3,66,000	
To 13% Unsecured Debentures A/c			2,92,800
To Equity Share Capital A/c			73,200
(Being the issue of 13% unsecured debentures and 1,464 equity shares of ₹100 each issued as ₹50 paid-up as per the Board resolution dated…..……)			
Equity Share Capital A/c	Dr.	3,75,000	
To Capital Reduction A/c			3,75,000
(Being the entry for reducing every share of ₹100 Each as ₹50 paid-up 7,500 equity shares @ ₹50 as Per the Board resolution dated ....…..)			
Cash A/c	Dr.	4,48,200	
To Equity Share Capital A/c			4,48,200
(Being the receipt of cash of ₹50 each for 8964 being the call made as per Board's resolution dated……..)			
Investments A/c	Dr.	10,000	
Capital Reduction (Balancing Figure)	Dr.	2,97,725	
To Goodwill A/c			1,00,000
To Stock A/c			50,000
To Fixed Assets A/c			1,50,000
To Provision for Doubtful Debts A/c			7,725
(Being the change in value of assets as per the resolution of the Board dated………..)			
Capital Reduction A/c	Dr.	11,275	
To Capital Reserve A/c			11,275
(Being the transfer of Capital Reduction A/c balance to Capital Reserve)			

JINX Prospectus Ltd.

Balance Sheet at 30th September, 2013

Particulars		Note No.	Amount ₹
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds			
(a) Share Capital			
8,964 Equity shares of ₹100 each fully paid up			8,96,400
(b) Reserves and Surplus			
Securities Premium			12,000
General Reserve			80,000
Capital Reserve			11,275
P&L A/c			80,000
(2) Share Application Money pending allotment			0
(3) Non – Current Liabilities			
13% Unsecured Debentures			2,92,800
(4) Current Liabilities			
Trade Payables (W. Note 3)			3,92,000
	Total		17,64,475
II. ASSETS			
(1) Non-current Assets			
(a) Fixed Assets (after reduction of ₹1,50,000 due to reconstruction)	8,30,000		
Less: Depreciation for ½ Year	83,000		7,47,000
(b) Non Current Investments (At Cost)			30,000
(2) Current Assets			
Stock and Stores			2,30,000
Trade Receivables	2,14,500		
Less: Provision for Doubtful Debts	7,725		2,06,775
Bank (W. Note 2)			5,50,700
	Total		17,64,475

Working Notes:

(1) No. of equity shares issued to cumulative preference shareholders	**1,464**
No. of shares held by Equity shareholders	7,500
Total:	8,964

(2) Bank Balance

		₹
Opening Balance on 31.3.2013		62,500
Add calls on shares @ ₹50 per share		
(8,964 ₹50 per share)		4,48,200
Balance on implementation of the scheme		5,10,700
Add: Change in cash balance (as given)	(+)	40,000
		5,50,700

(3) Creditors Balance = Balancing figure in the Balance Sheet

Alternative approach : Profit & Loss upto 30.9.2013		80,000
Add : Depreciation (non-cash item)		83,000
Cash from Operations	(A)	1,63,000
Change in Current Assets:		
Debtors	(+)	60,000
Stock	(+)	80,000
Cash Balance	(+)	40,000
Cash Outflow	(B)	1,80,000
Increase in creditors :		
Excess of (B) over (A)		17,000
Add: Opening Balance of Creditors		3,75,000
		3,92,000

LESSON ROUND UP

- ‘Corporate Restructuring’ implies restructuring or reorganizing a company or its business (or one of its businesses) or its financial structure, in such a way as to make it operate more effectively
- Corporate Restructuring aims at improving the competitive position of an individual business and maximizing it’s contribution to corporate objectives. It also aims at exploiting the strategic assets accumulated by a business i.e. natural monopolies, goodwill, exclusivity through licensing etc. to enhance the competitive advantages. Thus restructuring would help bringing an edge over competitors
- The term ‘amalgamation’ is used when two or more existing companies go into liquidation and a new company is formed to take over their business while the term ‘absorption’ is used when one or more existing companies go into liquidation and one existing company takes over or purchases their businesses.
- As per Accounting Standard (AS-14) issued by the Institute of Chartered Accountants of India, amalgamation means merging of one company with another or merging of two or more companies to form a new company or takes over of one company by the other. Hence, amalgamation includes absorption. In amalgamation the assets and liabilities of the transferor company (ies) are amalgamated with those of the transferee company.

- There are two type of amalgamation. Amalgamation in the nature of merger and amalgamation in the nature of purchase.
- According to Accounting Standard-14 there are two methods of accounting for amalgamations namely: (i) the Pooling of Interest Method; and (ii) the Purchase Method.
- According to Pooling of Interest Method, while recording the transactions in the books of the transferee company, the assets, liabilities and reserves (whether capital or revenue or arising on revaluation) of the transferor company are recorded at their existing carrying amounts and in the same form as at the date of amalgamation while as per the Purchase Method., the assets and liabilities of the transferor company should be incorporated either at their existing carrying amounts or the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation.
- Acquisition of business by a limited company, generally, refers to the purchase of a non-corporate business like sole- proprietorship or partnership form of business by a company. This does not necessarily mean that a limited company cannot acquire the business of a corporate body, i.e., another limited company. But strictly speaking, the acquisition of business of a limited company by another limited company comes under the purview of "Amalgamation, Absorption and Reconstruction of Companies.

SELF TEST QUESTIONS

1. What is the meaning of the term "Corporate Restructuring"? Explain the reasons of Corporate Restructuring and its different forms.
2. What do you mean by the term amalgamation? What are the different form of amalgamation? Explain in brief.
3. Explain the difference between pooling of interest method and purchase methods of amalgamation.
4. Following is the balance sheet of Vertical Ltd. as on 31st March, 2013:

			Amount (₹)
I	**EQUITIES AND LIABILITIES**		
1.	**Shareholders' funds**		
	(a) Share Capital		
	Authorised, Issued subscribed and paid up capital		
	8% Preference shares of ₹ 100 each	7,50,000	
	Equity shares of ₹ 10 each, fully called up and paid up	10,00,000	17,50,000
	(b) Reserve and surplus		
	General reserve		14,00,000
2.	**Non-current liabilities**		
	10% Debentures		7,00,000
3.	**Current Liabilities**		
	Trade payables		5,00,000
	TOTAL		**43,50,000**

II ASSETS	
1. Non-current Assets	
(a) Fixed Assets	
Tangible Assets & intangible Assets	32,50,000
(b) Investment	6,00,000
2. Current Assets	
Misc Current Assets	5,00,000
TOTAL	**43,50,000**

Horizontal Ltd agreed to take over the assets and liabilities of vertical limited on the following terms and conditions:

(i) (a) Discharge 10% debentures at a premium of 10% by issuing 10% debentures of Horizontal Ltd .

(b) Fixed assets 10% above the book value.

(c) Investments at par value.

(d) Current assets at a discount of 10%.

(e) Current liabilities at book value.

(ii) (a) Discharge the debenture holders of vertical limited Ltd. at 10% premium by issuing 15% debentures of Horizontal Ltd.

(b) Preference shareholders are discharged at a premium of 10% by issuing 8% preference shares of ₹ 100 each.

(c) Issue 3 equity shares of ₹ 10 each for every 2 equity shares in Horizontal Ltd.. and pay cash @ ₹ 3 per equity share.

Calculate consideration under:

(i) Net assets method; and (ii) Net payment method respectively.

5. Peppermint Ltd., registered with a capital of ₹ 10,00,000 in equity shares of ₹ 10 each ~~acquired~~ the business of M/s Rama and Krishna , the Balance Sheet of whom at the date of acquisition was as follows :

Liabilities	₹	Assets	₹
Bills Payable	80,000	Cash at Bank	1,45,000
Sundry Creditors	1,50,000	Bills Receivable	65,000
Reserve	70,000	Sundry Debtors	2,40,000
Capital Accounts:		Stock	90,000
Rama - 3,50,000		Furniture and Fixtures	10,000
Krishna - 3,50,000	7,00,000	Plant and Machinery	2,00,000
		Land and Buildings	2,50,000
	10,00,000		10,00,000

The assets and liabilities were subject to the following revaluation:

Plant and Machinery to be depreciated by 10%

Furniture and Fittings to be depreciated by 15%

Land and Buildings to be appreciated by 20%

A provision to be made for bad debts on debtors @ 2-1/2%

Goodwill of the firm was valued at ₹ 2,40,000.

The consideration was to be discharged as follows:

(i) Allotment of 10,000 Equity Shares of ₹ 10 each at ₹ 12 each.

(ii) Allotment of 5,000 14% Debentures of ₹ 100 each at a discount of 10%.

(iii) Balance in cash.

The cost of acquisition of the company amounted to ₹ 50,000.

You are required to show the journal entries in the books of the company and prepare the opening balance sheet of the company after the acquisition.

6. Under given is the balance sheet of Potato limited as on 31st March, 2013

		Amount (₹)
I. EQUITIES AND LIABILITIES		
1. Shareholders' funds		
(a) Share Capital		
Authorised, Issued subscribed and paid up capital		
12,500 9% preference shares of ₹ 8 each	1,00,000	
15,000 equity shares of ₹ 10 each	1,50,000	2,50,000
(b) Reserve and surplus		
Profit and Loss account		(98,000)
2. Non-current liabilities		
10% debentures		60,000
3. Current Liabilities		
Trade Payables	50,000	
Bank overdraft (Secured by Land and building)	1,20,000	
Debentures interest	4,200	1,74,200
TOTAL		**3,86,200**
II ASSETS		
1. Non-current Assets		
(a) Fixed Assets		
Freehold Land and building	34,000	

	Plant	96,000	
	Tools and dies	27,300	1,57,300
	(b) Other non-current expenses		
	Research and development expenses		18,000
2	**Current Assets**		
	Stock		1,42,500
	Trade receivables		53,400
	Investment		15,000
	TOTAL		**3,86,200**

The scheme of re-organisation detailed below has been agreed by all the parties approved by the Court. You are required to prepare:

(a) Journal entries recording the transactions in the books, including cash;

(b) The balance sheet of the company as on 1st April, 2013 after the completion of the scheme.

(i) The following assets are to be revalued as shown below: plant ₹ 59,000 tools and dies Rs. 15,000; stock ₹ 1,30,000 and debtors ₹ 48,700.

(ii) The research and development expenditure and debit balance of profit and loss account are to be written off.

(iii) Price of land recorded in the books at ₹ 6,000 is valued at ₹ 14,000 and is to be taken over by the debenture holders in part repayment of principal. The remaining freehold land and buildings are to be revalued at ₹ 40,000.

(iv) A creditor for ₹ 18,000 has agreed to accept a second mortgage debenture of 11% per annum secured on plant for ₹ 15,500 in settlement of his debt. Other creditors totaling ₹ 10,000 agreed to accept a payment of ₹ 0.85 in the rupee for immediate settlement.

(v) The investment at a valuation of ₹ 22,000 is to be taken over by the bank.

(vi) The ascertained loss is to be met by writing down the equity shares to Rs. 1 each and preference shares to ₹ 8 each. The authorised share capital is to be increased immediately to the original amount.

(vii) The equity shareholders agree to subscribe for two new ordinary shares at par for every share held. This cash is all received.

(viii) The costs of the scheme are ₹ 3,500. These have been paid and are to be written off. The debenture interest has also been paid.

Lesson 5

Consolidation of Accounts

LESSON OUTLINE

- Meaning and Definition of Holding and Subsidiary Company
- Preparation of CFS under the Companies Act, 2013
- Schedule III of the Companies Act, 2013
- Preparation of consolidated financial statements
- Holding company consisting of more than one subsidiary
- Preparation of consolidated profit and loss statement
- Lesson Round Up
- Self Test Questions

LEARNING OBJECTIVES

A holding company is one which acquires all or a majority of the equity shares of any other company called subsidiary company in order to have control over the subsidiary company. In order to understand the financial position of holding company, consolidations of accounts become very vital.

After studying this lesson you will be able to:

- Understand the concept of holding company and subsidiary company.
- Familiarize the legal requirements for preparation of final accounts of holding company.
- Prepare consolidated balance sheet and statement of profit and loss.
- Make appropriate accounting adjustments required for the preparation of consolidated balance sheet.
- Understand the concept of minority interest in consolidation of accounts.
- Appreciate the treatment of pre-acquisition profits and losses of the subsidiary company. Make adjustment regarding profit and loss on revaluation of assets of subsidiary company.
- Understand the calculation of goodwill or cost of control.
- Make adjustment for inter-company unrealized profits and inter-company transactions.
- Understand the treatment of bonus issue on consolidation of accounts.
- Make adjustment on dividend received from subsidiary company.

A consolidated financial statement is very useful for investors. It helps investors to easily understand overall corporate performance, without getting into each subsidiary's details.

MEANING AND DEFINITION OF HOLDING AND SUBSIDIARY COMPANY

According to section 2(46) of the Companies Act, 2013, "holding company", in relation to one or more other companies, means a company of which such companies are subsidiary companies.

According to section 2(87) of the Companies Act, 2013, "subsidiary company" or "subsidiary", in relation to any other company (that is to say the holding company), means a company in which the holding company—

(i) controls the composition of the Board of Directors; or

(ii) exercises or controls more than one-half of the total share capital either at its own or together with one or more of its subsidiary companies:

Provided that such class or classes of holding companies as may be prescribed shall not have layers of subsidiaries beyond such numbers as may be prescribed. For the purposes of this clause,—

(a) a company shall be deemed to be a subsidiary company of the holding company even if the control referred to in sub-clause (i) or sub-clause (ii) is of another subsidiary company of the holding company;

(b) the composition of a company's Board of Directors shall be deemed to be controlled by another company if that other company by exercise of some power exercisable by it at its discretion can appoint or remove all or a majority of the directors;

(c) the expression "company" includes any body corporate;

(d) "layer" in relation to a holding company means its subsidiary or subsidiaries.

The definition of a subsidiary as per the 2013 Act includes associates and joint ventures.

Explanation with Example

Suppose, H is holding company of S because 51 % shares are of H in S. S is also of holding Company of R because S have power to appoint the board of directors of R Company and then H is also holding Company of R.

PREPARATION OF CONSOLIDATED FINANCIAL STATEMENTS AS PER THE COMPANIES ACT

The Companies Act 1956 Act does not require preparation of consolidated financial statements ('CFS'). However, listed entities are required to prepare CFS (as per SEBI regulations). The Companies Act 2013 has made preparation of consolidated accounts mandatory for companies having one or more subsidiaries or associates or joint ventures. According to sub section 3 of the section 129 of the Companies Act, 2013, where a company has one or more subsidiaries or associates or joint ventures, it shall, in addition to its financial statements for the financial year, prepare a consolidated financial statement of the company and of all the subsidiaries or associates or joint ventures in the same form and manner as that of its own which shall also be laid before the annual general meeting of the company along with the laying of its financial statement.

The requirement to prepare CFS is largely consistent with internationally accepted practices. However, internationally, such requirements apply only to listed companies; and unlisted intermediate entities are generally exempted. The existing Indian and international accounting practices do not require preparation of CFS when the Company has investments only in associates and joint ventures (no subsidiaries).

According to the rules, the company shall also attach along with its financial statement, a separate statement containing the salient features of the financial statement of its subsidiary or subsidiaries or associates or joint venture in the Form 9.1.

The Consolidation of financial statements of the company shall be made in accordance with the Accounting Standards, subject however, to the requirement that if under such Accounting Standards, consolidation is not required for the reason that the company has its immediate parent outside India, then such companies will also be required to prepare Consolidated Financial Statements in the manner and format as specified under Schedule III to the Act.

SCHEDULE III OF THE COMPANIES ACT, 2013

The Schedule III of the Companies Act, 2013, provides certain general instructions for the preparation of consolidated financial statements.

1. Accordingly, where a company is required to prepare Consolidated Financial Statements, *i.e.*, consolidated balance sheet and consolidated statement of profit and loss, the company shall *mutatis mutandis* follow the requirements of Schedule III of the Companies Act, 2013, as applicable to a company in the preparation of balance sheet and statement of profit and loss. In addition, the consolidated financial statements shall disclose the information as per the requirements specified in the applicable Accounting Standards including the following:

   (i) Profit or loss attributable to "minority interest" and to owners of the parent in the statement of profit and loss shall be presented as allocation for the period.

   (ii) "Minority interests" in the balance sheet within equity shall be presented separately from the equity of the owners of the parent.

2. In Consolidated Financial Statements, the following shall be disclosed by way of additional information:

Name of the entity in the	Net Assets, *i.e.*, total assets minus total liabilities		Share in profitor loss	
	As % of consolidated net assets	Amount	As % of consolidated profit or loss	Amount
1	2	3	4	5
Parent Subsidiaries Indian				
1.				
2.				
3.				
Foreign				
1.				
2.				
3.				
Minority Interests in all subsidiaries Associates (Investment as per the equity method)				
Indian				
1.				
2.				
3.				
Foreign				
1.				
2.				
3.				
Joint Ventures (as per proportionate consolidation/ investment as per the equity method)				
Indian				
1.				

2.				
3.				
Foreign				
1.				
2.				
3.				
TOTAL				

3. All subsidiaries, associates and joint ventures (whether Indian or foreign) will be covered under consolidated financial statements.
4. An entity shall also disclose the 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.

PREPARATION OF CONSOLIDATED BALANCE SHEET

The following are the most important points which reserve special consideration in the preparation of the consolidated Balance Sheet of the holding company and its subsidiaries.

INVESTMENT IN SHARES OF SUBSIDIARY COMPANY

(a) when all the shares of the subsidiary are held by the holding company - (acquired at par): In such a case, the investment in shares of subsidiary company represent the ownership of the holding company in the equity or net assets of the subsidiary company. Net assets are the difference between the total assets and the liabilities of the subsidiary. Net assets are also equal to the total of all accounts relating to the shareholders, i.e., Share Capital, Reserves, Profit and Loss Account balance, etc. The principle of consolidation is very simple in this case. While preparing the Consolidated Balance Sheet, investments of the holding company in shares of subsidiary company have simply to be replaced by the net assets (i.e., total assets and liabilities) of subsidiary company.

Illustration 1

The Balance Sheet of the H Ltd. and S Ltd. as on 31st March, 2014 are given below:

		H Ltd. **Amount** (₹)	*S Ltd.* **Amount** (₹)
I	**EQUITIES AND LIABILITIES**		
1	**Shareholders' funds**		
(a)	Share Capital		
	Authorised, Issued subscribed and paid up capital		
	Equity shares of ₹ 100 each, fully called up and paid up	6,00,000	2,00,000
(b)	Reserve and surplus		
	Profit and Loss A/c	80,000	80,000
2	**Current Liabilities**		
	Trade Payables	75,000	48,000
	TOTAL	**7,55,000**	**2,48,000**
II.	**ASSETS**		
1	**Non-current Assets**		

(a)	Fixed Assets		
	Fixed Assets	5,55,000	2,48,000
(b)	Long term Investment		
	Shares in S Ltd. (at cost	2,00,000	-
	TOTAL	**7,55,000**	**2,48,000**

Solution:

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd.

as at 31st March, 2014

		S Ltd. **Amount** (₹)	
I	**EQUITIES AND LIABILITIES**		
1	**Shareholders' funds**		
(a)	Share Capital		
	Authorised, Issued subscribed and paid up capital		
	Equity shares of ₹ 100 each, fully called up and paid up		6,00,000
(b)	Reserve and surplus		
	Surplus A/c		80,000
2	**Current Liabilities**		
	Trade Payables		
	H Limited	75,000	
	S Limited	48,000	1,23,000
	TOTAL		**8,03,000**
II	**ASSETS**		
1	**Non-current Assets**		
(a)	Fixed Assets		
	H Limited	5,55,000	
	S Limited	2,48,000	8,03,000
	TOTAL		**8,03,000**

It is clear from the above consolidated balance sheet that the investment of H Ltd. in shares of S Ltd. amounting to ₹ 2,00,000 has been replaced by the net assets of S Ltd. amounting to ₹ 2,00,000 (i.e., Sundry Assets ₹ 2,48,000 - Trade Payables ₹ 48,000)

(b) When some of the shares of the subsidiary are held by the outsiders - In such a case, the outsiders holding shares in the subsidiary company will naturally claim a share in the net assets (i.e., the total assets minus liabilities) of the subsidiary company in proportion to their shareholding. While preparing the consolidated balance sheet, the amount of claim of the outside shareholders must be treated as a liability of the holding company and as such it has to be shown on the liabilities side of the balance sheet under the heading "Minority Interest". All the assets and liabilities of the subsidiary company have to be merged with those of the holding company which will eliminate investments of the holding company in the shares of the subsidiary company.

Illustration 2

The Balance Sheet of H Ltd. and S Ltd. as on 31st March, 2014 are given below:

Balance Sheet

		H Ltd. **Amount (₹)**	*S Ltd.* **Amount (₹)**
I	**EQUITIES AND LIABILITIES**		
1	**Shareholders' funds**		
(a)	Share Capital		
	Authorised, Issued subscribed and paid up capital		
	Equity shares of ₹ 100 each, fully called up and paid up	6,00,000	2,00,000
(b)	Reserve and surplus		
	Surplus A/c	80,000	80,000
2	**Current Liabilities**		
	Trade Payables	75,000	48,000
	TOTAL	**7,55,000**	**2,48,000**
II	**ASSETS**		
1	**Non-current Assets**		
(a)	Fixed Assets		
	Fixed Assets	6,05,000	2,48,000
(b)	Long term Investment		
	1,500, Shares in S Ltd. (at cost)	1,50,000	-
	TOTAL	**7,55,000**	**2,48,000**

Prepare the consolidated balance sheet of H Ltd. and S Ltd. as on 31st March, 2014.

Solution:

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd.

as at 31st March, 2014

		S Ltd. **Amount (₹)**	
I	**EQUITIES AND LIABILITIES**		
1	**Shareholders' funds**		
(a)	Share Capital		
	Authorised, Issued subscribed and paid up capital		
	Equity shares of ₹ 100 each, fully called up and paid up		6,00,000
(b)	Reserve and surplus		
	Surplus A/c		80,000

2	**Non-current liabilities**		
	Minority Interest		50,000
3	**Current Liabilities**		
	Trade Payables		
	H Limited	75,000	
	S Limited	48,000	1,23,000
	TOTAL		**8,53,000**
II.	**ASSETS**		
1	**Non-current Assets**		
(a)	Fixed Assets		
	H Limited	6,05,000	
	S Limited	2,48,000	8,53,000
	TOTAL		**8,53,000**

In this case, out of total 2,000 shares of S Ltd. 1,500 shares are held by H Ltd. Therefore, number of shares held by outsiders = (2,000 - 1,500) = 500 which is 1/4th of the total shares.

The net assets of S Ltd. = ₹ (2,48,000 - 48,000) = ₹2,00,000.

Therefore, the claim of the outside shareholders in the net assets of S Ltd. 1/4 x ₹2,00,000 = ₹ 50,000. This claim can also be ascertained by the paid-up value of the shares held by them i.e., 500 x ₹ 100 = ₹ 50,000.

This amount has been shown as a liability under the heading minority interest.

MINORITY INTEREST

The claim of outside shareholders in the subsidiary company has to be assessed and shown as a liability in the consolidate balance sheet. In the above Illustration, minority interest consists only the face value of the shares held by them. But it may so happen that the subsidiary company may have some accumulated profits and reserves or accumulated losses. Besides, it may have some profits or losses on account of revaluation of its assets on the date of acquisition of shares by the holding company. While calculating the amount of minority interest, all these items have to be taken into account and proportionate share of all such profits and reserves should be added to the amount of minority interest while proportionate share of all such losses should be deducted from the minority interest, thus, Minority Interest = paid-up value of shares held by minority shareholders + proportionate share of the company's profits and reserves + proportionate shares of profits on revaluation of assets of the company - proportionate share of company's losses – proportionate share of loss on revaluation of assets of the company.

The company's profit and reserves or loss will include both pre-acquisition and post-acquisition profits and reserves or losses.

But, if there are some preference shares of the subsidiary company held by outsiders, the minority interest in respect of the preference share will consist only of the face value of such shares and the dividend due on such shares if there are profits.

Illustration 3

The Balance Sheet of H Ltd. and S Ltd. on 31st March, 2014 are given below:

		H Ltd.	*S Ltd.*
I	**EQUITIES AND LIABILITIES**	**Amount** (₹)	**Amount** (₹)
1	**Shareholders' funds**		
(a)	Share Capital		
	Authorised, Issued subscribed and paid up capital		
	Equity shares of ₹ 100 each, fully called up and paid up	6,00,000	2,00,000
(b)	Reserve and surplus		
	General Reserve	60,000	25,000
	Surplus A/c	80,000	15,000
2	**Current Liabilities**		
	Trade Payables	75,000	48,000
	TOTAL	**8,15,000**	**2,88,000**
II	**ASSETS**		
1	**Non-current Assets**		
(a)	Fixed Assets		
	Fixed Assets	6,55,000	2,88,000
(b)	Long term Investment		
	1,600, Shares in S Ltd. (at cost)	1,60,000	-
	TOTAL	**8,15,000**	**2,88,000**

H Ltd. acquired shares in S Ltd. on 31st March, 2014. Prepare the Consolidated balance sheet of H Ltd. and S Ltd. as on that date.

Solution

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd.

as at 31st March, 2012

		S Ltd.	
I	**EQUITIES AND LIABILITIES**	**Amount** (₹)	
1	**Shareholders' funds**		
(a)	Share Capital		
	Authorised, Issued subscribed and paid up capital		
	Equity shares of ₹ 100 each, fully called up and paid up		6,00,000
(b)	Reserve and surplus		

	General reserve		60,000
	Capital Reserve:		
	4/5th of 25,000	20,000	
	4/5th of 15,000	12,000	32,000*
	Surplus Account		80,000
2	**Non-current liabilities**		
	Minority Interest		48,000
3	**Current Liabilities**		
	Trade Payables		
	H Limited	75,000	
	S Limited	48,000	1,23,000
	TOTAL		**9,43,000**
II	**ASSETS**		
1	**Non-current Assets**		
(a)	Fixed Assets		
	H Limited	6,55,000	
	S Limited	2,88,000	9,43,000
	TOTAL		**9,43,000**

* Profit in the subsidiary company as on the date of acquisition of control are capital profits.

Minority interest in this case has been ascertained in the following manner:

	₹
Paid-up value of 400 shares	40,000
Add : 1/5th shares of profit in S Ltd. 15,000 x 1/5	3,000
1/5 shares general reserve in S Ltd. 25,000 x 1/5	5,000
Minority Interest	48,000

PRE-ACQUISITION PROFITS AND RESERVES OF SUBSIDIARY COMPANY

Accumulated profits and reserves which appear in the balance sheet of the subsidiary company up to the date of acquisition of its shares by the holding company are called pre-acquisition profits and reserves. Both the holding company and the minority shareholders will have proportionate share in such profits and reserves. The share of the minority shareholders in such profit and reserves will be added to the amount of minority interest. But the holding company's proportionate share in such profits and reserve should be treated as capital profits and credited to Capital Reserve since the holding company cannot earn any revenue profits from its subsidiary before the shares are acquired in it. While preparing the consolidated balance sheet, this Capital Reserve should be shown on the liabilities side or if there is any Goodwill, it can be shown as a deduction from the Goodwill in the assets side.

PRE-ACQUISITION LOSSES OF SUBSIDIARY COMPANY

Accumulated losses of the subsidiary company upto the date of acquisition of shares by the holding company are called pre-acquisition losses. Both the holding company and the minority shareholders must share such losses in proportion to their respective holdings. The minority shareholders' share of such losses should be deducted from the amount of Minority Interest. But the holding company's share of such losses should be treated as capital loss and debited to Goodwill account. While preparing the Consolidated Balance Sheet, this Goodwill Account should be shown as an asset.

PROFIT ON REVALUATION OF ASSETS OF SUBSIDIARY COMPANY

If there is any profit resulting from the revaluation of assets of the subsidiary company whether before or after the date of acquisition of shares by the holding company, the same must be shared both by the holding company and the minority shareholders in proportion to their respective holdings. The minority shareholders' share of such profit should be added to the Minority interest. But the holding company's share should be treated as capital profits and dealt with like pre-requisitions profit and reserve.

Further, adjustment for depreciation on the increases or decreases in the value of assets would be made in the profit and loss account of the subsidiary. For appreciation in the value of assets, depreciation charge would be increased proportionately and the same would be deducted from the revenue profits of the subsidiary company. On the other hand, for revaluation loss due to decrease in the value of assets, excess depreciation provision should be written back.

LOSS ON REVALUATION OF ASSETS OF SUBSIDIARY COMPANY

If there is any loss resulting from the revaluation of the assets of the subsidiary company as on the date of acquisition of shares by the holding company the same must be shared both by the holding company and the minority shareholders in proportion to their respective holdings. The minority shareholders' share of such loss should be deducted from the amount of Minority interest. But, the holding company's share of such loss should be treated as capital loss and dealt with like pre-acquisition losses. But, if such loss occurs after the date of acquisition of shares by the holding company the same should be treated as ordinary loss.

GOODWILL OR COST CONTROL

In actual practice, it rarely happens that the cost of acquisition of shares in the subsidiary company agrees exactly with intrinsic value of the shares (i.e. the net assets of the subsidiary company) on the date of acquisition. If the price paid by the holding company for the shares acquired in the subsidiary company is more than the intrinsic value of the shares acquired, the difference should be treated as Cost of Control or Goodwill. If on the other hand, the price paid by the holding company for the shares acquired in the subsidiary company is less than the intrinsic value of the shares acquired, the difference should be treated as capital profits and credited to Capital Reserve. It should be noted that while computing the intrinsic value of the shares as on the date of acquisition of control, all profits and losses upto that date, have to be taken into account.

While preparing the consolidated balance sheet, such Goodwill or Capital Reserve, whatever may be the case, must be shown in the Balance Sheet.

Illustration 4

The Balance Sheets of H Ltd. and S Ltd. as on 31st March 2014 are given below:

		H Ltd. Amount (₹)	S Ltd. Amount (₹)
I	**EQUITIES AND LIABILITIES**		
1	**Shareholders' funds**		
(a)	Share Capital		
	Authorised, Issued subscribed and paid up capital		
	Equity shares of ₹ 100 each, fully called up and paid up	6,00,000	2,00,000
(b)	Reserve and surplus		
	General Reserve	60,000	40,000
	Surplus A/c	80,000	30,000
2	**Current Liabilities**		
	Trade Payables	75,000	48,000
	TOTAL	**8,15,000**	**3,18,000**
II	**ASSETS**		
1	**Non-current Assets**		
(a)	Fixed Assets		
	Tangible Fixed Assets	5,91,000	3,18,000
(b)	Long term Investment		
	1,600, Shares in S Ltd. (at cost)	2,24,000	-
	TOTAL	**8,15,000**	**3,18,000**

H Ltd. acquired the shares in S Ltd. on 31st March 2014. The plant worth book value of ₹ 60,000 included in sundry assets of S Ltd. was re-valued at ₹ 50,000 on this date.

Prepare the consolidated balance sheets of H Ltd. and S Ltd. as on that date.

Solution:

1. Pre-acquisition profits and reserves*

		₹
General Reserve as on 31.3.201		40,000
Surplus as on 31.3.2012		30,000
Total accumulated profits upto 31.3.2014		70,000
Holding Company's share	4/5 x 70,000	56,000
Minority Interest	1/5 x 70,000	14,000

2. Loss on revaluation of plant as on 31.3.2014*

Loss on revaluation of plant	₹ (60,000 - 50,000)	10,000
Holding Company's share	4/5 x 10,000	8,000
minority Interest	1/5 x 10,000	2,000

3. Minority Interest

Paid-up value of 400 shares	40,000
Add: 1/5th share of pre-acquisition profits and reserves	14,000
	54,000
Less: 1/5th shares of loss on revaluation of plant	2,000
Net amount due to minority shareholders	52,000

4. Goodwill or Cost of Control

Intrinsic value of shares held in S Ltd.:	
Paid-up value of 1,600 shares	1,60,000
Add: 4/5th share of pre-acquisition profits and reserves	56,000
	2,16,000
Less: 4/5th share of loss on revaluation of plant	8,000
Intrinsic value of 1,600 shares	2,08,000
Price paid for 1,600 shares	2,24,000
Cost of Control or Goodwill = ₹ (2,24,000 – 2,08,000)	16,000

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd.

as at 31st March 2014

		S Ltd. **Amount** (₹)
I	**EQUITIES AND LIABILITIES**	
1	**Shareholders' funds**	
(a)	Share Capital	
	Authorised, Issued subscribed and paid up capital	
	Equity shares of ₹ 100 each, fully called up and paid up	6,00,000
(b)	Reserve and surplus	
	General reserve	60,000
	Surplus A/c	80,000
2	**Non-current liabilities**	
	Minority Interest	52,000
3	**Current Liabilities**	
	Trade Payables	

	H Limited	75,000	
	S Limited	48,000	1,23,000
	TOTAL		**9,15,000**
II	**ASSETS**		
1	**Non-current Assets**		
(a)	**Fixed Assets**		
	H Limited	5,91,000	
	S Limited	3,08,000	8,99,000
	Goodwill		16,000
	TOTAL		**9,15,000**

POST-ACQUISITION PROFITS OR LOSSES

Profits earned or losses incurred by the subsidiary company after the date of acquisition of its shares by the holding company are called post-acquisition profits or losses. Both the holding company and the minority shareholders should share such profits or losses in proportion to their respective holdings. The minority shareholders' share in such profits should be added to the amount of minority interest while their share in such losses should be deducted. So far as the minority shareholders are concerned, there is no difference between the pre-acquisition profits or losses and the post-acquisition profits or losses. But, so far as the holding company is concerned, it makes a lot of difference. The holding company's share of such profits or losses should be treated as revenue profits or losses and as such credited or debited to its profit and loss account.

INTER-COMPANY UNREALISED PROFITS INCLUDED IN UNSOLD GOODS

If goods are sold by one company to the other (i.e., by the holding company to its subsidiary or *vice-versa*) at a profit and a part of it remains unsold at the end of the year, the unrealised profit and such goods remaining unsold must be provided for. But it is important to note here that the minority shareholders will not be affected in any way. Such unrealised profit has to be eliminated from the consolidated balance sheet in the following manner:

(i) The unrealised profits should be deducted from the current revenue profits of the company which sold the goods.

(ii) Again, the same should be deducted from the value of stock-in-trade of the company concerned.

INTER-COMPANY TRANSACTIONS

The holding company and the subsidiary company may have a number of inter-company transactions in any one or more of the following matters:

(i) Loans advanced by the holding company to the subsidiary company or vice versa. This appears as an asset in the balance sheet of the company which gives loan and as a liability in the balance sheet of the company which takes the loan.

If S Ltd. has taken a loan of ₹ 20,000 from H Ltd. then S Ltd.'s balance sheet shows a liability of ₹ 20,000, while H Ltd.'s balance sheet shows an asset of ₹ 20,000.

(ii) Bills of exchange given by one company and received by another company appears as bills payable in the balance sheet of the accepting company and as bills receivable in the balance sheet of the drawer company. If H Ltd. draws a bills of ₹ 10,000 on S Ltd. then H Ltd.'s books will show bills receivable ₹ 10,000 while. S Ltd.'s books will show bills payable ₹ 10,000.

(iii) Transactions relating to sale and purchase of goods on credit similarly appears as debtors in the balance sheet of the company selling goods and as creditors in the balance sheet of the company purchasing the goods.

(iv) Debentures issued by one company may be held by the other. If S Ltd. issues debentures of ₹ 50,000 which are held by H Ltd. then S Ltd.'s books will show a liability of ₹ 50,000 while H Ltd. books will show an asset of ₹50,000.

All the above inter-company transaction have to be eliminated while preparing the consolidated balance sheet. This can be done by deducting the inter company transactions from the respective items on both sides of the balance sheet.

CONTINGENT LIABILITIES

If the contingent liabilities relate to the outsiders they must be shown by way of a footnote in the consolidated balance sheet. But a contingent liability in respect of a transaction between holding and subsidiary companies (internal contingent liability) will disappear from the foot note as they appear as actual liability in the consolidated balance sheet.

Illustration 5

From the following balance sheets of H Ltd. and its subsidiary S Ltd. drown up at 31st March, 2014, prepare a consolidated balance sheet as at that date, having regard to the following:

(i) Reserves and Profit and Loss Account (Cr.) of S Ltd. stood at ₹ 25,000 and ₹ 15,000 respectively on the date of acquisition of its 80% shares by H Ltd.

(ii) Machinery (book-value ₹ 1,00,000) and Furniture (Book-value ₹ 20,000) of S Ltd. were revalued at ₹ 1,50,000 and ₹ 15,000 respectively for the purpose of fixing the price of its shares; book values of other assets remaining unchanged. These values are to be considered for consolidation purposes.

Balance Sheet of H Ltd. as on 31st March, 2014

		H Ltd. **Amount** (₹)		*S Ltd.* **Amount** (₹)	
I	**EQUITIES AND LIABILITIES**				
1	**Shareholders' funds**				
(a)	Share Capital				
	Authorised, Issued subscribed and paid up capital				
	Equity shares of ₹ 100 each, fully called up and paid up		5,00,000		1,00,000
(b)	Reserve and surplus				
	General Reserve	2,00,000		75,000	
	Profit and Loss A/c	1,00,000	3,00,000	25,000	1,00,000
2	**Current Liabilities**				
	Trade Payables		1,55,000		50,000
	TOTAL		**9,50,000**		**2,50,000**
II	**ASSETS**				

1	**Non-current Assets**				
(a)	Fixed Assets				
	Machinery	3,00,000		90,000	
	Furniture	50,000		17,000	
	Other Assets	4,40,000	7,90,000	1,43,000	2,50,000
(b)	Long term Investment				
	800, Shares at ₹ 200 each in S Ltd. (at cost)		1,60,000		-
	TOTAL		**9,50,000**		**2,50,000**

Solution:

Working Notes:

1. Pre-acquisition profits and reserves of S Ltd.

		₹
Reserve		25,000
Profit and Loss Account		15,000
		40,000
H Ltd.'s	= 4/5 x 40,000	32,000
Minority Interest	= 1/5 x 40,000	8,000

2. Profit on revaluation of assets of S Ltd.

Profit on Machinery	₹ (1,50,000 - 1,00,000)	50,000
Less: Loss on Furniture	₹ (20,000 - 15,000)	5,000
Net profit on revaluation		45,000
H Ltd.'s share	4/5 x 45,000	36,000
Minority Interest	1/5 x 45,000	9,000

3. Post-acquisition reserve of S Ltd.

Post-acquisition reserves	= ₹ (75,000 - 25,000)	50,000
H Ltd.'s share	4/5 x 50,000	40,000
Minority Interest	1/5 x 50,000	10,000

4. Post-acquisition profits of S Ltd.

Post-acquisition profits ₹ (25,000 - 15,000)	10,000
Add: Excess depreciation charged on furniture @ 15% on ₹ 5,000 i.e. (20,000 - 15,000)	750
	10,750
Less: Under-depreciation on machinery @ 10% on ₹ 50,000 i.e. (1,50,000 - 1,00,000)	5,000

Adjusted post-acquisition profits		5,750
H Ltd.'s share	4/5 x 5,750	4,600
Minority Interest	1/5 x 5,750	1,150

Note: Rate of depreciation has been ascertained as follows:

Machinery $= \frac{10,000\ *}{1,00,000} \times 100 = 10\%$

Furniture $= \frac{3,000\ *}{20,000} \times 100 = 15\%$

5. Minority Interest

Paid-up value of (1,000 - 800) 200 shares held by outsiders, i.e., 200 x ₹ 100	20,000
Add : 1/5th share of pre-acquisition profits and reserves	8,000
" 1/5th share of profit on revaluation	9,000
" 1/5th share of post-acquisition reserves	10,000
" 1/5th share of post-acquisition profit	1,150
	48,150

6. Cost of Control or Goodwill

Paid-up value of 800 shares held by H Ltd. i.e., 800 x ₹ 100	80,000
Add: 4/5th share of pre-acquisition profits and reserves	32,000
4/5th share of profit on revaluation	36,000
Intrinsic value of the shares on the date of acquisition	1,48,000
Price paid by H Ltd. for 800 shares	1,60,000
Less: Intrinsic value of the shares	1,48,000
Cost of Control or Goodwill	12,000

* *The difference between the book figure stated in point (ii) of the problem and the figures in the balance sheet of S Ltd.*

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd.

as at 31st March, 2014

		S Ltd. **Amount** (₹)	
I	**EQUITIES AND LIABILITIES**		
1	**Shareholders' funds**		
(a)	Share Capital		
	Authorised, Issued subscribed and paid up capital		
	Equity shares of ₹ 100 each, fully called up and paid up		5,00,000
(b)	Reserve and surplus		

	Reserve		2,00,000	
	Add: 4/5 shares in post acquisition reserve of 'S' Limited		40,000	2,40,000
	Surplus Account		1,00,000	
	Add: 4/5 shares in post acquisition profits of 'S' Limited		4,600	1,04,600
2	**Non-current liabilities**			
	Minority Interest			48,150
3	**Current Liabilities**			
	Trade Payables			
	H Limited		1,50,000	
	S Limited		50,000	2,00,000
	TOTAL			**10,92,750**
II	**ASSETS**			
1	**Non-current Assets**			
(a)	Fixed Assets			
	Machinery			
	H Limited		3,00,000	
	S Limited	1,00,000		
	Add: Appreciation	50,000		
	Total	1,50,000		
	Less: Depreciation	15,000	1,35,000	4,35,000
	Furniture			
	H Limited		50,000	
	S Limited	20,000		
	Less:: Decrease in Value	5,000		
		15,000		
	Less: Depreciation	2,250	12,750	62,750
	Goodwill		12,000	12,000
	Other Assets			
	H Limited		4,40,000	
	S Limited		1,43,000	5,83,000
	TOTAL			**10,92,750**

PREFERENCE SHARES IN SUBSIDIARY COMPANY

Preference share capital in subsidiary company should be shown alongwith minority interest in the consolidated balance sheet. However, if a part of the nominal value of non-participating preference share capital of the subsidiary is held by the holding company, it should be adjusted in cost of control against the cost of investment in preference shares. The balance of the preference share capital held by the outsiders should be included in minority interest.

BONUS SHARES

The issue of bonus shares by the subsidiary company will increase the number of shares held by the holding company as well as the minority shareholders. Issue of bonus shares may or may not affect the cost of control depending upon whether such shares are issued out of capital profits or revenue profits.

(a) *Issue of bonus shares out of capital profit (Pre-acquisition profits):* In this case there will be no effect on accounting treatment because while calculating the cost of control the share of the holding company in pre-acquisition profit is reduced because of capitalisation of profit and the paid-up value of shares held in subsidiary company is increased. Hence there is no effect on cost of control when bonus shares are issued from pre-acquisition profit.

(b) *Issue of bonus shares out of post acquisition profit:* In this case, a part of the revenue profits will get capitalised resulting in decrease of cost of control or increase in capital reserve.

TREATMENT OF DIVIDEND

Dividends may be received out of capital or revenue profits of the subsidiary company. Dividend received by the holding company from the capital profits of the subsidiary company are credited to investment in shares of the subsidiary account thereby reducing the cost of control or increasing capital reserve.

On the other hand, dividend received out of the revenue profits (i.e., post-acquisition profits) are treated as income and credited to profit & loss Account by the holding company. If dividend declared partly out of capital profits (i.e., pre-acquisition profits) and partly out of revenue profits (i.e., post- acquisition profits), the dividend received is divided into two parts in proportion to its declaration out of capital profits and revenue profits. The dividend pertaining to the first part (i.e., capital profits) is credited to Investment Account reducing the cost of control or increasing the capital reserve and dividend pertaining to the second part (i.e., revenue profits) is credited to profit and loss Account or surplus account.

It may be noted that in the absence of information whether dividend has been declared out of pre-acquisition or post-acquisition profits, it is assumed that dividend is out of profits for the year for which the dividend is declared.

If the dividend has simply been proposed by the subsidiary company and appears as ‘Proposed Dividend’ in its Balance sheet, holding companies share of such dividend will appear with the Surplus or Profit & loss Account balance in the consolidated Balance sheet and share of such dividend belonging to minority shareholders will be added to minority interest. Proposed dividend need not be shown in the consolidated Balance sheet because it has been added to the minority interest and profit & loss Account balance of the holding company.

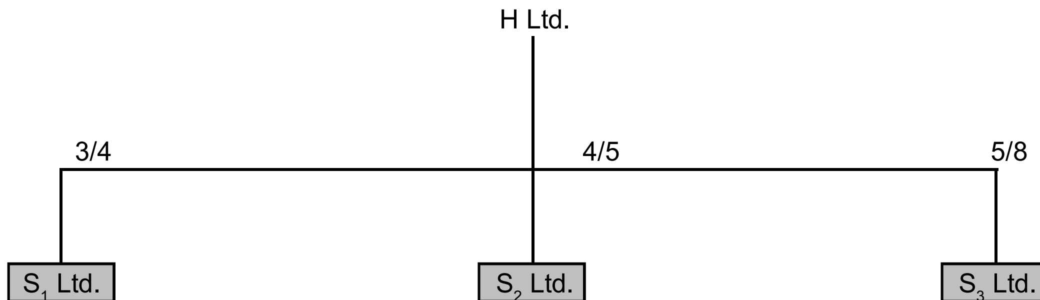
If *proposed dividend* is not given in the *Balance sheet* of the subsidiary company or directors of this company have not appropriated the profits for proposed dividend, then the following procedure is followed:

(i) Calculate the cost of control and minority interest etc. in the usual manner without any adjustment for the proposed dividend.

(ii) Deduct from minority interest its share of proposed dividend and show the same as a separate item in the consolidated Balance sheet.

HOLDING COMPANY CONSISTING OF MORE THAN ONE SUBSIDIARY

A holding company may have a number of subsidiaries without any mutual holding in between the subsidiaries. The following chart will clearly show the position:



In this case, holding company H Ltd. acquires shares of 3/4th, 4/5th and 5/8th of S_1 Ltd., S_2 Ltd. and S_3 Ltd. respectively and as such the investment account of holding company will show investment in S_1 Ltd., S_2 Ltd. and S_3 Ltd. instead of one in the usual case. The calculation of cost of control, minority interest, elimination mutual indebtedness, unrealised profits on closing stock etc. of each company should be done following the usual principles.

Illustration 6

(More than one subsidiary company)

Sun Ltd. owns 80% of issued capital of Moon Ltd. and 90% of issued capital of Star Ltd. The following are the balances of all the companies as on 31.3.2014.

		Sun Ltd (₹)	*Moon Ltd* (₹)	*Star Ltd* (₹)
I	**EQUITIES AND LIABILITIES**			
1	**Shareholders' funds**			
(a)	Share Capital			
	Authorised, Issued subscribed and paid up capital			
	Equity shares of ₹ 100 each, fully called up and paid up	3,20,000	20,000	25,000
(b)	Reserve and surplus			
	General Reserve	68,000	6,000	12,500
2	**Non-current liabilities**			
	Current Account	–	22,000	18,000
3	**Current Liabilities**			
	Current liabilities	40,000	6,000	10,000
	Proposed Dividend	20,000	–	2,500
	TOTAL	**4,48,000**	**54,000**	**68,000**

II	**ASSETS**			
1	**Non-current Assets**			
(a)	Fixed Assets			
	Fixed Assets	1,70,000	10,000	27,000
	Less: Provision for Depreciation	70,000	6,000	9,000
		1,00,000	4,000	18,000
(b)	Long term Investment			
	Shares in Moon Ltd. (at cost)	15,000	–	–
	Shares in Star Limited	25,000	–	–
2	**Current Assets**			
	Current Assets	2,68,000	50,000	50,000
	Current Account			
	Moon Limited	20,000	–	–
	Star Limited	20,000	–	–
	TOTAL	**4,48,000**	**54,000**	**68,000**

Additional information:

1. At the time of acquiring the shares the subsidiaries had the following Revenue Reserves:

Moon Ltd.	₹6,000
Star Ltd.	₹3,000

2. Neither of the subsidiaries has paid any dividend since acquisition of shares.

3. Payment of creditors of Moon Ltd. by Sun Ltd. to the extent of ₹ 2,000 has not been considered in the books of Moon Ltd.

4. A remittance of ₹2,000 by Star Ltd. to Sun Ltd. has not yet been adjusted in the books of Sun Ltd.

5. The Stock of Moon Ltd. includes ₹ 3,000 purchased from Sun Ltd. which made 25% profit on cost. Sun Ltd.'s stock includes ₹ 5,000 purchased from Star Ltd.'s which made 20% profit on sales.

Prepare the consolidated Balance Sheet of Sun Ltd. and its subsidiaries — Moon Ltd. and Star Ltd.

Solution:

Working Notes:

A. Sun Ltd. holding in Moon Ltd.

1. Sun Ltd.'s shares in Moon Ltd. 80/100 = 4/5th

   and Minority Interest in Moon Ltd. 20/100 = 1/5

2. Pre-acquisition Revenue Reserve in Moon Ltd. (Capital Profits)

		₹
Revenue Reserve upto the date of acquisition		6,000
Sun Ltd.'s share	4/5 x ₹6,000	4,800

Minority interest	1/5 x ₹6,000	1,200

3. Post-acquisition Revenue Reserves in Moon Ltd. (Revenue Profits)
   Revenue Reserve since the date of acquisition = ₹ (6,000 – 6,000) Nil

4. Minority Interest in Moon Ltd.

Paid-up value of shares held by outsiders = 20/100 x 20,000	4,000
Add: 1/5 share of Pre-acquisition Revenue Reserve	1,200
Minority Interest	5,200

5. Cost of Control in Moon Ltd.

Intrinsic value of the shares held in Moon Ltd.	
Paid-up value of the shares held 80/200 x 20,000	16,000
Add: 4/5th share of pre-acquisition Reserve in Moon Ltd.	4,800
Intrinsic value of shares held	20,800
Less: Price paid for the shares held	15,000
Capital Reserve	5,800

6. Unrealised Profit included in Stock of Moon Ltd.

   Cost for Moon Ltd. is the selling price of Sun Ltd.

   Let the cost price to Sun Ltd. be ₹100

   Profit ₹25

   Selling price ₹ (100 + 25) = ₹125

Profit on selling price	25/125 = 1/5th
Unrealised profit	1/5 x ₹3,000 = ₹600

B. Sun Ltd. holding in Star Ltd.

1. Sun Ltd.'s shares in Star Ltd. 90/100 = 9/10th
   and Minority Interest in Star Ltd. 10/100 = 1/10th

2. Pre-acquisition Revenue Reserve in Star Ltd. (Capital Profits)

		₹
Revenue Reserve upto the date of acquisition		3,000
Sun Ltd.'s share	9/10 x ₹3,000	2,700
Minority interest	1/10 x ₹3,000	300
		3,000

3. Post-acquisition Revenue Reserves in Star Ltd. (Revenue Profits)

	₹
Revenue Reserve as per Balance Sheet	12,500
Add: Proposed Dividend	2,500

		15,000
Less: Revenue Reserve as on the date of acquisition		3,000
Post-acquisition Revenue Reserve		12,000
Sun Ltd.'s shares	= 9/10 x ₹12,000	10,800
Minority Interest	= 1/10 x ₹12,000	1,200
		12,000

4. Minority Interest in Star Ltd.

Paid-up value of shares held by outsiders = 25,000 x 1/10	2,500
Add: 1/10th share of Pre-acquisition Revenue Reserve	300
Add: 1/10th share of Post-acquisition Revenue Reserve	1,200
	4,000

5. Cost of Control in Star Ltd.

Intrinsic value of the shares held in Star Ltd.

Paid-up value of the shares held - 9/10 x ₹ 25,000	22,500
Add: 9/10th share of Pre-acquisition Revenue Reserve in Star Ltd.	2,700
Intrinsic value of shares held	25,200
Less: Price paid for the shares held	25,000
Capital Reserve	200

C. Sun Ltd.

1. Unrealised Profit included in Stock of Sun Ltd.

Sun Ltd. Cost Price is the selling price of Star Ltd.

Unrealised profit = $₹5{,}000 \times \frac{20}{100} = ₹1{,}000$

2. Revenue Reserves of Sun Ltd.

Revenue Reserve as per Balance Sheet	68,000	
Add: 9/10 share of Post-acquisition Revenue Reserve in Star Ltd.	10,800	
		78,800
Less: Unrealised Profit included in Stock ₹ (600 + 1,000)		1,600
Adjusted Balance		77,200

Consolidated Balance Sheet of Sun Ltd. and its Subsidiaries Moon Ltd. and Star Ltd. as at 31st March, 2014

				Amount (₹)
I	**EQUITIES AND LIABILITIES**			
1	**Shareholders' funds**			
(a)	Share Capital			
	Authorised, Issued subscribed and paid up capital			
	Equity shares of ₹— each, fully called up and paid up			3,20,000
(b)	Reserve and surplus			
	Capital Reserve on consolidation			
	Moon Ltd.		5,800	
	Star Ltd.		200	6,000
	Revenue Reserve			77,200
2	**Non-current liabilities**			
	Minority Interest			
	Moon Limited		5,200	
	Star Limited		4,000	9,200
3	**Current Liabilities**			
	Sun Limited		40,000	
	Moon Limited	6000		
	Less payment by Sun limited	2000	4000	
	Star Limited		10,000	54,000
	Suspense Account*			4,000
	Proposed dividend			20,000
	TOTAL			**4,90,400**
II	**ASSETS**			
1	**Non-current Assets**			
(a)	Fixed Assets			
	Fixed Assets			
	Sun Limited		1,70,000	
	Moon Limited		10,000	
	Star Limited		27,000	
			2,07,000	
	Less: Provision for depreciation		85,000	1,22,000

2	**Current Assets**		
	Sun Limited	2,68,000	
	Moon Limited	50,000	
	Star Limited	50,000	
		3,68,000	
	Less: Profit included in stock	1,600	
		3,66,400	
	Add: Cash in transit	2,000	3,68,400
	TOTAL		**4,90,400**

* *Unexpected credit by Sun Ltd. to Moon Ltd.*

Note: Difference in Current Account has been treated as cash-in-transit.

PREPARATION OF CONSOLIDATED PROFIT AND LOSS STATEMENT

While preparing the Consolidated Profit and Loss Statement of the holding company and its subsidiary, the items appearing in the Profit and Loss Statement of the holding and subsidiary companies have to be aggregated. But in doing so, the following adjustments have to be made:

(i) Transfer of goods between the holding company and the subsidiary company should be eliminated both from the purchases and sales appearing in the Consolidated Profit and Loss Statement.

(ii) Stock Reserve for unrealised profit in respect of inter-company transactions should be created by debiting Consolidated Profit and Loss Statement and crediting Stock Reserve Account.

(iii) The share of profits of the subsidiary company arising before the date of acquisition of shares by the holding company that belongs to the holding company will be debited to the Consolidated Profit and Loss Statement and credited to Capital Reserve or Goodwill Account as the case may be. In case of loss the entry will be just reversed.

(iv) The share of profits or losses belonging to the minority shareholders will be respectively credited or debited to Minority Interest Account.

(v) Dividends received from the subsidiary company by the holding company should be eliminated from both the sides of the Consolidated Profit and Loss Statement.

(vi) Care should be taken to see that both the companies pass entries for interest accrued and outstanding on debentures of the subsidiary company held by the holding company. The debenture interest should be eliminated from both the sides of the Consolidated Profit and Loss Statement to the extent to which it relates to the debentures held by the holding company.

(vii) If the subsidiary company has passed entries for proposed dividend and the holding company has taken credit for its shares of the dividends, the holding company's share should be eliminated from both the sides of the Consolidated Profit and Loss Statement. The necessary changes should also be made on both the sides of the Consolidated Balance Sheet. However, if the holding company has not passed entries for proposed dividends of the subsidiary company, the debit in respect of the proposed dividend should be reduced by the holding company's share in such proposed dividend and obviously, the liability in respect of proposed dividend in the Consolidated Balance Sheet should also be reduced.

(viii) If there are profits and the dividends on cumulative preference shares are in arrears, the arrears of

dividends on preference shares held by the Minority shareholders should be debited to the Consolidated Profit and Loss Statement and credited to Minority Interest Account.

(ix) If fixed assets of the subsidiary company are revalued at the time of acquisition of shares by the holding company without any alteration in book-values, the excess or short depreciation should be adjusted by debiting or crediting the Consolidated Profit and Loss Statement and crediting or debiting the respective Asset Account.

(x) The minority interest will consist of its proportion of total profits after adjustment of excess or short depreciation due to over or under valuation of fixed assets, but before adjusting the proportionate unrealised profit on stock.

It is important to note here that the consolidated Profit and Loss Statement has got no concern with the Consolidated Balance Sheet. It is prepared in addition to the Consolidated Balance Sheet to serve the purpose of showing the total profits earned by the group of companies for a particular period.

Illustration 7

The Trial Balances of H Ltd. and S Ltd. as on 31st December 2013 were as under:

	H Ltd.		***S Ltd.***	
	Dr. ₹	*Cr.* ₹	*Dr.* ₹	*Cr.* ₹
Equity Share Capital				
(Share of ₹ 100 each)		10,00,000		2,00,000
7% Preference Share Capital				
(Share of ₹ 100 each)		—		2,00,000
Reserves		3,00,000		1,00,000
6% Debentures		2,00,000		2,00,000
Trade Receivables/Payables	80,000	90,000	50,000	60,000
P&L A/c balance		20,000		15,000
Purchases/Sales	5,00,000	9,00,000	6,00,000	9,50,000
Wages & Salaries	1,00,000		1,50,000	
Debenture Interest	12,000		12,000	
General Expenses	80,000		60,000	
Preference-Dividend up to 30.6.2013		3,500	7,000	
Stock (31.12.2013)	1,00,000		50,000	
Cash at Bank	13,500		6,000	
Investment in S Ltd.	5,28,000		—	
Fixed Assets	11,00,000		7,90,000	
Total	**25,13,500**	**25,13,500**	**17,25,000**	**17,25,000**

Investment in S Ltd. were acquired on 1.4.2013 and consisted of 80% of Equity Capital and 50% of Preference Capital. Depreciation on fixed assets is written off @ 10% p.a. After acquiring control over S Ltd., H Ltd. supplied to it goods at cost plus 20%, the total invoice value of such goods being ₹ 60,000; 1/4 of such goods was still in stock at the end of the year.

Prepare the Consolidated Profit and Loss Statement for the year ended on 31st December, 2013.

Solution

Consolidated Profit and Loss Statement of H Ltd. and S Ltd.
for the year ended 31st December, 2013

	Particulars	*Note No.*	₹
I.	Revenue from operations	1	17,90,000
II.	Total revenue		17,90,000
III.	Expenses		
	Cost of Material purchased/Consumed	2	10,40,000
	Changes of Inventories of finished goods		
	Employee benefit expense (1,00,000 + 1,50,000)		2,50,000
	Finance cost (12,000 + 12,000)		24,000
	Depreciation and amortization expense[1,10,000+79,000]		1,89,000
	Other expenses [80,000 + 60,000]		1,40,000
	Total expenses		16,43,000
IV.	Profit before Tax (II-III)		1,47,000
	Profit transferred to Consolidated Balance Sheet		
	Profit After Tax		1,47,000
	Preference dividend	3,500	
	Preference dividend payable	3,500	(7,000)
			1,40,000
	Less: Minority interest (WN 3)		(7,000)
	Capital reserve"		(7,000)
	Investment Account- dividend for 3 months (prior to acquisition)		(1,750)
	Stock reserve $\frac{60{,}000 \times 20}{4 \times 120}$		(2,500)
	Profit to be transferred to consolidated balance sheet		1,21,750

Notes to Accounts

	₹	₹
1 Revenue from Operations		
H Ltd.	9,00,000	
S Ltd.	9,50,000	
Total	18,50,000	
Less : Intragroup sales (H sold to S)	(60,000)	17,90,000
"*Capital Reserve is made up of 3 month's profit upto 1.4.2013 i.e. ¼ x 35,000 x 80/100.*		
2 Cost of Materials Purchased/Consumed		
H Ltd.	5,00,000	
S Ltd.	6,00,000	
Total	11,00,000	
Less : Intragroup sales (H sold to S)	(60,000)	10,40,000
Working Note		
Profit of Subsidiary		
Revenue From Operations		9,50,000
Less : Expenses		
Cost of Material purchased/Consumed	6,00,000	
Changes of Inventories of finished goods		
Employee benefit expense	1,50,000	
Finance cost	12,000	
Depreciation and amortization expense	79,000	
Other expenses	60,000	9,01,000
Profit Before Tax		49,000
Preference Dividend		7,000
Preference Dividend Payable		7,000
Profit available for shareholders		35,000
Minority Share (20 %)		7,000

LESSON ROUND-UP

- A holding company is one which acquires all or a majority of the equity shares of any other company called subsidiary company in order to have control over the subsidiary company.
- Consolidation of balance sheet and profit and loss account implies preparation of a single balance sheet and profit and loss account of the holding company and its subsidiaries by aggregating all items

of assets, liabilities, incomes, expenses, etc., of the holding company and its subsidiaries.

- Investment in shares of subsidiary company represents the ownership of the holding company in the equity or net assets of the subsidiary company.
- Minority interest is *equal to* the paid-up value of shares held by minority shareholders *plus* proportionate share of the company's profits and reserves *plus* proportionate shares of profits on revaluation of assets of the company *minus* proportionate share of company's losses *minus* proportionate share of loss on revaluation of assets of the company.
- Accumulated profits and reserves which appear in the balance sheet of the subsidiary company up to the date of acquisition of its shares by the holding company are called pre-acquisition profits and reserves.
- Accumulated losses of the subsidiary company upto the date of acquisition of shares by the holding company are called pre-acquisition losses.
- If the price paid by the holding company for the shares acquired in the subsidiary company is more than the intrinsic value of the shares acquired, the difference is treated as cost of control or goodwill.
- If the price paid by the holding company for the shares acquired in the subsidiary company is less than the intrinsic value of the shares acquired, the difference is treated as capital profits and credited to capital reserve.
- Profits earned or losses incurred by the subsidiary company after the date of acquisition of its shares by the holding company are called post-acquisition profits or losses.
- When goods are sold by one company to the other at a profit and a part of it remains unsold at the end of the year, there arise the unrealised profit on such goods remaining unsold.
- The holding company and the subsidiary company may have a number of inter-company transactions which may be eliminated while preparing the consolidated balance sheet.
- Contingent liabilities relate to the outsiders must be shown by way of a footnote in the consolidated balance sheet. But a contingent liability in respect of a transaction between holding and subsidiary companies will disappear from the foot note.
- Issue of bonus shares by the subsidiary company will increase the number of shares held by the holding company as well as the minority shareholders. Issue of bonus shares may or may not affect the cost of control depending upon whether such shares are issued out of capital profits or revenue profits.

SELF-TEST QUESTIONS

(These are meant for re-capitulation only. Answers to these questions are not to be submitted for evaluation)

(1) The Balance Sheets of Rose Ltd. and its subsidiary Lotus Ltd. as on 31st March, 2014 are as under:

Particulars	***Rose Ltd. Amount (₹)***	***Lotus Ltd. Amount (₹)***
EQUITIES AND LIABILITIES		
Shareholder's Funds		
Share capital		
Equity shares of ₹ 10 each	48,00,000	20,00,000

10% Preference shares of ₹ 10 each		7,00,000	3,80,000
Reserves and Surplus			
General Reserve		5,50,000	4,20,000
Profit & Loss A/c		10,00,000	6,00,000
Non Current Liabilities			
Current Liabilities			
Bank Overdraft		1,20,000	70,000
Trade Payables		4,30,000	4,80,000
Bills payables		NIL	1,60,000
	Total	76,00,000	41,10,000
Assets			
Non Current Assets			
Plant and machinery		12,00,000	5,00,000
Motor vehicles		9,50,000	7,50,000
Furniture and Fittings		6,50,000	4,00,00
Goodwill		4,50,000	03,00,000
Investments		26,00,000	4,50,000
Current Assets			
Stock		4,50,000	7,20,000
Cash at bank		2,25,000	2,10,000
Trade Receivables		9,30,000	7,80,000
Bills receivable		1,45,000	NIL
Total		76,00,000	41,10,000

Details of acquisition of shares by Rose Ltd. are as under:

Nature of shares	*No. of shares acquired*	*Date of acquisition*	*Cost of acquisition*
Preference shares	14,250	1.4.2011	₹ 3,10,000
Equity shares	80,000	1.4.2012	₹ 9,50,000
Equity shares	70,000	1.4.2013	₹ 8,00,000

Other information:

(i) On 1.4.2013 profit and loss account and general reserve of Lotus Ltd. had credit balances of ₹ 3,00,000 and ₹ 2,00,000 respectively.

(ii) Dividend @ 10% was paid by Lotus Ltd. for the year 2012-2013 out of its profit and loss account balance as on 1.4.2013. Rose Ltd. credited its share of dividend to its profit and loss account.

(iii) Lotus Ltd. allotted bonus shares out of general reserve at the rate of 1 share for every 10 shares held. Accounting thereof has not yet been made.

(iv) Bills receivable of Rose Ltd. were drawn upon Lotus Ltd.

(v) During the year 2013-2014 Rose Ltd. purchased goods from Lotus Ltd. for ₹ 1,00,000 at a sale price of ₹ 1,20,000. 40% of these goods remained unsold at close of the year.

(vi) On 1.4.2013 motor vehicles of Lotus Ltd. were overvalued by ₹ 1,00,000. Applicable depreciation rate is 20%.

(vii) Dividends recommended for the year 2013-2014 in the holding and the subsidiary companies are 15% and 10% respectively.

Prepare consolidated Balance Sheet as on 31st March, 2014.

(2) On December 31, 2013 the Balance Sheets of Exe Ltd. And Wye Ltd. were as follows :

Particulars	***Exe Ltd. Amount (₹)***	***Wye Ltd. Amount (₹)***
EQUITIES AND LIABILITIES		
Shareholder's Funds		
Share capital (shares of ₹100 each)	15,00,000	5,00,000
Reserves and Surplus		
General Reserve	9,50,000	1,50,000
Profit & Loss A/c	80,000	1,05,000
Non Current Liabilities		
Current Liabilities		
Trade Payables	4,38,000	3,83,000
Provision for taxation	3,53,000	2,11,000
Total	33,21,000	13,49,000
Assets		
Non Current Assets		
Land & Buildings	5,34,000	1,35,000
Plant & Machinery	11,15,000	4,28,000
Current Assets		
Stock	6,42,000	3,92,000
Cash at bank	2,18,000	1,18,000
Trade Receivables	7,80,000	2,70,000
Prepaid Expenses	32,000	6,000
Total	33,21,000	13,49,000

Both companies have arrangements with their bankers for overdraft facilities to meet contingencies. On July 1, 2013 Exe. Ltd. Acquired 80% of the shares in Wye Ltd. To pay for them, it allotted by way of consideration, 7½% fully paid Redeemable Preference Shares (newly created) of the value of ₹6,00,000 in the capital of the company. The shares are redeemable after 10 years.

Trading results for 2013 showed that Exe Ltd. has earned a profit of ₹ 3,00,000 after writing off 10% depreciation on Plant and Machinery and after providing for taxation. It paid a dividend of 12% on the equity shares. After writing off 10% depreciation on its Plant and Machinery, the Profit and Loss Account of Wye Ltd. showed loss of ₹1,20,000. Exe Ltd., decided to make a provision in its books against its share of the loss of Wye Ltd.

There was no addition to or retirement of fixed assets in 2013. The current assets and liabilities (other than bank balance or overdraft) stood as follows on December 31, 2013:

	Exe. Ltd.	***Wye Ltd.***
	₹	₹
Stock	6,10,000	4,08,000
Book Debts	7,50,000	2,60,000
Prepared Expenses	22,000	6,000
Cash paid by Wye Ltd.	1,10,000	——
Cash received by Exe Ltd.,	——	90,000
Sundry Creditors	4,50,000	2,50,000
Provision for Taxation	2,90,000	2,50,000

Prepare the Consolidated Balance Sheet of the two companies as at December 31, 2013.

(3) From the following balance sheets of Vipul Ltd. and its subsidiary Vedika Ltd. as on 31st March, 2013 and the additional information provided thereafter, prepare the consolidated balance sheet of the two companies as on that date:

EQUITIES AND LIABILITIES	***Vipul Ltd. Amount (₹)***		***Vedika Ltd. Amount (₹)***	
Shareholders' funds				
Share Capital				
Authorised, Issued subscribed and paid up capital				
Equity shares of ₹ 10 each, fully called up and paid up		10,00,000		2,00,000
Reserve and surplus				
General reserve	3,10,000	-		
Profit and Loss A/c	1,50,000	4,60,000	40,000	40,000
Current Liabilities				
Sundry Creditors	2,30,000	**2,30,000**	69,000	69,000
TOTAL		**16,90,000**		**3,09,000**
ASSETS				
Non-current Assets				
Fixed Assets				
Fixed Assets		11,62,000		1,80,000

Long term Investment				-
Shares in Vedika Ltd. (at cost)		1,42,000		-
Current Assets				
Current Assets		3,86,000		1,24,000
Discount on issue of shares	-			5,000
TOTAL		16,90,000		3,09,000

On 31st December, 2012 Vipul Ltd. acquired the shares in Vedika Ltd. On 1st April, 2012, Vedika Ltd.'s profit and loss account showed a debit balance of 8,000. On 31st March, 2013, Vedika Ltd. decided to revalue its fixed assets at 2,00,000.

Lesson 6

Valuation of Shares and Intangible Assets

LESSON OUTLINE

- Valuation of Shares
- Methods of Valuation of Shares
  - Net Asset Basis or Intrinsic Value Method
  - Yield Basis
  - Valuation based on Rate of Return
  - Valuation basis an Productivity
- Special factors for Valuation Factor of Shares
- Valuation of Intangibles assets
- Valuation of Goodwill
- Lesson Round UP
- Self Test Questions

LEARNING OBJECTIVES

Valuation is a very interesting topic. Valuation becomes very important in choosing investments for a portfolio, in deciding on the appropriate price to pay or receive in a takeover and in making investment, financing and dividend choices when running a business. The premise of valuation is that we can make reasonable estimates of value for most assets, and that the same fundamental principles determine the values of all types of assets, real as well as financial. Some assets are easier to value than others, the details of valuation vary from asset to asset, and the uncertainty associated with value estimates is different for different assets, but the core principles remain the same. The objective of this lesson is to get students aware about different aspects related to valuation of shares, goodwill, trademarks and other intangibles.

After the end of this lesson, you will able to :

- Understand the different methods of valuation of shares.
- Familiarize with the concept of fair value of shares.
- Understand the procedure of valuation of preference shares.
- Understand the meaning of intangible assets.
- Evaluate the identifiability of intangible assets.
- Explain the recognition of intangible assets.
- Appreciate the acquisition of intangible assets by way of government grants.
- Understand the treatment of internally generated goodwill.
- Conceptualize the recognition of an expense on intangible assets.
- Explain the amortization of intangible assets
- Explain the retirement and disposals of intangible assets

“Valuation of shares & intangibles has a very important role particularly at the time of merger, amalgamation, sale transfer of entities/assets.”

I. VALUATION OF SHARES

Need for Valuation of Shares

The necessity for valuation of shares arises *inter alia* in the following circumstances:

(i) Assessments under the Wealth Tax Act.

(ii) Purchase of a block of shares which may or may not give the holder thereof a controlling interest in the company.

(iii) Purchase of shares by employees of the company where the retention of such shares is limited to the period of their employment.

(iv) Formulation of schemes of amalgamation, absorption, etc.

(v) Acquisition of interest of dissenting shareholders under a scheme of reconstruction.

(vi) Compensating shareholders on the acquisition of their shares by the Government under a scheme of rationalisation.

(vii) Conversion of shares, say, conversion of preference shares into equity.

(viii) Advancing a loan on the security of shares.

(ix) Resolving a deadlock in the management of a private limited company on the basis of the controlling block of shares being given to either of the parties.

Normally, the price prevailing on the stock exchange is accepted. However, valuation by expert is called for when parties involved in the transaction/deal/scheme, etc., fail to arrive at a mutually acceptable value or the agreements or articles of association, etc.. For isolated transactions of relatively small blocks of shares which are quoted on the stock exchanges, generally the ruling stock exchange price provides the basis of valuation. Thus, valuation by a valuer becomes necessary when:

(i) Shares are unquoted.

(ii) Shares relate to private limited companies.

(iii) The Court directs for valuation by an expert.

(iv) Articles of Association or relevant agreements so provide.

(v) Large block of shares is under transfer.

(vi) The law/applicable statue so requires.

Methods of Valuation of Shares

Principally two basic methods are used for share valuation: one on the basis of net assets and the other on the basis of earning capacity or yield.

Net Assets Basis or Intrinsic Value Method

The method relating to net asset basis may take various forms depending upon circumstances:

(i) Break-up value method (or liquidation value method);

(ii) Appraised value method; and

(iii) Book-value method.

Depending on the circumstances of the case, goodwill may or may not be included. Goodwill comes in for distinct consideration only when the number of shares involved is large giving to the holder a measure of control. Normally, earning represents the result of application of all assets of every description in the business, whether it is plant and machinery or goodwill or patent or know-how; for a small number of shares in a going concern, earning is the only appropriate basis.

Valuation of shares on the basis of assets is generally not recommended for a going concern, because, there, the predominant factor is yield; but for certain types of companies, for example, investment companies, assets basis valuation may be acceptable since yield itself will depend almost wholly on the assets position. In case of a company in respect of which no realistic yield or earning capacity is discernible, because of highly uneven past results, valuation only on assets basis may be acceptable.

For a company which shows consistent loss over a number of immediate past years and which has no apparent prospect of recovery, the appropriate method would be the break-up value method. According to Sidney, an authority in share valuation, the realisable value of assets, for arriving at the break-up value, should be discounted at rates varying from 20% to $33^1/_3$% for taking care of realisation losses and expenses. Book value method does not have any practical application except to disclose the unexpired costs of asset of a going concern which were acquired in the course of the company's operations. But statutes like the Gift Tax Act, Wealth Tax Act, etc., have in fact adopted book value method for valuation of unquoted equity shares for companies other than an investment company. Book value of assets does help the valuer in determining the useful employment of such assets and their state of efficiency. In turn, this leads the valuer to the determination of rehabilitation requirements with reference to current replacement values.

In all cases of valuation on assets basis, except book value basis, it is important to arrive at current replacement and realisation value. It is more so in case of assets like patents, trade marks, know-how, etc., which may possess values substantially more or less than those shown in the books.

The mechanism of asset valuation is simple:

(i) Arrive at the current replacement costs of assets for valuation based on appraisal or, in the case of a firm which is not a going concern, determine the net realisable value for break-up valuation and deduct therefrom all liabilities in the books of account and such other liabilities which have not been recorded but are likely to rank for payment, and the amount payable to preference shareholders. The approach should be conservative. Under provision for taxation, liabilities on account of gratuities, arrears of preference dividends, etc., are instances, of what may not appear in books.

(ii) If circumstances suggest existence of goodwill from a study of the profit record, particular advantages, etc., the same should be evaluated with reference to any method appropriate for the purpose for addition to the result obtained in (i) above.

(iii) The result, as arrived at, shall represent the asset value for the whole undertaking; to arrive at value per share, the same should be divided by the number of equity shares in the company provided all shares are equally paid-up. If the company has equity shares of varying fully paid-up values, the total value should first be allocated to the different paid-up value groups and each such allocation would be divided by the number of shares in each of such groups.

Yield Basis

Yield basis valuation may take the form of valuation based on rate of return and productivity factor.

Valuation Based on Rate of Return

Rate of return refers to the returns which a shareholder earns on his investment. It may be classified into (a) Rate of dividend and (b) Rate of earning.

Valuation based on rate of dividend

This method of valuation is suitable for small blocks of shares because small shareholders are usually interested

in dividends. The value of a share according to this method is ascertained as follows:

$$\text{Value of share} = \frac{\text{Possible rate of dividend}}{\text{Normal rate of dividend}} \times \text{Paid up value per share}$$

OR

$$= \frac{\text{Dividend (in rupees) per share} \times 100}{\text{Normal rate of dividend}}$$

$$\text{Possible rate of dividend} = \frac{\text{Total profit available for dividend} \times 100}{\text{Total paid up equity capital}}$$

In other words, dividend on equity shares should be calculated by deducting from the maintainable profits:

(i) taxation;

(ii) transfers to reserve;

(iii) transfers to debenture redemption fund;

(iv) preference dividend, and

by dividing the remaining by the number of shares.

Valuation based on rate of earning: This method of valuation of shares is suitable for valuing large block of company's shares because they are more interested in company's earnings rather than what the company distributes in the form of dividends. The value of a share on this basis can be calculated as follows:

$$\text{Value of share} = \frac{\text{Rate of earning} \times \text{Paid-up value per share}}{\text{Normal rate of earning}}$$

$$\text{Rate of earning} = \frac{\text{Actual profit earned} \times 100}{\text{Capital employed}}$$

Rate of earning is calculated by taking into account the total capital employed including long-term borrowings. Since the total capital is taken into account, the profit figure should be before debenture interest, preference dividend but after income tax. This is quite appropriate when the dividend is much more than the rate of earning on capital.

Valuation based on price earning ratio: This method is suitable for ascertaining the market value of shares which are quoted on a recognised stock exchange. According to this method, the shares are valued on the basis of earning per share multiplied by price earning ratio. Thus,

$$\text{Market value of share} = \text{Price earning ratio} \times \text{Earning per share}$$

$$\text{Earning per share} = \frac{\text{Profit available for equity shareholders}}{\text{Number of equity shares}}$$

$$\text{Price earning ratio} = \frac{\text{Market value per share}}{\text{Earning per share}}$$

Capitalisation factor: The value of a share according to yield basis can also be ascertained by finding out the capitalisation factor or the multiplier. The capitalisation factor will be ascertained by dividing 100 by the normal rate of return.

$$\text{Capitalisation factor} = \frac{100}{\text{Normal rate of return}}$$

The profit available is capitalised by multiplying it with the capitalisation factor. The value of equity share is obtained by dividing the capitalised value by the number of equity shares.

Valuation Based on Productivity Factor

Productivity factor is a concept of relative earning power. It represents the earning power in relation to the value of assets employed for such earnings. This gives a ratio which is applied to the net worth of the business as on the valuation date to arrive at the projected earning figure for the company. This projected earning after necessary adjustments (discussed later) shall be multiplied by the appropriate capitalisation factor to arrive at the value of the company's business. The total value is divided by the number of equity shares to ascertain the value of each share.

The productivity factor based valuation is really a method for arriving at a reliable figure of future profits. The steps are the following:

(i) Take a number of years whose results are relevant to the future. Determine net worth of the business at the commencement and close of each of the accounting years under consideration and find out the average net worth for each year by adding the opening and closing net worth and dividing the result by 2; and, in turn, arriving at the average net worth of the business during the period under study.

(ii) Determine the net worth of the business on the valuation date.

(iii) Ascertain the average, weighted, if necessary, adjusted profit earned during the years under consideration.

(iv) Find out the percentage that (iii) bears to (i); that represents the productivity factor i.e.

$$= \frac{\text{Average (weighted) profit x 100}}{\text{Average (weighted) networth}}$$

(v) Apply the productivity factor as obtained in (iv) above to the net worth on the valuation date to find out the projected income in future.

(vi) Adjust the projected taxed income for factors like appropriations for provision for replacement and rehabilitation of plant and equipment, tax, dividends on preference shares, under utilisation of productive capacity, effects of restrictions on monopoly, etc.

(vii) Determine the normal rate of return for the company, having particular regard to the nature and size of the undertaking.

(viii) Determine the appropriate capitalisation factor or the multiplier based on normal rate of return in the way discussed earlier.

(ix) Apply the multiplier obtained in (viii) above to the adjusted projected taxed income to arrive at the capitalised value of the undertaking.

(x) Divide the result in (ix) above by the number of equity shares to arrive at the value per share.

In this context, it may be noted that very often companies have non-trading assets like investments, and sometimes idle assets in their balance sheets. The income from non-trading assets does not reflect the earning power of the company and consequently that part of income should be taken out of consideration in determining the average maintainable profit. Also, the value of non-trading and idle assets, after proper determination, should be excluded in the determination of net worth at each stage. But non-trading assets should be added to the value of undertaking as obtained in (ix) above.

Determination of Normal Rate of Return and Capitalisation Factor

This obviously has a tremendous bearing on the ultimate result, but unfortunately it is subjective and, therefore, valuers differ more widely in this area than any other in the whole valuation process. As a general rule, the nature of investment would decide the rate of return. Companies, investment in which is more risky would call for a larger rate of return, and, consequently they will have a lower capitalisation factor and lower valuation than companies with assured profits. For investments in Government securities, the risk is least and, consequently, an

investor would be satisfied with a very low rate of return. In a logical order, we find mortgage debentures, being riskier than government paper, require slightly higher rate of return. Preference shares are less risky than equity shares but more risky than mortgage debentures; preference shares rank in between debentures and equity shares in the matter of return. Equity shares are exposed to highest risks and, consequently, the normal rate of return is highest in case of equity shares, though equity shares of progressive and soundly managed companies, provide a safeguard against inflation - equity share prices are likely to rise sufficiently high to counteract the effect of a rise in prices.

The above also applies to companies and industries and the normal rate of return will always depend on the attendant risk. In this respect, net tangible asset backing is relevant. The higher net tangible asset backing for each share, greater would be the confidence of the investor. Normally, 2 to 3 times backing is considered satisfactory. This ratio should be reviewed carefully to ascertain whether shares are inadequately covered or too much covered which may indicate over capitalisation in the form of idle funds or inadequate use of productive resources. Symptoms suggesting idle assets would be holding of large cash and bank balances, high current ratio, unutilised land, plant and machinery, etc. The normal rate of return should be increased suitably in either case. Further, if any disabilities attach to the concerned share such as the share being partly paid, the normal rate of return would be higher.

If the concerned company has special features, the normal rate of return will have to be suitably modified. Thus, the following additional factors are to be considered:

(i) Restrictions on transfer of shares - The normal rate of return will be increased say, by ½%.

(ii) Disabilities attached to shares will also cause the normal rate of return to go up e.g. if shares are partly paid-up, the investors will expect a higher yield (say by ½% higher) than in case of fully paid shares.

(iii) Dividend performance - stability in dividend will decrease the normal rate.

(iv) Financial prudence on the part of the company's management also affects the normal rate of return. A company which distributes only a part of the profit will attract investors without offering high yield.

(v) Net asset backing is important from the point of view of safety. The poor net asset backing will increase the normal rate since the investors consider themselves unsafe.

Fair Value of Shares

The fair value of a share is the average of the value of shares obtained by the net assets method and the one obtained by yield method. Under net assets method, the value of an equity share is arrived at by valuing the assets of a company and deducting therefrom all the liabilities and claims of preference shareholders and dividing the resultant figure by the total number of equity shares with the same paid up value. Under yield method, the value of an equity share is arrived at by comparing the expected rate of return with the normal rate of return. If the expected rate of return is more than normal rate of return, the market value of the share is increased proportionately.

The fair value of shares can be calculated by using the following formula:

$$\text{Fair value of share} = \frac{\text{Value by net asset method + Value by yield method}}{2}$$

This method is also known as dual method of share valuation. This method attempts to minimise the demerits of both the methods. This is of course, no valuation but a compromised formula for bringing the parties to an agreement. However, it is recognised in Government circles for valuing shares of investment companies for wealth tax purposes.

Special Factors for Valuation of Shares

Valuation of equity shares must take note of special features in the company or in the particular case. These are briefly stated below:

(a) Importance of the size of the block of shares: Valuations of the identical shares of a company may vary quite significantly at the same point of time on a consideration of the size of the block of shares under negotiation. It is common knowledge that the holder of 75% of the voting power in a company can alter even the provisions of the articles of association to suit himself; a holder of voting power exceeding 50% and less than 75% can substantially influence the operations of the company even to alter the articles of association or comfortably pass a special resolution.

Even persons holding less than 50% of the total voting strength in a public limited company may control the affairs of the company, if the shares carrying the rest of the voting power are widely scattered; such shareholders rarely combine to defeat a determined block. Usually a person holding 10 to 15% of the total voting power is in a position to have his way in the company - even to change the provisions of the articles of association or pass any special resolution.

The above analysis is associated with the concept of the controlling interest, which according to most authorities carries a separate value to the tune of additional 10 to 20% of the value of shares otherwise obtained.

(b) Restricted transferability: Along with principal considerations of yield and safety of capital, another important factor is the easy exchangeability or liquidity. Shares of reputed companies generally enjoy the advantage of easy marketability which is of great significance to the holder. At the time of need, he may get cash in exchange of shares without being required to hunt out a willing buyer, or without being required to go through a process of long negotiation and valuation. Generally quoted shares of good companies are preferred for the purpose. On the other hand, holders of shares of unquoted public companies or of private companies do not enjoy this advantage; therefore, such shares, however good, are discounted for lack of liquidity at rates which may be determined on the basis of circumstances of each case. The discount may be either in the form of a reduction in the value otherwise determined or an increase in the normal rate of return. Generally, the articles of private companies contain provisions for offering shares to one who is already a member of the company and this necessarily restricts the ready market for the shares. These shares are also discounted for limited transferability. But exceptions are also there; by acquisition of a small block, if one can extend his holding in the company to such an extent as to effectively control the company, the share values may not be depressed in that deal.

(c) Dividends and valuation: Generally companies paying dividends at steady rates enjoy greater popularity and the prices of their shares are high while shares of companies with unstable dividends do not enjoy confidence of the investing public as to the returns they expect to get and consequently they suffer in valuation. For companies paying dividends at unsteady rates, the question of risk also becomes great and it depresses the price. The question of risk may be looked upon from another angle. A company which pays only a small proportion of its profit as dividend and thus builds up reserves is less risky than the one which has a high pay out ratio. The dividend rate is also likely to fluctuate in the latter case. Investors, however, do not like a company whose pay-out ratio is too small.

Shares are generally quoted high immediately before the declaration of dividend if the dividend prospect is good; or immediately after the declaration of dividend (if it is satisfactory) to take care of the dividend money that the prospective holder would get.

(d) Bonus and right issues: Share values have been noticed to go up when bonus or right issues are announced, since they indicate an immediate prospect of gain to the holder although, in the ultimate analysis, it is doubtful whether really these can alter the valuation. Bonus issues are made out of the accumulated reserves in the employment of the business, which in no way contribute to the increased earning capacity of the business and ultimately depress the dividend rate since the same quantum of profit would be distributed over a larger number of shares, which in turn also would depress the market value of the shares. However, a progressive company generally picks up the old rate of dividend after a short while but this is no way a result of bonus issue; it is the contribution of growth potential of the company.

However, in the case of right issues, the existing holders are offered the shares forming part of the new issue;

more funds flows into the company for improving the earning capacity. Share values will naturally depend on the effectiveness with which new funds will be used.

Valuation of Preference Shares

These are valued on yield basis in a going concern. Compared to equity shares, the rate of return in preference shares would be, generally, lower because of greater safety. With fluctuations in the normal rate of return in respect of preference shares, the value of preference share will fluctuate but in the opposite direction, i.e., if the normal rate of return increases, the value tends to diminish. For instance, 12% preference shares of ₹ 100 each would be valued at ₹ 85.72 when the expected rate of return is 14% (i.e., 12/14 x 100). The same share would be valued at ₹ 120 if the expected rate of return is 10% (i.e., 12/10 x 100).

In case the dividend on cumulative preference shares is in arrears, the present value of such arrears of dividend (if there is a possibility of their payment) should be added to the value of preference share calculated.

As stated earlier, a valuer must exercise his own judgement in valuing preference shares, because of the diminishing real value of the fixed preference dividend. This is considered to be a handicap for sellers in an inflationary economy. The yield based valuation of preference shares would hold good only if:

(i) the dividend on the share has been paid regularly and it is reasonably expected that it would continue to be paid; and

(ii) that investment is adjudged by the criteria that the total assets of the concern are equal to 4 or 5 times the preference capital.

Preference shares may have certain additional rights, for example, the right to get an additional share of profits or the right to get the share converted into equity shares at a certain rate. The right to get an additional share of profit will probably increase the market value of the share depending upon the size of the total profit and the conditions under which the additional dividend will come to preference share holders. Total yield per share will have to be worked out and on that basis the market value will be ascertained by the formula:

$$\frac{\text{Total yield per share}}{\text{Normal rate of yield}} \times 100$$

The right to get the preference share converted into equity share will be valuable only if the equity share of the company commands good value in the market. As against this, there will also be the possibility that wholesale conversion into equity shares may depress the dividend on these shares and thus bring down their price. The price of such a right will be roughly equal to the difference in the market value of an equity share and the conversion price. Suppose holders of preference shares of ₹ 100 have a right to convert their holding into equity shares at the end of 3 years at ₹ 130 per equity share and the market value of the equity share at the time is likely to be ₹ 160 which is not likely to be affected by the conversion. The right of conversion in the circumstances would be ultimately worth ₹ 30 (₹ 160 minus ₹ 130). Taking 12% as the proper rate of interest, the present value of such a right (discounting it @ 12% for 3 years) would be ₹ 21.36. The preference share therefore will command a value based upon its yield plus ₹ 21.36.

Illustration 1

From the following figures calculate the value of a share of ₹ 10 on (i) dividend basis, and (ii) return on capital employed basis, the market expectation being 12%.

Year ended 31st March	*Capital Employed*	*Profit*	*Dividend (%)*
₹	₹	₹	
2010	5,00,000	80,000	12
2011	8,00,000	1,60,000	15
2012	10,00,000	2,20,000	18
2013	15,00,000	3,75,000	20

Solution:

(i) Valuation of share on dividend basis:

The dividend rate on the simple average is 65/4 or $16\frac{1}{4}$ %. But since the dividend has been rising it would be better to take the weighted average which come to 17.6% ¾ thus:

Year ended	*Rate*	*Weight*	*Product*
31st March			
2010	12	1	12
2011	15	2	30
2012	18	3	54
2013	20	4	80
		10	176

Dividing 176 by ₹ 10, we get 17.6%.

The value of the share on the basis of dividend (weighted average) should be

$\frac{17.6}{12}$ x ₹ 10 = ₹ 14.67.

(ii) Valuation of share on return on capital employed basis:

The return on capital employed for each year and its weighted average is as follows:

Year ended	*Return on capital*	*Weight*	*Product*
31st March	employed %		
2010	16	1	16
2011	20	2	40
2012	22	3	66
2013	25	4	100
		10	222

Weighted average is 22.2%.

The value of the share should be:

$\frac{22.2}{12}$ x ₹ 10 = ₹ 18.50.

Illustration 2

Diamond Limited

Balance Sheet as at 31st March, 2014

Particulars	*Note No.*	*Amount as at 31st March,2014* ₹	*Amount as at 31st March,2013* ₹
1	2	3	4
I. **EQUITY AND LIABILITIES**			
(1) Shareholders' funds			
(a) Share Capital		2,00,000	
(b) Resrve and Surplus	1	72,000	
(2) **Current liabilities**			
(a) Trade payable		1,28,000	
(b) Provision for Income Tax		60,000	
TOTAL		**4,60,000**	
II. **ASSETS**			
(1) Non current-assets			
(a) Fixed Assets		2,60,000	
(b) Preliminary expenses	2	12,000	
(2) Current Assets			
(a) Inventories		48,000	
(b) Trade receivable		88,000	
(c) Cash at bank		52,000	
TOTAL		**4,60,000**	

Note No. 1

Reserve and Surplus

General reserve	40,000
Profit and loss account	32,000
	72,000

Note No. 2

Fixed Assets

Land and buildings	1,10,000
Plant and machinery	1,30,000
Patents	20,000
	2,60,000

The expert valuer valued the land and buildings at ₹ 2,40,000; goodwill at ₹ 1,60,000; and plant and machinery at ₹ 1,20,000. Out of the total debtors, it is found that debtors of ₹ 8,000 are bad. The profits of the company have been as follows:

	₹
31.3.2012	92,000
31.3.2013	88,000
31.3.2014	96,000

The company follows the practice of transferring 25% of profits to general reserve. Similar type of companies earn at 10% of the value of their shares. Ascertain the value of shares of the company under:

(i) intrinsic value method;

(ii) yield value method; and

(iii) fair value method.

Solution:

Diamond Ltd.

Valuation of shares

(i) Intrisic value method

	₹
Assets:	
Land and buildings	2,40,000
Goodwill	1,60,000
Plant and machinery	1,20,000
Patents and trade marks	20,000
Stock	48,000
Debtors less bad debts	80,000
Bank balance	52,000
	7,20,000
Less: Liabilities:	
Sundry creditors	1,28,000
Net assets	5,92,000

Intrinsic value of shares (each share) $= \frac{\text{Net Assets}}{\text{No. of shares}}$

$= ₹\frac{5,92,000}{20,000} = ₹29.60$

(ii) Yield value method

	₹
Total profit of last three years	2,76,000
Less: Bad debts	8,000

2,68,000

Average profit = $\frac{₹2,68,000}{3}$ = 89,333

Add: Decrease in depreciation on plant and machinery say @ 15% on ₹10,000 1,500

Less: Increase in depreciation on land and building say @ 10% on ₹1,30,000 13,000

Average profit 77,833

Less: Transfer to reserve

@ 25% of ₹ 77,833 19,458

Profit available for dividend 58,375

Rate of dividend = $\frac{₹58,375}{2,00,000} \times 100$ = ₹ 29.187%

Yield value of each share = $\frac{\text{Rate of Divicend}}{\text{Normal rate of return}}$ x Paid-up value of each share

= $\frac{29.187}{10}$ x 10 = ₹29.19

(iii) Fair value method

Fair value of each share = $\frac{\text{Intrinsic value} + \text{Yield Value}}{2}$

= $\frac{₹29.60 + ₹29.19}{2}$ = ₹29.40

Illustration 3

From the following particulars calculate the value of share of Z Ltd. on yield basis:

Z Limited

Balance Sheet as at 31st March, 2014

Particulars	*Note No.*	*Amount as at 31st March,2014*	*Amount as at 31st March,2013*
		₹	₹
I. **EQUITY AND LIABILITIES**			
(1) **Shareholders' funds**			
(a) Share Capital		12,00,000	
(b) Resrve and Surplus	1	400,000	
(2) **Non-current liabilities**			
10% Debentures		2,00,000	

(3) **Current liabilities**		
(a) Trade payable		4,00,000
TOTAL		22,00,000
II. **ASSETS**		
(1) **Non current-assets**		
(a) Fixed Assets	2	13,00,000
(2) Current Assets		
(a) Work in-progress and Inventories		5,00,000
(b) Trade receivable		3,00,000
(c) Cash at bank		1,00,000
TOTAL		22,00,000
Note Nos 1		
Share capital		
80,000 Equity shares of ₹ 10 each	8,00,000	
4,000, 9% equity shares of ₹ 100 each	4,00,000	
	12,00,000	
Note No 2		
Fixed Assets		
Land and buildings	5,00,000	
Plant and machinery	6,00,000	
Patents	2,00,000	
	13,00,000	

Land and buildings to be valued at ₹ 9,00,000. The company's earnings were as follows:

Year ended 31st March	*Profits before tax* (₹)	*Tax paid* (₹)
2009	3,00,000	80,000
2010	4,00,000	1,60,000
2011	1,00,000	40,000
2012	5,00,000	2,30,000
2013	5,50,000	3,00,000

The company paid managerial remuneration of ₹60,000 per annum but it will become ₹1,00,000 in future. There has been no change in capital employed. The company paid dividend of 90 paise per share and it will maintain the same in future. The company proposes to build up a plant rehabilitation reserve. Dividend rate in this type of company is fluctuating and the asset backing of an equity share is about 1-1/2 times. The equity shares with an average dividend of 8% sell at par. (Tax rate is assumed to be 40%).

Solution:

Average maintainable profits in future. Profit of 2010-11 is not considered because of low profits for abnormal reasons.

Year ended 31st March	*Profits* ₹	*Weight*	*Product*
2009	3,00,000	1	3,00,000
2010	4,00,000	2	8,00,000
2012	5,00,000	3	15,00,000
2013	5,50,000	4	22,00,000
		10	48,00,000

		₹
Weighted average:		4,80,000
Adjustment:		
Less: Increase in managerial remuneration		40,000
		4,40,000
Less: Tax @ 40%		1,76,000
Profit available for distribution		2,64,000
Less: Rehabilitation Reserve (12.5% estimated)		33,000
		2,31,000
Less: Dividend on Preference Shares		36,000
Profit available for distribution to equity shareholders		1,95,000

₹1,95,000 capitalised at 8% = $\frac{₹\,1{,}95{,}000 \times 100}{8}$ = ₹24,37,500

The value of equity share will be = $\frac{₹\,24{,}37{,}500}{80{,}000}$ = ₹30.47

Alternatively:

Assets backing per equity share:		₹
Total Asset as per balance sheet		22,00,000
Add: Increase in value of land and buildings		4,00,000
		26,00,000
Less: Sundry creditors	4,00,000	
10% Debentures	2,00,000	
9% Preference shares	4,00,000	10,00,000
Net assets available for equity shareholders		16,00,000
Equity share capital		8,00,000

Asset backing	2 times	
Normal dividend rate	8.0%	
Less: For higher dividend rate (9%) and stability (say)	0.5%	
Less: For higher asset backing 2 times as		
compared to 1.5 times) (say)	0.5%	
Adjusted normal rate of return	7.00	
Capital employed:		
Equity share capital		8,00,000
9% Preference share capital		4,00,000
10% Debentures		2,00,000
Reserves		4,00,000
Increase in value of land and buildings		4,00,000
		22,00,000
Profit after tax		2,64,000
Add: Debenture interest (after effect of income tax)		12,000
Profit earned		2,88,000
Rate of earning: $\frac{₹\ 2,88,000}{₹\ 22,00,000} \times 100 = 13.09\%$		

(Since the capital employed includes the amount of debentures, debenture interest after the effect of income tax has been adjusted.)

Value of share:

On actual dividend basis $= \frac{9}{7} \times 10 = ₹12.90$ (appx.)

On earning basis $= \frac{10.45}{7} \times 10 = ₹18.7$

Illustration 4

Year ended 31st March	*Average net worth (excluding investment)*	*Adjusted taxed profit*
	₹	₹
2011	18,50,000	1,80,000
2012	21,20,000	2,00,000
2013	21,30,000	2,30,000

The aforesaid figures relate to a company which has ₹10,00,000 on equity shares of ₹100 each and ₹3,00,000 in 9% preference shares of ₹100 each. The company has investments worth ₹2,50,000 (at market value) on the valuation date the yield in respect of which has been excluded in arriving at the adjusted tax profit figures. It is usual for similar type of companies to set aside 25% of the taxed profit for rehabilitation and replacement purposes.

On the valuation day the net worth (excluding investment) amounts to ₹22,00,000. The normal rate of return expected is 9%. The company paid dividends consistently within a range of 8 to 10% on equity shares over the previous seven years and the company expects to maintain the same. Compute the value of each equity share on the basis of productivity.

Solution:

Since both profits and net worth of the company are showing a steady growth, it would be reasonable to attach due weightage to them for valuation purposes.

Year ended 31st March	*Average Net worth* ₹	*Adj. taxed profit* ₹	*Weight factors*	*Weighted Net worth* ₹	*Profit* ₹
2011	18,50,000	1,80,000	1	18,50,000	1,80,000
2012	21,20,000	2,00,000	2	42,40,000	4,00,000
2013	21,30,000	2,30,000	3	63,90,000	6,90,000
			6	1,24,80,000	12,70,000
Weighted average				20,80,000	2,11,667

Productivity Factor = $\frac{₹\,2,11,6\,67}{₹\,20,80,000} \times 100 = 10.18\%$

	₹
Net worth on valuation date = ₹22,00,000	
Projected future maintainable profit = 10.18% of ₹22,00,000	2,23,960
Less: Rehabilitation and replacement @ 25%	55,990
	1,67,970
Less: Preference Dividend	27,000
	1,40,970
₹1,40,970 capitalised @ 9% rate of return would be	15,66,333
Add: Value of investments	2,50,000
Value of 10,000 equity shares	18,16,333

Therefore, the value of each equity share would be = $\frac{18,16,334}{10,000}$ = ₹181.63.

Illustration 5

From the following balance sheet of M.P. Products Ltd., find out the values of equity shares and preference shares:

M.P. Products Ltd.

Balance Sheet of as at 31st March, 2014

Particulars	Note No.	Amount as at 31st March,2014	Amount as at 31st March,2013
		₹	₹
1	2	3	4
I. **EQUITY AND LIABILITIES**			
(1) **Shareholders' funds**			
(a) Share Capital	1	3,00,000	
(b) Resrve and Surplus	2	40,000	
(2) **Current liabilities**			
(a) Short-term borrowings	3	5,000	
(b) Trade Payables	3	60,000	
(b) Other current liabilities	4	20,000	
TOTAL		4,25,000	
II. **ASSETS**			
(1) **Non-current-assets**			
(a) Fixed Assets	5	1,90,000	
(b) Other non current assets	6	3,000	
(2) **Current Assets**			
(a) Inventories		80,000	
(b) Trade Receivables		1,50,000	
(c) Cash		2,000	
TOTAL		4,25,000	

Note No. 1:

Share capital

	₹
20,000 equity shares of ₹ 10 each	2,00,000
8% 1,000 preference shares of ₹100 each	1,00,000
	3,00,000

Note No. 2

Reserve and Surplus

Reserve	30,000
Profit and loss account	10,000
	40,000

Note No. 3

Short-term borrowing

Overdrafts	5,000
	5,000

Note No. 5	₹
Fixed Assets	
Machinery	1,60,000
Furniture	5,000
Goodwill	25,000
	1,90,000
Note No. 6	
Other non-current assets	
Preliminary expenses	3,000

Further information

Goodwill is valued at ₹ 15,000. Stock is overvalued by ₹ 10,000. Machinery is undervalued by ₹ 15,000.

Solution :

		₹
Net Assets:		
Goodwill		15,000
Machinery		1,75,000
Furniture		5,000
Stock		70,000
Debtors		1,50,000
Cash		2,000
		4,17,000
Less: Liabilities		
Creditors	60,000	
Proposed preference dividend	8,000	
Overdraft	5,000	
Other liabilities	12,000	85,000
		3,32,000
Less: Preference share capital		1,00,000
Net Assets for equity shareholders		2,32,000

Intrinsic value of equity shares: ₹ 2,32,000 / 20,000 = ₹ 11.60 per share.

Intrinsic value of preference shares:

₹ 100 + Proposed dividend i.e., ₹ (8,000 / 1,000) = ₹ 8 = ₹ 108 per share.

If they are participating preference shares, the excess of net assets less preference share capital over the paid-up value of equity shares will be distributed over equity shares and preference shares converting them to equivalent number of same paid-up values. The share of surplus appropriate to each equity and preference share is to be added to the paid up amount of the respective shares. The total excess may also be distributed in the ratio of equity

capital and preference capital. Participating shares in this connection are taken to mean that they participate in surplus in liquidation *pari-passu* with equity shares. In reality, the articles of association will govern the situation.

Assuming the preference shares in Illustration above are participating shares, determine the values of equity shares and preference shares, assuming they rank *pari-passu*.

	₹
Net Assets less preference share capital (as above)	2,32,000
Less: Equity share capital	2,00,000
Surplus	32,000

Equivalent number of equity and preference shares :

20,000 equity shares equivalent to	20,000 shares of ₹10 each
1,000 preference shares equivalent to	10,000 shares of ₹10 each
	30,000 shares of ₹10 each

Surplus per share of ₹10 = $\frac{₹\,32{,}000}{30{,}000}$ = ₹1.07

Hence the value of equity shares: ₹10 + ₹1.07 = ₹11.07 per share.

Value of preference shares: ₹100 + ₹8 + (₹1.07 x 10) = ₹118.70

Or, the surplus of ₹32,000 may be divided between equity capital and preference capital in the ratio of 2 : 1, i.e., ₹21,333 and ₹10,667 respectively.

Values of shares:

Equity: $\frac{₹2,00,000 + ₹21,333}{20,000} = \frac{₹2,21,333}{20,000} = ₹11.07$

Preference: $\frac{₹1,00,000 + ₹10,667 + 8,000}{1,000} = \frac{₹1,8,667}{1,000} = ₹118.67$

Illustration 6

Mark Ltd.

Balance Sheet as at 31st March, 2014

Particulars	*Note No.*	*Amount as at 31st March,2014*	*Amount as at 31st March,2013*
		₹	₹
1	2	3	4
I. **EQUITY AND LIABILITIES**			
(1) **Shareholders' funds**			
(a) Share Capital	1	4,00,000	
(b) Resrve and Surplus	2	(5,000)	
(2) **Non-current liabilities**			

10% Debentures		50,000
(3) **Current liabilities**		
Trade Payables		95,000
TOTAL		5,40,000
II. **ASSETS**		
(1) **Non current-assets**		
(a) Fixed Assets	3	5,33,000
(b) Other non current assets	4	7,000
TOTAL		5,40,000

Note No. 1

Share Capital	₹
10,000 12% Preference Shares of ₹10 each fully paid	1,00,000
30,000 Equity Shares of ₹10 each fully paid	3,00,000
	4,00,000

Note No 2

Reserve & Surplus	₹
General Reserve	10,000
Debenture redemption fund	20,000
	30,000
Less: Profit & Loss (Dr Balance)	35,000
	(5,000)

Note No. 3

Fixed Assets	₹
Sundry Assets	5,48,000
Discount on debentures	15,000
	5,33,000

Note No. 4

Other non-current assets	₹
Preliminary Expenses	5,000
Discount on debentures	2,000
	7,000

Additional information

The debenture interest is owing for six months and dividends on preference shares are in arrears for one year. Assuming the assets are worth their book values, show the approximate value of preference and equity shares if :

(i) Preference shares are preferential as to capital and arrears are payable in a winding up; and:

(ii) Preference shares are preferential as to capital but arrears of preference dividends are not payable.

Solution:

Calculation of net assets	₹	₹
Sundry Assets		5,48,000
Less: Depreciation Fund	15,000	
10% Debentures	50,000	
Sundry Creditors	95,000	
Debentures interest for six months	2,500	1,62,500
		3,85,500

(i) If preference shares are preferential as to capital and arrears are payable in a winding up, then the share valuation will be as under :

	₹	₹
Net Assets		3,85,500
First payments to the preference shareholders :		
Preference Share Capital	1,00,000	
Arrears of preference dividends for one year @ 12%	12,000	1,12,000
Balance to equity shareholders		2,73,500
Hence, Worth of Preference Shares : $\frac{1,12,000}{10,000}$ = ₹11.20 each		
Equity Shares : $\frac{2,73,500}{30,000}$ = ₹ 9.12 each		

(ii) If preferential shares are preferential as to capital but arrears are not payable, then the valuation will be as follows :

	₹
Net Assets	3,85,500
Less: Preference Share Capital	1,00,000
Hence Valuation of :	

Per Preference Share : $\frac{₹1,00,000}{10,000}$ = ₹10 each

Per Equity Share : $\frac{₹2,85,000}{30,000}$ = ₹ 9.52 each

SUMMARY OF VALUATIONOFSHARES

A. Net Asset Value Method

***Step 1** :* Compute Net Operating Asset (*Refer Capital Employed Computation under Valuation of Goodwill*).

***Step 2** :* Add Value of Goodwill and Non operating Assets if any (eg. Investments)

Step 3 *:* Divide the aggregate of Step 1 & 2 by the number of shares outstanding as at Valuation date.

B. Yield based

The Various Methods under this are Dividend Capitalisation Method Earnings Capitalisation Method & Productivity Factor Method.

1. Dividend Capitalisation Method

Step 1 : Ascertain Dividend per share

Step 2 : Ascertain Normal rate of return.

Step 3 : Capitalise the Dividend per share at above normal rate of return to arrive at value per share.

$$\text{Value per share} = \frac{\text{DPS}}{\text{NRR}} \times 100$$

(Where DPS = Dividend Per Share

NRR = Normal Rate of Return)

2. Earnings Capitalisation Method

Step 1 : Compute Earnings Per Share (EPS).

Step 2 : Ascertain Normal Rate of Return (NRR).

Step 3 : Value per share is arrived by capitalising at NRR.

$$\text{Value per share} = \frac{\text{EPS} \times 100}{\text{NRR}}$$

3. Productivity Factor Method

Step 1 : Computation of Productivity factor

(a) Compute weighted average net worth of a given period.

(b) Compute weighted average Profit After Tax (PAT) for the same period.

(c) Compute Productivity factor

$$\text{Production Factor} = \frac{\text{Weighted Average PAT} \times 100}{\text{Weighted Average Net Worth}}$$

Step 2 : Ascertain Net worth on the valuation date.

Step 3 : Compute Future Maintainable Profit (FMP).

Future Maintenance Profit = Net Worth x Productivity Factor.

Step 4 : Ascertain Adjusted FMP ie., Future Maintenance Profit as per Step 3 adjusted for changes in business. *(eg. Change of tax rate)*.

Step 5 *:* Ascertain Normal rate of return.

Step 6 : Capitalise Adjusted FMP at NRR to arrive at value of business.

Step 7 : Add : Non operating Assets (*eg. Investments*) to above value of business.

Less : Preference Share Capital (*if any*)

Step 8 : Value per share = (Step 6 + Step 7) / Number of Shares

4. Market Price Method

Step 1 : Ascertain Earnings Per Share.

Step 2 : Ascertain from published sources the Price Earnings Multiples for similar size Company operating in the same industry.

Step 3 : Value per share = EPS X PE Ratio.

II. VALUATION OF INTANGIBLE ASSETS

INTANGIBLE ASSETS

Intangible asset is defined as a capital asset having no physical existence, its value being dependent on the rights that possession confers upon the owner. Intangible assets are expected to benefit the firm beyond the current operating cycle of the business. It implies that they are non-current assets. Intangibles are not basically different from other non-monetary assets as they are expected to benefit the owner beyond the current operating cycle of the business. But like other non-monetary assets, intangibles asset has no physical existence. Thus, intangibles are assets which cannot be seen, touched and have no volume like tangibles but have right to future benefits. However, not all assets which lack physical substance are regarded as intangible assets i.e., account receivables, short-term pre-payment etc., are of non-physical nature but classified as current assets.

Though intangibles provide future benefits, there is a high degree of uncertainty regarding the value of the future benefits to be received. Some intangibles relate to the development and manufacture of a product, such as, patents, copyrights, etc. while some others relate to the creation and maintenance of the demand for the product such as, trade marks.

Accounting Standard (AS) 26 Intangible Assets issued by the Institute of Chartered Accountants of India deals with meaning and valuation of intangible assets. According to this Accounting Standard, an intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

To understand this definition, the meaning of non-monetary asset must be clear. An asset is a resource (a) controlled by an enterprise as a result of past events; and (b) from which future economic benefits are expected to flow to the enterprise. Monetary assets are money held and assets to be received in fixed or determinable amounts of money. Non-monetary assets are assets other than monetary assets.

Following are the features of intangible assets :

(i) It is non-physical in nature.

(ii) It gives the specific rights to the holders over several future years.

(iii) It is possible for multiple uses at the same time.

(iv) It creates future value.

(v) It is identifiable as non-monetary asset.

(vi) It has limited ability to protect property rights.

(vii) Investment in intangible assets is basically risky.

Enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas,

franchises, customer or supplier relationships, customer loyalty, market share and marketing rights. Goodwill is another example of an item of intangible nature which either arises on acquisition or is internally generated.

Not all the items described in the above paragraph will meet the definition of an intangible asset, that is, identifiably, control over a resource and expectation of future economic benefits flowing to the enterprise. If an item covered by AS-26 does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in an amalgamation in the nature of purchase, it forms part of the goodwill recognised at the date of the amalgamation.

Some intangible assets may be contained in or on a physical substance such as a compact disk (in the case of computer software), legal documentation (in the case of a licence or patent) or film (in the case of motion pictures). The cost of the physical substance containing the intangible assets is usually not significant. Accordingly, the physical substance containing an intangible asset, though tangible in nature, is commonly treated as a part of the intangible asset contained in or on it.

In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. In determining whether such an asset should be treated Fixed Assets, or as an intangible asset under AS 26, judgement is required to assess as to which element is predominant.

The definition of an intangible asset requires that an intangible asset be identifiable. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill. Goodwill arising on an amalgamation in the nature of purchase represents a payment made by the acquirer in anticipation of future economic benefits.

An intangible asset can be clearly distinguished from goodwill if the asset is separable. An asset is separable if the enterprise could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without also disposing of future economic benefits that flow from other assets used in the same revenue earning activity. But separability is not a necessary condition for identifiability since an enterprise may be able to identify an asset in some other way.

An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits.

Market and technical knowledge may give rise to future economic benefits. An enterprise controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, or a restraint of trade agreement (where permitted).

The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the enterprise. For example, the use of intellectual property in a production process may reduce future production costs rather than increase future revenues.

Approaches for Valuing Intangible Assets

Valuation of intangible assets is a difficult exercise. The physical form of intangible assets makes it difficult to identify the future economic benefits that the organisation can expect to obtain from the intangible assets. Many intangible assets do not have alternative use and cannot be divided into components or parts for resale. Infact, intangible assets normally do not have an active market. Many times, they are not separable from the business and hence it becomes difficult to value them separately from the business.

There are three approaches used in valuing intangible assets; (i) cost approach, (ii) market value approach and (iii) economic value approach. The valuer has to select the apprpach after considering a number of factors like credibility, objectivity, relevance and practicality.

In cost approach, expenditure incurred in developing the asset is aggregated. If the asset has been purchased recently, its purchase price may be taken to be the cost.

In market value approach, valuation is made by reference to transactions involving similar assets that have taken place recently in similar markets. The approach is possible if there is existence of an active market of comparable intangible assets and adequate information in respect of transactions that have taken place recently is available.

Economic value approach is based on the cash flows or earnings attributable to those assets and the capitalisaiton thereof, at an appropriate discount rate or multiple. The valuer has to identify the cash flow-earnings directly associated with the intangible assets like the cash flows arising from the utilization of a patent or copyright, licensing of an intangible asset, etc. It is possible only if cash flows from the intangible asset are identifiable from the accounts and budgets, forecasts or plans of the enterprise.

Recognition and Initial Measurement of an Intangible Asset

An intangible asset should be recognised if, and only if:

(a) it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and

(b) the cost of the asset can be measured reliably.

An enterprise should assess the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset. An intangible asset should be measured initially at cost.

Separate Acquisition of Intangible Assets

If an intangible asset is acquired separately, the cost of the intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets. The cost of an intangible asset comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), and any directly attributable expenditure on making the asset ready for its intended use. Directly attributable expenditure includes, for example, professional fees for legal services. Any trade discounts and rebates are deducted in arriving at the cost. If an intangible asset is acquired in exchange for shares or other securities of the reporting enterprise, the asset is recorded at its fair value, or the fair value of the securities issued, whichever is more clearly evident.

Acquisition of Intangible Assets as Part of an Amalgamation

An intangible asset acquired in an amalgamation in the nature of purchase is accounted for in accordance with Accounting Standard (AS) 14, Accounting for Amalgamations.

Judgement is required to determine whether the cost (i.e. fair value) of an intangible asset acquired in an amalgamation can be measured with sufficient reliability for the purpose of separate recognition. Quoted market prices in an active market provide the most reliable measurement of fair value. If no active market exists for an asset, its cost reflects the amount that the enterprise would have paid, at the date of the acquisition, for the asset in an arm's length transaction between knowledgeable and willing parties, based on the best information available.

Certain enterprises that are regularly involved in the purchase and sale of unique intangible assets have developed techniques for estimating their fair values indirectly. These techniques may be used for initial measurement of an intangible asset acquired in an amalgamation in the nature of purchase if their objective is to estimate fair value and if they reflect current transactions and practices in the industry to which the asset belongs. These techniques include, where appropriate, applying multiples reflecting current market transactions to certain indicators driving the profitability of the asset (such as revenue, market shares, operating profit, etc.) or discounting estimated future net cash flows from the asset.

A transferee recognises an intangible asset that meets the recognition criteria, even if that intangible asset had not been recognised in the financial statements of the transferor; and if the cost (i.e. fair value) of an intangible

asset acquired as part of an amalgamation in the nature of purchase cannot be measured reliably, that asset is not recognised as a separate intangible asset but is included in goodwill.

Unless there is an active market for an intangible asset acquired in an amalgamation in the nature of purchase, the cost initially recognised for the intangible asset is restricted to an amount that does not create or increase any capital reserve arising at the date of the amalgamation.

Acquisition of Intangible Assets by way of a Government Grant

In some cases, an intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant. This may occur when a government transfers or allocates to an enterprise intangible assets such as airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources. Such an intangible asset is recognised at a nominal value or at the acquisition cost, as appropriate; any expenditure that is directly attributable to making the asset ready for its intended use is also included in the cost of the asset.

Internally Generated goodwill

Internally generated goodwill should not be recognised as an asset.

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

(a) a research phase; and

(b) a development phase.

If an enterprise cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the enterprise treats the expenditure on that project as if it were incurred in the research phase only.

1. Research Phase

No intangible asset arising from research (or from the research phase of an internal project) should be recognised. Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred.

Examples of research activities are:

(a) activities aimed at obtaining new knowledge;

(b) the search for, evaluation and final selection of, applications of research findings or other knowledge;

(c) the search for alternatives for materials, devices, products, processes, systems or services; and

(d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

2. Development Phase

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

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale;

(b) its intention to complete the intangible asset and use or sell it;

(c) its ability to use or sell the intangible asset;

(d) how the intangible asset will generate probable future economic benefits. Among other things, the enterprise

should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and

(f) its ability to measure the expenditure attributable to the intangible assets during its development reliably.

Examples of development activities are:

(a) the design, construction and testing of pre-production or pre-use prototypes and models;

(b) the design of tools, jigs, moulds and dies involving new technology;

(c) the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and

(d) the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognised as intangible assets.

Cost of an Internally Generated Intangible Asset

The cost of an internally generated intangible asset is the sum of expenditure incurred from the time when the intangible asset first meets the recognition criteria. Reinstatement of expenditure recognised as an expense in previous annual financial statements or interim financial reports is prohibited.

The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and making the asset ready for its intended use. The cost includes, if applicable:

(a) expenditure on materials and services used or consumed in generating the intangible asset;

(b) the salaries, wages and other employment related costs of personnel directly engaged in generating the asset;

(c) any expenditure that is directly attributable to generating the asset, such as fees to register a legal right and the amortisation of patents and licences that are used to generate the asset; and

(d) overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset (for example, an allocation of the depreciation of fixed assets, insurance premium and rent). Allocations of overheads are made on bases similar to those used in allocating overheads to inventories. AS 16, Borrowing Costs, establishes criteria for the recognition of interest as a component of the cost of a qualifying asset. These criteria are also applied for the recognition of interest as a component of the cost of an internally generated intangible asset.

The following are not components of the cost of an internally generated intangible asset:

(a) selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to making the asset ready for use;

(b) clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance; and

(c) expenditure on training the staff to operate the asset.

Recognition of an Expense on Intangible Asset

Expenditure on an intangible item should be recognized as an expense when it is incurred unless:

(a) it forms part of the cost of an intangible asset that meets the recognition criteria;

(b) the item is acquired in an amalgamation in the nature of purchase and cannot be recognized as an intangible asset.

If this is the case, this expenditure (included in the cost of acquisition) should form part of the amount attributed to goodwill (capital reserve) at the date of acquisition.

In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, the expenditure is recognised as an expense when it is incurred. For example, expenditure on research is always recognised as an expense when it is incurred. Examples of other expenditure that is recognised as an expense when it is incurred include:

(a) expenditure on start-up activities (start-up costs), unless this expenditure is included in the cost of an item of fixed asset. Start-up costs may consist of preliminary expenses incurred in establishing a legal entity;

(b) expenditure on training activities;

(c) expenditure on advertising and promotional activities; and

(d) expenditure on relocating or re-organising part or all of an enterprise.

Subsequent Expenditure on Intangible Assets

Subsequent expenditure on an intangible asset after its purchase or its completion should be recognised as an expense when it is incurred unless:

(a) it is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and

(b) the expenditure can be measured and attributed to the asset reliably.

If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.

After initial recognition, an intangible asset should be carried at its cost less any accumulated amortisation and any accumulated impairment losses.

Amortisation on Intangible Assets

1. Amortisation Period

The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.

As the future economic benefits embodied in an intangible asset are consumed over time, the carrying amount of the asset is reduced to reflect that consumption. This is achieved by systematic allocation of the cost of the asset, less any residual value, as an expense over the asset’s useful life. Amortisation is recognised whether or not there has been an increase in, for example, the asset’s fair value or recoverable amount.

Given the history of rapid changes in technology, computer software and many other intangible assets are susceptible to technological obsolescence. Therefore, it is likely that their useful life will be short.

If control over the future economic benefits from an intangible asset is achieved through legal rights that have

been granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless:

(a) the legal rights are renewable; and

(b) renewal is virtually certain.

The following factors, among others, indicate that renewal of a legal right is virtually certain:

(a) the fair value of the intangible asset is not expected to reduce as the initial expiry date approaches, or is not expected to reduce by more than the cost of renewing the underlying right;

(b) there is evidence (possibly based on past experience) that the legal rights will be renewed; and

(c) there is evidence that the conditions necessary to obtain the renewal of the legal right (if any) will be satisfied.

2. Amortisation Method

The amortisation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. The amortisation charge for each period should be recognised as an expense unless some Accounting Standard permits or requires it to be included in the carrying amount of another asset.

Amortisation is usually recognised as an expense. However, sometimes, the economic benefits embodied in an asset are absorbed by the enterprise in producing other assets rather than giving rise to an expense. In these cases, the amortisation charge forms part of the cost of the other asset and is included in its carrying amount. For example, the amortisation of intangible assets used in a production process is included in the carrying amount of inventories.

3. Residual Value

The residual value of an intangible asset should be assumed to be zero unless:

(a) there is a commitment by a third party to purchase the asset at the end of its useful life; or

(b) there is an active market for the asset and:

   (i) residual value can be determined by reference to that market; and

   (ii) it is probable that such a market will exist at the end of the asset's useful life.

4. Review of Amortisation Period and Amortisation Method

The amortisation period and the amortisation method should be reviewed at least at each financial year end. If the expected useful life of the asset is significantly different from previous estimates, the amortisation period should be changed accordingly. If there has been a significant change in the expected pattern of economic benefits from the asset, the amortisation method should be changed to reflect the changed pattern. Such changes should be accounted for in accordance with AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

Recoverability of the Carrying Amount – Impairment Losses

To determine whether an intangible asset is impaired, an enterprise applies Accounting Standard on Impairment of Assets. which explains how an enterprise reviews the carrying amount of its assets, how it determines the recoverable amount of an asset and when it recognises or reverses an impairment loss.

If an impairment loss occurs before the end of the first annual accounting period commencing after acquisition for an intangible asset acquired in an amalgamation in the nature of purchase, the impairment loss is recognised as an adjustment to both the amount assigned to the intangible asset and the goodwill (capital reserve) recognised

at the date of the amalgamation. However, if the impairment loss relates to specific events or changes in circumstances occurring after the date of acquisition, the impairment loss is recognised under Accounting Standard on Impairment of Assets and not as an adjustment to the amount assigned to the goodwill (capital reserve) recognised at the date of acquisition.

In addition to the requirements of Accounting Standard on Impairment of Assets, an enterprise should estimate the recoverable amount of the following intangible assets at least at each financial year end even if there is no indication that the asset is impaired:

(a) an intangible asset that is not yet available for use; and

(b) an intangible asset that is amortised over a period exceeding ten years from the date when the asset is available for use.

The recoverable amount should be determined under Accounting Standard on Impairment of Assets and impairment losses recognised accordingly.

Retirements and Disposals on Intangible Assets

An intangible asset should be derecognised (eliminated from the balance sheet) on disposal or when no future economic benefits are expected from its use and subsequent disposal.

Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the statement of profit and loss.

VALUATION OF GOODWILL

Goodwill may be defined as the value of the reputation of a business house in respect of profits expected in future over and above the normal level of profits earned by undertakings belonging to the same class of business. In other words, goodwill is the present value of a firm's anticipated super normal earnings. The term 'super normal earnings' means the excess of earnings attributable to operating tangible and intangible assets (other than goodwill) over and above the normal rate of return earned by representative firms in the same industry. Thus, goodwill may be described as the value attaching to a prosperous business because of factors that other firms do not possess to the same degree.

In his **"A Dictionary for Accountants", Kohler** defines goodwill as

> "the current value of expected future income in excess of a normal return on the investment in net tangible assets.....".

NEED FOR VALUATION OF GOODWILL

In the case of partnership, the necessity of valuing goodwill arises in connection with the following:

1. When there is a change in the profit-sharing ratio among the partners;
2. When a new partner is admitted;
3. When a partner retires or dies; and
4. When the firm sells its business to a company or is amalgamated with another firm.

In the case of a joint stock company, the need for evaluating goodwill may arise in the following cases:

1. When the business or company is to be sold to another company or when the company is to be amalgamated with another company.
2. When, stock exchange quotations not being available, shares have to be valued for taxation purposes - gift tax, etc.;

3. When a large block of shares, so as to enable the holder to exercise control over the company concerned, has to be bought or sold; and
4. When the company has previously written off goodwill and wants to write it back.
5. When the company is being taken over by the government.

FACTORS AFFECTING GOODWILL

The factors leading to goodwill are the following:

1. Special locational advantages;
2. Special commercial advantages such as a long-term contract for supply of raw materials at a low price or for sale of finished goods at remunerative prices;
3. Advantages because of prior entry specially if later is very difficult;
4. Advantages enjoyed by it because of certain patents available to it;
5. Technical know-how possessed by the firm;
6. The research and development effort; and
7. Above all, the advantage enjoyed by the superiority of its man-power specially management; this is reflected in superior products, better exploitation of markets, new products and new markets, etc.

The first four factors are temporary in nature; the other three are permanent.

Factors having a bearing on valuation: In addition to what has already been stated, in a valuation, consideration of the following factors is also necessary:

(a) Nature of the industry, its history and the risks to which it is subject;

(b) Prospects of the industry in the future;

(c) The company’s history - its past performance and its record of past profits and dividends;

(d) The basis of valuation of assets of the company and their value;

(e) The ratio of liabilities to capital;

(f) The nature of management and the chance for its continuation;

(g) Capital structure or gearing;

(h) Size, location and reputation of the company’s products;

(i) The incidence of taxation;

(j) The number of shareholders;

(k) Yield on shares of companies engaged in the same industry, which are listed in the stock-exchanges;

(l) Composition of purchasers of the products of the company; and

(m) Size of block of shares offered for sale since for large blocks very few buyers would be available and that has a depressing effect on the valuation. Question of control, however, may become important, when large blocks of shares are involved.

To put the above in different words, the factors would be:

(i) Profitability: Profitability of a concern is the chief factor in valuation of goodwill. One who pays for goodwill looks to the future profit. The profits that are expected to be earned in future are extremely important for

valuation of goodwill. The following are the important factors that have a bearing on future profits and, therefore, the value of goodwill :

(a) Personal skill in management;

(b) Nature of business;

(c) Favourable location;

(d) Access to supplies;

(e) Patents and trade marks protection;

(f) Exceptionally favourable contracts; and

(g) Capital requirements and arrangement of capital.

N.B.: A very careful estimate of the profits expected to be earned by the firm and the amount of capital employed to earn such profits, has to be made;

(ii) General reputation which the firm or the company and its management enjoys;

(iii) Yield expected by investors in the industry to which the firm or company belongs.

DETERMINATION OF FUTURE MAINTAINABLE PROFIT

Determination of future maintainable profits, based on past record is a delicate and complicated task as it involves not only the objective consideration of the available financial information but also subjective evaluation of many other factors, such as capabilities of the company's management, general economic conditions, future Government policies, etc. Guiding principles can be laid down only in respect of the former and the valuer will have to give due consideration to the other matters according to his reading of the situation in each individual case. The steps necessary to arrive at the future maintainable profits of a company are: (a) calculation of past average taxed earnings; (b) projection of the future maintainable taxed profits; and (c) adjustments of preferred rights.

(a) *Calculation of past average earnings*: In order to calculate the past average earnings, it is necessary to decide upon the number of years whose results should be taken for averaging; select these years and adjust their profits to make them acceptable for averaging.

The number of years to be selected must be large enough so as to cover generally the length of a business cycle; an average for a shorter period might not be suitable. But it should not go too far back, e.g., results in the 80's will have no bearing on the results expected in the 90's. In inflationary conditions, that are present today, it is considered that a relatively shorter period may be more representative since it reveals more recent results. Similarly, for companies having steady and gradual growth, average of a shorter period is more useful. In some unusual circumstances, average of still shorter period or even only one year's profit may be more significant in estimating future earnings, such as where a change in the business or a change in trading conditions forces the valuer to discard earlier years and to rely upon one year only or to select certain normal years and exclude others. In all these matters, a sound reasoning would alone aid the valuer. Whether a 3 yearly, 5 yearly or longer average would reflect the correct future earnings of a company mostly depends upon the nature of the individual case.

The followings are some items which generally require adjustment in arriving at the average of the past earnings:

(i) Elimination of material non recurring items such as loss of exceptional nature through strikes, fires, floods and theft, etc., profit or loss of any isolated transaction not being part of the business of the company, lumpsum compensation or retiring allowances, damages and costs in legal actions, abnormal repair charges in a particular year, etc.

(ii) Elimination of income and profits and losses from non-trading assets.

(iii) Elimination of any capital profit or loss or receipt or expense included in the profit and loss account.

(iv) Adjustments for any interest, remuneration, commission, etc., foregone or overcharged by directors and other managerial personnel.

(v) Adjustments for any matters suggested by notes, appended to the accounts or by qualifications in the Auditor's Report, such as provision for taxation and gratuities, bad debts, under or over provision for depreciation, inconsistency in valuation of stock, etc.

(vi) Taxation: According to the opinion of the valuer, the tax rates may be such as were ruling for the respective years or the latest ruling rate may be deducted from the average profit. However, the consensus of opinion is for adjusting tax payable rather than tax-paid because so many short-term reliefs and tax holidays might have reduced the effective tax burden.

(vii) Depreciation: It is a significant item that calls for careful review. The valuer may adopt book depreciation provided he is satisfied that the rate was realistic and the method was suitable for the nature of the company and they were consistently applied from year to year. But imbalances do arise in cases where consistently written down value method was in use and heavy expenditure in the recent past has been made in rehabilitating or expanding fixed assets, since the depreciation charges would be unfairly heavy and would prejudice the seller. Under such circumstances, it would be desirable to readjust depreciation suitably as to bring a more equitable charge on the profits meant for averaging.

In averaging past earnings, another important factor comes up for consideration is the trend of profits earned. It is indeed imperative that estimation of maintainable profits be based only on the available record, i.e., the record of past earnings, but indiscrete use of past results may lead to an entirely fallacious and unrealistic result. In this regard, three situations may have to be faced. Where the past profits of a company are widely fluctuating from year to year, an average fails to aid future projection. In such cases, a study of the whole history of the company and of earnings of a fairly long period may be necessary. If the profits of a company do not show a regular trend, upward or downward, an average of the cycle can usefully be employed for projection of future earnings. In some companies, profits may record a distinct rising or falling trend from year to year; in these circumstances, a simple average fails to consider a significant factor, namely, trend in earnings. The shares of a company which record a clear upward trend of past profits would certainly be more valuable than those of a company whose trend of past earnings indicates a static or down-trend. In such cases, a weighing average, giving more weight to the recent years than to the past, is appropriate. A simple way of weighing is to multiply the profits by the respective number of the years arranged chronologically so that the largest weight is associated with the most recent past year and the least for the remotest. (Similarly, if net worth is under consideration, the respective years average net worth may also be weighted in a similar way).

(b) Projection of future maintainable taxed profits: Projection is more a matter of intelligent guesswork since it is essentially an estimation of what will happen in the risky and uncertain future. The average profit earned by a company in the past could be normally taken as the average profit that would be maintainable by it in the future, if the future is considered basically as a continuation of the past. If future performance as the company is viewed as departing significantly from the past, then appropriate adjustments will be called for before accepting the past average profit as the future maintainable profit of the company. These are stated below:

(i) Discontinuance of a part of the business;

(ii) Under-utilisation of installed capacity;

(iii) Expansion programmes;

(iv) Major change in the policy of the company; and

(v) Adjustment for rehabilitation and replacement.

(c) Adjustments of preferred rights: In arriving at the average profits and their future projection, all charges

including interest on debentures and other borrowings are of course deducted. But the dividend on preference shares should also be considered after the estimate of future profits has been arrived at. Dividends payable to preference shareholders, according to the terms of their issue, should be deducted from the maintainable profit.

NORMAL RATE OF RETURN

Normal rate of return is the rate of return that the investors in general expect on their investments in a particular industry. This rate differs from industry to industry. The normal rate of return is required to be adjusted in the light of certain circumstances, i.e.

(i) Risk attached to the investment: If a business is having more risk the rate of return should also be more. Risk may be due to high borrowings or by the nature of business.

(ii) Period of investment: The longer the period of investment, the higher is the rate of return.

(iii) Higher bank rate: An increase in bank rate gives higher expectations to the investors.

(iv) Boom period: When there is a boom in the industry, the investors have higher expectations and the normal rate of return is to be increased.

CAPITAL EMPLOYED

The goodwill of a business depends on the amount of capital employed also. The term ‘capital employed’ for the valuation of goodwill should be calculated from the point of view of shareholders. Capital employed may be expressed as the aggregate of share capital and reserves less the amount of non-trading assets and fictitious assets. It can also be ascertained by adding up the present value of trading assets and deducting all liabilities. For this purpose, the amount of debentures or loans should also be excluded from capital employed. Of course any profit or loss on revaluation of assets should be taken into account.

It is considered desirable to use average capital employed in place of ‘capital employed’ because the capital employed must be such as may fairly represent the capital investment throughout the year. Average capital employed is the average of capital employed at the beginning and that employed at the end of the year. But if the current year’s profit is not disturbed during the year itself the average capital employed is to be ascertained by deducting half the profit from capital employed at the end. This is appropriate for goodwill to be ascertained by reference to current year’s profit and current year’s capital employed.

Illustration 7

EXE LIMITED

Balance Sheet as at 31st March, 2014

Liabilities	₹	*Assets*	₹	₹
11% Preference Share		Fixed Assets:		
Capital	5,00,000	Cost	50,00,000	
Equity Share Capital	20,00,000	*Less :* Depreciation	30,00,000	20,00,000
Reserves and Surplus	25,00,000	Capital Work in-Progress		40,00,000
10% Loans	27,00,000	6% Government Securities		5,00,000
Current Liabilities		Current Assets		25,00,000
and Provisions	15,00,000	Underwriting Commission		2,00,000
	92,00,000			92,00,000

The company earned a profit of ₹ 9,00,000 after tax @ 50% in 2000-01. The capital work in progress represents additional plant equal to half the capacity of the present plant; it will be immediately operational, there being no difficulty in sales. With effect from 1st April, 2001, two additional part-time directors are being appointed at ₹ 75,000 p.a. Ascertain the future maintainable profit and the capital employed, assuming the present replacement cost of fixed assets is ₹ 1,00,00,000 and the annual rate of depreciation is 10% on original cost.

Solution:

Future Maintainable Profit:

		₹
After-tax profit at present		9,00,000
Add: Tax		9,00,000
Depreciation - 10% of ₹ 50,00,000		5,00,000
Present profit before depreciation and tax		23,00,000
Less: Interest of Investments (non-trading income)		30,000
		22,70,000
Add: Increase in profit since sales will increase by 50%		11,35,000
		34,05,000
Less: Depreciation @ 10% on ₹ 1,00,00,000	10,00,000	
on ₹40,00,000	4,00,000	
	14,00,000	
Additional Remuneration	1,50,000	15,50,000
Less: Tax @ 50%		9,27,500
Future Maintainable Profit		9,27,500
Capital Employed:		
Fixed Assets - Present Replacement Cost		1,00,00,000
Depreciation (adjusted)		60,00,000
		40,00,000
Additions to Plant		40,00,000
		80,00,000
Current Assets		25,00,000
		1,05,00,000
Less: 10% Loans	27,00,000	
Current Liabilities and Provisions 15,00,000		42,00,000
Capital Employed		63,00,000

Alternatively:

		₹
Preference Share Capital		5,00,000
Equity Share Capital		20,00,000
Reserves and Surplus - At present		25,00,000
Profit on Revaluation	20,00,000	45,00,000
		70,00,000
Less: Non-trading assets, Investments		5,00,000
Underwriting Commission	2,00,000	7,00,000
Capital Employed		63,00,000

Methods of Valuing Goodwill

There are basically two methods of valuing goodwill: (i) Simple profit method; (ii) Super profit method.

(i) Simple Profit Method

Goodwill is sometimes valued on the basis of a certain number of years' purchase of the average profits of the past few years. While calculating average profits for the purposes of valuation of goodwill certain adjustments are made. Some of them are the following:

(a) All actual expenses and losses not likely to occur in the future are added back to profits;

(b) Expenses and losses expected to be borne in future are deducted from such profits;

(c) All profits likely to come in the future are added; and

(d) Even actual profits not likely to recur are deducted.

After having adjusted profit in the light of future possibilities, average profits are estimated and then the value of goodwill is estimated i.e., the average profits are ascertained and then the average is multiplied by a particular number, representing the number of years' purchase. If goodwill is to be valued at 3 years' purchase of the average profits which come to ₹ 20,000, the goodwill will be ₹ 60,000, i.e., 3 x ₹ 20,000.

This method has nothing to recommend itself since goodwill is attached to profits over and above what one can earn by starting a new business and not to total profits. It ignores the amount of capital employed for earning the profit. However, it is usual to adopt this method for valuing the goodwill of the practice of a professional person such as a chartered accountant or a doctor.

(ii) Super Profit Method

In this case the future maintainable profits of the firm are compared with the normal profits for the firm. Normal earnings of a business can be judged only in the light of normal rate of earning and capital employed in the business. However, this method of valuing goodwill would require the following informations:

1. A normal rate of return for representative firms in the industry.
2. The fair value of capital employed.
3. Estimated future maintainable profit.

Example: In the Illustration No. 1 given above, suppose the investors are satisfied with 12% return, then normal profit will be ₹ 7,56,000 i.e. 12% of ₹ 63,00,000. The future maintainable profit being ₹ 9,27,500, super profit will be ₹ 1,71,500. There are three methods of calculating goodwill based on super profit which are as under:

(a) (i) Purchase of Super Profit Method

Goodwill as per this method is: Super profit x A certain number of years. Under this method, an important point to note is that the number of years of purchase as goodwill will differ from industry to industry and from firm to firm. Theoretically, the number of years is to be determined with reference to the probability of a new business catching up with an old business. Suppose it is estimated that in four years' time a business, if started de novo, will be earning about the same profits as an old business is earning now, goodwill will be equivalent to four times the super profits. In the example given above, goodwill will be ₹ 6,86,000 i.e., 4 x ₹ 1,71,500.

(ii) Sliding Scale Valuation of Super Profit

This method is a variation of the purchase method. This has been advocated by A.E. Cutforth and is based upon the theory that the greater the amount of super profit, the more difficult it would be to maintain. In this method the super profit is divided into two or three divisions. Each of these is multiplied by a different number of years' purchase, in descending order from the first division. For example, if super profit is estimated at ₹ 2,25,000, goodwill be calculated as follows:

	₹
First ₹ 75,000 say 5 years	3,75,000
Second ₹ 75,000 say 4 years	3,00,000
Third ₹ 75,000 say 3 years	2,25,000
Total goodwill	9,00,000

(b) Annuity Method of Super Profit

Goodwill as per this method is: Super profit x Annuity of Re. 1 at the normal rate of return for the stated number of years. Goodwill in this case is the discounted value of the total amount calculated as per purchase method. The idea behind super profit method is that the amount paid for goodwill will be recouped during the coming few years. But in this case, there is a heavy loss of interest. Hence, properly speaking what should be paid now is only the present value of super profits paid annually at the proper rate of interest. Tables show that the present value @ 12% of Re. 1 received annually for four years is 3.037. In the above illustration, the value of goodwill under this method will be ₹ 5,20,845 i.e. 3.037 x 1,71,500.

(c) Capitalisation of Super Profit

In this method the amount of super profit is capitalised at the normal rate of return. In other words, this method tries to find out the amount of capital needed for earning the super profit. The formula is:

$$\frac{\textbf{Average Annual Super Profit X 100}}{\textbf{Normal Rate of Return}}$$

In the example given above, the value of goodwill will be ₹ 14,29,167 i.e.

$$\frac{₹\ 1{,}71{,}500 \text{ X } 100}{12}$$

There is also another method of capitalisation frequently used. Under this method adjusted average profits are capitalised on the basis of normal rate of return and from such a value, the net assets of the business are substracted to arrive at the value of goodwill.

In the illustration given above, the value of total business will be ₹ 77,29,167 or say ₹ 77,29,200. Therefore goodwill will be 14,29,200, i.e. ₹ 77,29,200 less ₹ 63,00,000.

This method puts a very large value on goodwill. Really it is useful only when the future maintainable profit is less than the normal profit. It then determines the proper value of the firm.

Suppose the total net tangible assets of a company is ₹ 50 lakhs; the normal rate of return in the concerned industry is 14%; and the company earns a profit of ₹ 8,40,000. The total value of the business will be ₹ 60 lakhs, i.e. $\frac{8,40,000 \times 100}{14}$

In that case the goodwill will be ₹ 10 lakhs. The normal profit being ₹ 7,00,000, the super profit will be ₹ 1,40,000; goodwill, therefore, will be more than seven years' purchase. This is too high since it is not expected that super profits will continue for as long as seven years.

Suppose, on the other hand, that the future maintainable profit is ₹ 6,30,000. In that case the total value of business will be ₹ 45 lakhs, i.e., $\frac{16,30,000 \times 100}{14}$

There is naturally no goodwill since the actual profit is less than the normal profit. However, it will be improper to pay ₹ 50 lakhs for the business since then the earning will not be 14%. The proper value of the business is ₹ 45 lakhs.

Illustration 8

A Ltd. proposed to purchase the business carried on by M/s. X & Co. Goodwill for this purpose is agreed to be valued at three years' purchase of the weighted average profits of the past four years. The appropriate weights to be used are:

2010-11	1	2012-13	3
2011-12	2	2013-14	4

The profit for these years are: 2010-11 - ₹ 1,01,000; 2011-12 - ₹ 1,24,000; 2012-13- ₹ 1,00,000 and 2013-14 - ₹ 1,40,000.

On a scrutiny of the accounts the following matters are revealed:

(i) On 1st December, 2012 a major repair was made in respect of the plant incurring ₹ 30,000 which was charged to revenue. The said sum is agreed to be capitalised for goodwill calculation subject to adjustment of depreciation of 10% p.a. on reducing balance method.

(ii) The closing stock for the year 2011-12 was overvalued by ₹ 12,000.

(iii) To cover management cost an annual charge of ₹ 24,000 should be made for the purpose of goodwill valuation.

Compute the value of goodwill of the firm.

Solution:

Calculation of Adjusted Profits

	₹	₹
Profits – 2010-11		1,01,000
Less: Management expenses		24,000
Adjusted Profits - 2010-11		77,000
Profits – 2011-12		1,24,000
Less: Over-valuation of closing stock	12,000	
Management expenses	24,000	36,000
Adjusted Profits – 2011-12		88,000

Profits – 2012-13		1,00,000
Add: Over-valuation of opening stock	12,000	
Major repairs of plant to be treated		
as capital expenditure	30,000	42,000
		1,42,000
Less: Depreciation on capital expenditure		
@ 10% p.a. for 4 months from		
December 1, 2012 to March 31, 2013		
$\frac{30,000 \times 10 \times 4}{100 \times 12}$		1,000
		1,41,000
Less: Management expenses		24,000
Adjusted Profits – 2012-13		1,17,000
Profits – 2013-14		1,40,000
Less: 10% Depreciation on ₹ 29,000 (block value		
₹ 30,000 - ₹ 1,000 - capital expenditure)		2,900
		1,37,100
Less: Management expenses		24,000
Adjusted Profits – 2012-13		**1,13,100**

Calculation of Average Profits

Year ended 31st March	*Profits* ₹	*Weight*	*Product*
2010-11	77,000	1	77,000
2011-12	88,000	2	1,76,000
2012-13	1,17,000	3	3,51,000
2013-14	1,13,100	4	4,52,400
		10	10,56,400

Average Profits = 10,56,400 - 10 = 1,05,640

Goodwill at three years' purchase = ₹ 1,05,640 x 3

= ₹ 3,16,920

Illustration 9

From the following information ascertain the value to goodwill of X Ltd. under super profit method.

Balance Sheet as on 31st March, 2014

Liabilities	₹	*Assets*	₹
Paid-up capital:		Goodwill at cost	50,000
5,000, shares of ₹ 100 each		Land and buildings	
fully paid	5,00,000	at cost	2,20,000
Bank overdraft	1,16,700	Plant and machinery	
Sundry creditors	1,81,000	at cost	2,00,000
Provision for taxation	39,000	Stock in trade	3,00,000
Profit and loss appropriation		Book debts less	
Account	1,13,300	provision for bad	
		debts	1,80,000
	9,50,000		9,50,000

The company commenced operations in 2008 with a paid-up capital of ₹ 5,00,000. Profits for recent years (after taxation) have been as follows:

Year ended 31st March ₹	
2010	40,000 (loss)
2011	88,000
2012	1,03,000
2013	1,16,000
2014	1,30,000

The loss in 2010 occurred due to a prolonged strike.

The income-tax paid so far has been at the average rate of 40%, but it is likely to be 50% from April 2013 onwards. Dividends were distributed at the rate of 10% on the paid up capital in 2011 and 2012 and at the rate of 15% in 2013 and 2014. The market price of shares is ruling at ₹ 125 at the end of the year ended 31st March, 2013. Profits till 2013 have been ascertained after debiting ₹ 40,000 as remuneration to the director. The company has approved a remuneration of ₹ 60,000 with effect from 1st April, 2013. The company has been able to secure a contract at an advantageous price thereby it can save materials worth ₹ 40,000 per annum for the next five years.

Solution:

Valuation of Goodwill of X Ltd.

(i) Capital employed:	₹
Land and building at cost	2,20,000
Plant and machinery at cost	2,00,000
Stock in trade	3,00,000

Sundry debtors		1,80,000
		9,00,000
Less: Sundry liabilities:		
Bank overdraft	1,16,700	
Sundry creditors	1,81,000	
Provision for taxation	39,000	3,36,700
Capital employed at the end of the year		5,63,300
Add back		
Dividend paid for the year	75,000	
Less: Half of the profits	65,000	10,000
Average capital employed		5,73,300

(ii) Normal Rate of Return:

Average dividends for the last 4 years 12.5%Market price of shares on 31st March ₹ 125

Normal rate of return:

Note: It may be more appropriate to relate the normal rate of return to the dividend paid in the last two years since price is related to dividend expected in future and, for that, the most recent experience is relevant.

In that case the normal rate of return will be $\frac{15 \times 100}{125}$ = 12%

(iii) Normal Profit on Average Capital employed:

@ 10% on ₹ 5,73,300 57,330

@ 12% on ₹ 5,73,300 68,796

(iv) Future Maintainable Profits - Weighted Average:

Year ended 31st March	*Profits* ₹	*Weight*	*Product* ₹
2011	88,000	1	88,000
2012	1,03,000	2	2,06,000
2013	1,16,000	3	3,48,000
2014	1,30,000	4	5,20,000
		10	11,62,000

Average annual profit (after tax) 1,16,200

Average annual profit (before tax)	$\frac{1,16,200 \times 100}{60}$	1,93,667
Adjustments		
(i) Increase in remuneration	- 20,000	
(ii) Saving in cost of materials	+40,000	20,000
		2,13,667

Less: Taxation @ 50%	1,06,833
Future maintainable profit	1,06,834

(v) Super Profits

	Normal Rate 12%	**Normal Rate** 10%
	₹	₹
Average maintainable profits	1,06,834	1,06,834
Normal profit on capital employed	68,796	57,330
Super profit	38,038	49,504
Goodwill at 5 years' purchase of super profits	1,90,190	2,47,520
Goodwill at 3 years' purchase	1,14,114	1,48,512

Note: Three to five years' purchase of super profits can be taken as fair value of goodwill. Thus, depending on the assumptions regarding the normal rate of return and the number of years' purchase, goodwill may range between ₹ 1,14,114 and ₹ 2,47,520.

SUMMARY OF VALUATION OF GOODWILL

Methods of Valuing Goodwill:

Average Profits Method, Super Profits Method, Capitalisation Method & Annuity Method.

1. Average Profits Method:

(i) Ascerain Profits of Normal year of the Business Return which shall be adjusted for

(a) Non recurring items *eg*: Profit on sale of Asset

(b) Non Operating items *eg*: Income from Investments

(c) Changes in Business Condition *eg*: Change in Tax rates.

(ii) Computation of Average Profits

Note: Simple Average = For Fluctuating Profits

Weighted Average = For Increasing / Decreasing Profits in a trend.

(iii) Goodwill is Computed as the no. of years purchase of average profits.

Note: No. of years purchase represents the multiplication factor.

2. Super Profits Method:

***Step 1** :* Ascertain Normal Rate of Return (NRR) for the Industry in which the Company whose Goodwill being valued.

***Step 2** :* Compute actual profits - operating profits made by the Company.

***Step 3** :* Compute actual capital employed - Either Terminal Capital employed or Average Capital employed = Opening Capital Employed + Closing Capital 2 (or) = Closing Capital employed - 1/2 the year profit.

(or) = Opening Capital employed + 1/2 the year profit. Capital employed is calculated under two approaches as follows:

(a) *Shareholders Approach* :

Capital employed = Share capital + Reserves & Surplus – Miscellaneous Expenditure

(b) *Longterm funds Approach*

Capital employed = Shareholder funds + Longterm borrowings.

The Capital employed ascertained as above is referred as Liabilities side approach and is to be adjusted for the changes in values of Operating Assets and after excluding non operating Assets. Capital employed can alternatively be calculated under the Assets side Approach as follows:

(a) Value of operating Assets to Business.

(b) Less Outside Liabilities

(c) Capital Employed = (a) - (b)

Step 4 : Compute Normal Profit ie., excess of actual profits (2) over normal profit (4)

Step 5 *:* Compute super profit ie., excess of actual profits (2) over normal profit (4)

Step 6 *:* Goodwill = No. of Years purchase x Super Profits 3. Capitalisation Method

Steps 1,2 and 3 same as in Super profit method.

Step 4 *:* Compute Normal Capital employed.

Normal Capital employed = Actual Profit x 100

Normal rate of Return

Step 5 *:* Goodwill = Excess of Normal Capital employed over Actual Capital Employed.

4. Annuity Method Goodwill under this method calculated by multiplying the Annuity Factor with the Average Profit or Super Profit.

LESSON ROUND-UP

– Principally two basic methods are used for share valuation i.e. net assets basis and earning capacity or yield basis.

– The method relating to net asset basis may be on break-up value method, appraised value method and book-value method.

– Yield basis valuation may take the form of valuation based on rate of return and productivity factor.

– Rate of return refers to the returns which a shareholder earns on his investment which may be classified into rate of dividend and rate of earning.

– The value of a share according to rate of return method is as follows:

$$\text{Value of share} = \frac{\text{Possible rate of dividend}}{\text{Normal rate of dividend}} \times \text{Paid up value per share}$$

– The value of a share based on rate of earnings is as follows:

$$\text{Value of share} = \frac{\text{Rate of earning}}{\text{Normal rate of earning}} \times \text{Paid-up value per share}$$

- The fair value of a share is the average of the value of shares obtained by the net assets method and the one obtained by yield method.
- The fair value of shares can be calculated as follows:

$$\text{Fair value of share} = \frac{\text{Value by net asset method + Value by yield method}}{2}$$

- An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.
- An intangible asset must have: identifiability, control over a resource; and expectation of future economic benefits flowing to the enterprise.
- An intangible asset should be recognised if, and only if: it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and the cost of the asset can be measured reliably.
- If an intangible asset is acquired in exchange for shares or other securities of the reporting enterprise, the asset is recorded at its fair value, or the fair value of the securities issued.
- Internally generated goodwill should not be recognized as an asset.
- The cost of an internally generated intangible asset is the sum of expenditure incurred from the time when the intangible asset first meets the recognition criteria.
- The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life.
- To determine whether an intangible asset is impaired, an enterprise applies Accounting Standard on Impairment of Assets.

SELF-TEST QUESTIONS

(These are meant for re-capitulation only. Answers to these questions are not to be submitted for evaluation)

1. Compute the values of equity shares of companies A and B on the basis of dividend and that of yield on capital employed. The following information is provided:

	Company A	*Company B*
	₹	₹
Profit per year	1,00,000	1,00,000
7½% Preference capital	2,00,000	6,00,000
Equity capital (₹ 100 each)	8,00,000	4,00,000

Assume that all the profits were distributed. Market expectation is 10%.

2. You, as Auditor, are required to fix the 'fair value' of the shares of T Ltd., on 31st March, 2014. The company's position was as follows:

Particulars	*Note No.*	*Amount as at 31st March,2014*	*Amount as at 31st March, 2013*
I. **EQUITY AND LIABILITIES**			
(1) **Shareholders' funds**			

	Note	Amount
(i) Share Capital		
5,000 shares of ₹ 10 each		5,00,000
(j) Resrve and Surplus		
Reserve fund	1	1,50,000
Profit and Loss		5,10,000
(2) **Current Liabilities**		
Accounts payable		48,000
TOTAL		12,08,000
II. **ASSETS**		
(1) **Non Current-Assets**		
(h) Fixed Assets	2	73,000
(i) Non-Current Investment	3	3,35,000
(2) **Current assets**		
Stock in trade		4,50,000
Trade Receivables	4	2,80,000
Cash and Bank Balance		70,000
TOTAL		12,08,000

	Amount in ₹	**Amount in ₹**
Note No. 1		
Profit and Loss:		
Balance from 2012-13	80,000	
Profit for 2012-13	4,30,000	5,10,000
Note No. 2		
Fixed Assets		
Building at cost 80,000		
Furniture at cost	3,000	
	83,000	
Less: Depreciation Reserve	10,000	73,000
Note No. 3		
Investment at Cost:		
G.P. Notes for ₹ 2,00,000	1,80,000	
Indian Gold Loan		
20,000Repayable 2014	2,00,000	
	3,80,000	
Less: Depreciation reserve	45,000	3,35,000

Note No 4

Trade receivables

Books debts considered good	3,00,000	
Less: Bad depts. Reserve	20,000	2,80,000

You are given the following information:

(1) The company's prospects for 2013-14 are equally good.

(2) Its buildings are now worth ₹ 3,50,000.

(3) Public companies doing similar business show a profit earning capacity of 15 per cent on market value of their shares.

(4) Profits for the past three years have shown an increase of ₹ 50,000 annually.

(5) Investments yield 8% net on the book value on the whole.

3. Given below is the Balance Sheet of Imperial Manufacturing Co. Limited:

Particulars	*Note No.*	*Amount ₹ as at 31st March,2014*	*Amount ₹ as at 31st March, 2013*
I. **EQUITY AND LIABILITIES**			
(1) **Shareholders' funds**			
(a) Share Capital			
8,800 shares of ₹ 250 each		22,00,000	
(b) Resrve and Surplus			
Reserve fund		8,24,000	
Profit and Loss		6,12,000	
(2) **Non-current Liabilities**			
Workmen's savings account		2,27,000	
Provident fund account		54,000	
(3) **Current Liabilities**			
Trade Payable		38,86,000	
TOTAL		1,08,03,000	
II. **ASSETS**			
(1) **Non Current-Assets**			
(a) Fixed Assets		29,94,000	
(b) Non-Current Investment		17,00,000	
(c) Other Non-Current Assets	1	25,000	
(2) **Current assets**			
Stck in trade		26,00,000	
Trade Receivables		3,35,000	

Cash and bank balance		31,49,000
TOTAL		1,08,03,000

	Amount in ₹	Amount in ₹
Note no 1		
Fixed Assets		
Land (at cost)	2,21,000	
Building (at cost)	11,73,000	
Machinery etc. (at cost)	20,58,000	
Furniture	5,000	
	34,57,000	
Less: Depreciation fund account	4,63,000	29,94,000

You are given the following information

Depreciation fund is in excess by ₹ 54,000 of the amount of actual depreciation. Find out the intrinsic value of the share.

4. It is provided in the Articles of Association that on the death of a shareholder, his shares shall be purchased by the remaining shareholders at a price to be settled by the Auditors, on the basis of the last balance sheet.

   It is further provided that for this purpose, goodwill was to be of the value of three years' purchase of the average annual profits for the last four years. The last balance sheet is as follows:

Particulars	*Note No.*	*Amount ₹ as at 31st March,2014*	*Amount ₹ as at 31st March, 2013*
1	*2*	*3*	*4*
I. **EQUITY AND LIABILITIES**			
(1) **Shareholders' funds**			
(a) Share Capital			
20,000 shares of ₹ 10 each		2,00,000	
(b) Resrve and Surplus			
Reserve fund		1,00,000	
Profit and Loss		35,000	
(2) **Non-current liabilities**			
Debentures		2,00,000	
(3) **Current liabilities**			
Trade Payable		1,50,000	
TOTAL		6,85,000	
II. **ASSETS**			
(1) **Non current-assets**			

(d) Fixed Assets			1,00,000
(e) Non-current investment		1	1,50,000
(2) **Current assets**			
Stck in trade			2,50,000
Trade Receivables			1,50,000
Cash and bank balance			35,000
TOTAL			6,85,000
	Amount in ₹		
Note No.1			
Investment at cost	1,50,000		
(Market value ₹	1,25,000)		

The profits for the last four years were (after tax) ₹15,000, ₹20,000, ₹25,000 and ₹40,000 respectively.

You are required to state with details of working the price which should be paid per share.

5. What do you mean by intangible asset?
6. Define the term 'useful life' related to intangible asset.
7. What is meant by identifiability of an intangible asset?
8. Whar ate approaches for valuing intangible assets ?
9. How is an intangible asset recognized? How is initial measurement of an intangible asset done?
10. What are the special points you will keep in mind when an intangible asset is acquired as part of an amalgamation?
11. How is an intangible asset dealt with in the following cases :
    (a) acquired by way of a government grant; and
    (b) acquired in an exchange of assets.
12. How will you deal with internally generated intangible assets in the books of account?
13. How does research phase differ from development phase in respect of recognition of an intangible asset?
14. What do you know about ascertainment of cost of an internally generated intangible asset?
15. Which expenditure on an intangible asset is an expense?
16. How is subsequent expenditure on an intangible asset dealt with?
17. What do you know about amortization of an intangible asset?
18. What have you to say in respect of residual value of an intangible asset?
19. (a) During the Year 2013-14, Pragati Ltd. starts developing a new production process. During the year, expenditure incurred was ₹ 20 lakhs, of which ₹ 18 lakhs was incurred before 1st March, 2014 and 2 lakhs was incurred between 1st March, 2014 and 31st March, 2014. The company demonstrated that on 1st March, 2014 the production process met the criteria for recognition as an intangible asset. The recoverable

amount of the know-how embodied in the process (including future cash outflows to complete the process before it was available for use) was estimated to be 10 lakhs.

(i) What is the value of the intangible asset as on 31st March, 2014?

(ii) What amount will be treated as an expense?

(b) Continuing the problem mentioned in part (a) above, suppose during the year ended 31st March, 2014 additional expenditure incurred on the new production process was ₹ 40 lakhs. On 31st March, 2014 the recoverable amount of the know how embodied in the process (including future cash outflows to complete the process before it was available for use) was estimated to be ₹ 38 lakhs.

(i) What is the total cost of the production process on 31st March, 2014?

(ii) What is the impairment loss?

(iii) When can impairment loss be reversed in a subsequent period?

*[**Ans:** (a)(i) 2 lakhs; (ii) ₹ 18 lakhs; (b) (i) 42 lakhs, (ii) 4 lakhs, (iii) The impairment loss will be reserved in a subsequent period if the requirements given in AS-28 on Impairment of Assets are met.]*

20. Brite Lite Ltd. purchases an exclusive right to generate hydro-electric power for fifty years. The costs of generating hydro-electric power are much lower than the costs of obtaining power from alternative sources. It is expected that the geographical area surrounding the power station will demand a significant amount of power from the power station for at least fifty years. What is the period over which the company should amortize the right to generate power? *(**Ans.** 50 years)*

21. Kwik Ltd. purchases an exclusive right to operate a toll motorway for twenty five years. There is no plan to construct alternative routes in the area served by the motorway. It is expected that this motorway will be in use for at least twenty five years. What is the period over which the company should amortize the right to operate the motorway? *(**Ans.** 25 years)*

Lesson 7

Liquidation of Company

LESSON OUTLINE

- Meaning of liquidation of company
- Consequences of winding up of a company
- Preferential creditors
- Preparation of statement of affairs
- Format of statement of affairs
- Liquidator final statement of accounts
- Format of Liquidator's final statement of accounts
- B-List of Contributories
- Lesson Round Up
- Self Test Questions

LEARNING OBJECTIVES

Liquidation (or "winding up") is a process by which a company's existence is brought to an end. First, a liquidator is appointed, either by the shareholders or the court. The liquidator represents the interests of all creditors. The liquidator supervises the liquidation, which involves collecting and realising the company's assets (turning them into cash), discharging the company's liabilities, and distributing any funds left over among the shareholders in accordance with the provisions of Companies Act, 1956 .The objective of this lesson is to make students aware about the accounting provisions relating to liquidation of companies. After studying this lesson, one should be able to

- Understand the meaning of liquidation and liquidation process
- Understand the provisions relating to prepare the statement of affairs at the time of liquidation of company.
- Understand the legal provisions relation to distribution of funds by liquidator
- Understand the meaning of B-List of contributories

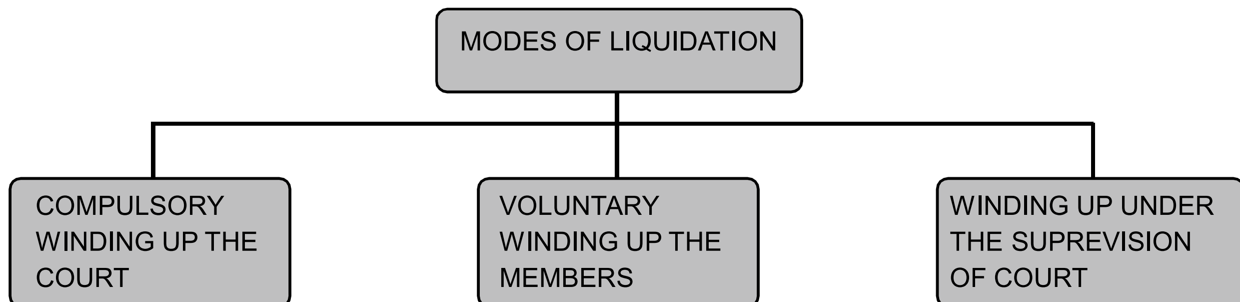
The process whereby the life of a company is ended and its property is administered for the benefit of its creditors & members is called liquidation

MEANING OF LIQUIDATION OF A COMPANY

Liquidation or winding up is a Legal term and refers to the procedure through which the affairs of the company are wound up by law.

Winding up of a company has been defined in the Companies Act 1956 as "The process whereby its life is ended and its property is administered for the benefit of its creditors & members". An Administrator called the Liquidator is appointed and he takes control of the company, collects its assets, pays its debts & finally distributes any surplus among the members in accordance with their rights.

Section 425 (1) of the companies act provides that a company can be liquidated in any of the following three ways:



Generally the provisions of the Act with respect to the winding up apply to winding up of a company whether it be by the court or voluntary or subject to the supervision of the court [Section 425 (2)]

CONSEQUENCES OF WINDING UP

The following are the consequences of winding up:

1. An officer called a liquidator is appointed & he takes over the administration of the company. He may be appointed by High Court, members or by the creditors as the case may be.
2. The powers of the board of directors will cease & will now vest the liquidator.
3. Winding up order or resolution of voluntary winding up shall operate as a notice of discharge to all the members of the company. Members of company are called '**Contributories**'.
4. Liquidator of the company will prepare a list of contributories who be made liable to contribute to the assets of the company in case assets are not sufficient to meet the claims of various claimants. In case there is a surplus in the assets, the liquidator of the company will prepare a list of those members, who are entitled to share this surplus.
5. Liquidator of the company will collect & realise its assets & distribute the proceeds among right claimants as per the procedure of the law.
6. Winding up ultimately leads to dissolution of the company. The company's life will come to an end & it will be no more an artificial person in the eyes of law.

CONTRIBUTORY

According to section 428 of the Companies Act, 1956, a contributory is "every person liable to contribute to the assets of a company in the event of it being wound up & includes a holder of fully paid up shares, & also any person alleged to be contributory "

A Contributory can be either a present member or a past member.

FRAUDULENT PREFERENCE

Fraudulent preference takes place when one creditor is preferred to another creditor in the matter of payment of his dues. It has been made in the provisions of section 531 that every transfer of property or money made within 6 months before the commencement of winding up which amounts to fraudulent preference is invalid.

VOLUNTARY TRANSFER

All voluntary transfers made by the company within a period of one year or before the presentation or petition for winding up or the passing of a resolution for voluntary winding up, are void as against the liquidator.

EMPLOYEES & OFFICERS

According to section 444, a winding up order operates as a notice of discharge to the employees & officers of the company, except when the business of the company is being continue.

INTEREST ON LIABILITIES

Interest on liabilities is payable upto the date of actual payment if the company is solvent. But if the company is insolvent, interest on liabilities is payable upto the date of commencement of insolvency proceedings.

ORDER OF PAYMENT

The amount received from the assets not specifically pledged & the amounts contributed by the contributories must be distributed by the liquidator in the following order:

1. Expenses of winding up including the liquidators remuneration
2. Creditors secured by the floating charge on the assets of the company
3. Preferential creditors
4. Unsecured creditors
5. The surplus, if any, amongst the contributories (i.e. preference shareholders & equity shareholders) according to their respective rights & interests.

PREFERENCE SHAREHOLDERS

Preference shareholders get the priority over the equity shareholders as regards the payment of their capital & the dividend payable upto the ate of winding up. The holders of cumulative preference shares are entitled to arrears of dividend if there is a surplus after the return of the amount of the equity shareholders or if the Articles state that arrears of preference dividend are to be paid before anything is paid to equity shareholders.

EQUITY SHAREHOLDERS

Any surplus left after making payment to preference shareholders is distributed among the equity shareholders if all the shares are equally paid up. But if the shares are called in unequal proportions, the liquidator should see that the capital contribution by the shareholders should be the same.

It may be remembered that calls in advance will have priority in repayment over the paid up share capital of that class.

PREFERENTIAL CREDITORS

Under Section 530 of the Companies Act , the following creditors are treated as preferential creditors:

1. All revenues, taxes, cesses & rates payable to the government or local authority will be treated as preferential creditors provided that it must become due within 12 months before the date of winding up.
2. 4 months salary & wages due to the employees of the company will be treated as preferential provided that it must become due within 12 months before the date of winding up. Maximum of ₹ 20000 will be treated as preferential creditors.

All accrued holiday remuneration payable to an employee due to termination of his employment is treated as preferential

The person who advances money for making the payment under (ii) & (iii) mentioned above will be treated as preferential.

1. Any sum payable by the company under the Employees State Insurance Act, 1948 will be treated as preferential provided that it must become due within 12 months before the date of winding up.
2. Compensation payable by the company under Workmen Compensation Act, 1923 is treated as preferential.
3. Any sum payable by the company to its employees from a Providend Fund, Pension Fund, Gratuity Fund or any other fund maintained foe the welfare of the employees.
4. The expenses of investigation held Under Section 235 or 237 will be treated as preferential.

PREPARATION OF THE STATEMENT OF AFFAIRS

The officers and directors of a company under liquidation must, according to section 454 read with section 511A, make out and submit, within 21 days of the Tribunal order (or within such extended time, not exceeding three months, as the liquidator or the Tribunal may allow), a statement showing the following

(a) The assets of the company, stating separately the cash balance in hand and at bank, if any, and the negotiable securities, if any, held by the company;

(b) Its debts and liabilities;

(c) The names, residences and occupations of its creditors, stating separately the amount of secured and unsecured debts and in the case of secured debts, particulars of the securities given, whether by company or its officers, their value and dates on which they were given;

(d) The debt due to the company and the names, residences and occupations of the persons from whom the amount likely to be realised on account thereof;

(e) Such further or other information as may be prescribed, or as the official liquidator may require.

The statement has to be prepared even in case of voluntary winding up.

The statement has to be properly verified by an affidavit. It has to be open for inspection by any person stating himself in writing to be creditors or contributory of the company, on payment of prescribed fee. The person concerned can also acquire a copy or extract from it. The form in which it*has to be made out has been prescribed by the Supreme Court. The suggested format is given below ;

FORMAT OF STATEMENT OF AFFAIRS

FORM NO. 57

[See Rule 127]

In the High Court at............. (Or) in the District Court at.............

Original Jurisdiction............. In the matter of Companies Act, 1956

In the matter of .... LTD.

Company Petition No.... of 20.....

Statement of affairs under section 454

Statement of affairs of the above named company as on the............. day of... 20 ... the date of the winding up order *[or* the order appointing Provisional Liquidator or the date directed by the Official Liquidator].

I/We .... of .... do solemnly affirm and say that the statement made overleaf and the several lists hereunto annexed marked 'A' to T are to the best of my/our knowledge and belief a full. true and complete statement as to the affairs of the above named company, on the day of .... 20 ... the date of the winding up order *[or* the order appointing Provisional Liquidator or the date directed by the Official Liquidator]. and that the said company carries/carried on the following business:

(*Here set out nature of company's business*).

Signature(s)

Solemnly affirmed at ...... this .... day of .... 20. Before me.

Commissioner for Oaths

The Commissioner is particularly requested. before swearing the affidavit. to ascertain that the full name, address and description of the deponent are stated. and to initial any crossings out or other alterations in the printed form. A deficiency in the affidavit in any of the above respects will entail its refusal by the Court. and will necessitate its being re sworn.

Note: The several lists annexed are not exhibits to the affidavit.

STATEMENT OF AFFAIRS AND LISTS TO BE ANNEXED

Statement as to the affairs of.... Ltd .• on the ...... day of... 20 , being the date of the winding up order *[or* order appointing Provisional Liquidator *or* the date directed by the Official Liquidator as the case may be] showing assets at estimated realisable values and liabilities expected to rank :

Assets not specifically pledged (as per List 'A ')

		Estimated realisable values
		₹
Balance at bank Cash in hand	....	
Marketable Securities	....	
Bills Receivable	....	
Trade Debtors	....	
Loans and Advances Unpaid Calls	....	
Stock in Trade	....	
Work in progress	....	
....	....	
....	....	
....	....	

Freehold property. Land & Buildings	....	....	....	....	....	....
Leasehold property	....	....	....	....	....	....
Plant & Machinery	....	....	....	....	....	....
Furniture. Fittings. Utensils. etc.	....	....	....	....	....	....
Investments other than marketable securities	....	....	....	....	....	....
Livestock	....	....	....	....	....	....
Other property.etc.	....	....	....	....	....	....
....	....	....	....	....	....	....
....	....	....	....	....	....	....

Asset specifically Pledged (as per list 'B')	***(a) Estimated realisable values*** ₹	***(b) Due to Secured Creditors*** ₹	***(c) Deficiency ranking as unsecured*** ₹	***(d) Surplus carried to last column*** ₹
....				
....				
₹				

Estimated surplus from assets specifically pledged ....

Estimated total assets available for preferential creditors, debenture holders secured by a floating charge, and unsecured creditors (carried forward) ....

	₹
Summary of Gross Assets	(d)
Gross realisable value of assets specifically pledged	
Other assets — — — —	
Gross Assets ₹	

Estimated total assets available for preferential creditors, debenture holders secured by a floating charge, and unsecured creditors] (brought forward).

Liabilities

(e)

Gross Liabilities (to be deducted from surplus or added to deficiency as the case may be).

Secured creditors (as per List 'B') to extent to which claims are estimated to be covered by assets specifically pledged [item *(a)* or *(b)* on preceding page, whichever is the less][Insert in 'Gross Liabilities' column only]Preferential creditors (as per List 'C')

Estimated balance of assets available for debenture holders secured by a floating charge and unsecured creditors

Debenture holders secured by a floating charge (as per list 'D')

Estimated Surplus/Deficiency as regards Debenture holders

Unsecured creditors (as per list 'E')

"Estimated unsecured balance of claims of creditors partly secured on specified assets, brought from preceding page (C)

Trade Accounts

Bills Payable

Outstanding Expenses

....

....

Contingent liabilities (state nature)

Estimated Surplus/Deficiency as regards creditors] [being difference between Gross Assets broughtfrom preceeding page *(d)* andGross Liabilities as per column *(e)]*Issued and Called up Capital:

.... preference shares of .... each

₹...................... Called up (as per List 'F')

.... equity shares of………………….. each

₹..................... Called up (as per List 'G')

Estimated Surplus/Deficiency as regards Members] (as per List 'H')

Lists A to G containing details of assets and liabilities and supplementary schedules are not given. Their contents is as given below

1. List A gives a complete list of assets which are not in the hands of or pledged in favour of secured creditors
2. List B gives the details of assets which are specifically pledged with creditors both fully secured and partly secured
3. List C is a list of preferential creditors and the amount due
4. List D is the details of debenture holders having a floating charge
5. List E contains names of unsecured creditors and the amount due
6. List F gives the details and holding of preference shareholders
7. List G is a list of equity shareholders together with the amount of shares held

List H is a statement showing how the surplus or deficiency in the statement of affairs arose as a result of profits and losses of the given.

Illustration No. 1

The following information is extracted from books of Mehsana Limited on 31st July, 2012 on which date a winding up order was made.

Unsecured creditors	3,50,000
Salaries due for five months	20,000
Managing director's remuneration	30,000
Bills payable	1,06,000
Debtors — good	4,30,000
doubtful (estimated to produce rs. 62,000)	1,30,000
— bad	88,000
Bills receivable (good ₹ 10,000)	16,000
Bank overdraft	40,000
Land (estimated to produce ₹5,00,000)	3,60,000
Stock (estimated to produce ₹5,80,000)	8,20,000
Furniture and fixtures	80,000
Cash in hand	4,000
Estimated liability for bills discounted	60,000
Secured creditors holding first mortgage on land	4,00,000
Partly secured creditors holding second mortgage on land	2,00,000
Weekly wages unpaid	6,000
Liabilities under workmen's compensation Act,1925	2,000
Income tax due	8,000
5000 9% Mortgage debentures of 100 each interest payable to 30th June and 31st December, paid 30th June, 2012	5,00,000
Share capital :	
20,000 10% preference share s of ₹ 10 each	2,00,000
50,000 Equity shares of ₹ 10 each	5,00,000
General reserve since 31st December, 2004	1,00,000

In 2009, the company earned profit of ₹ 4, 50,000 but thereafter it suffered trading losses totaling ₹ 5,84,000. The company also suffered a speculation loss of ₹ 50,000 during the year 2010. Excise authorities imposed a penalty of ₹ 3,50,000 in 2011 for evasion of tax which was paid in 2012.

From the foregoing information, prepare the Statement of Affairs and the Deficiency Account.

Solution

Unsecured Creditors as per List E :	**₹**
Unsecured creditors	3,50,000
One month's Salaries (4 month' salaries are preferential)	4,000
Managing Director's Remuneration	30,000
Bills Payabl	1,06,000

Bank Overdraft	40,000
Liability on Bills Discounted	60,000
Amount uncovered in respect of partly secured creditors (₹ 2,00,000 – ₹ 1,00,000 value of security of second mortgage on land)	1,00,000
	6,90,000

Preferential creditors as per List C:	₹
Salaries for 4 months	16,000
Weekly wages	6,000
Liabilities under Workmen's Compensation Act, 1925	2,000
Income Tax due	8 ,000
	32,000

LUCKY LTD (IN LIQUIDATION)

STATEMENT OF AFFAIRS

As on July, 2008

				Estimated realisable value
Assets				
Assets not specifically pledged (as per list A)				
Cash in hand				4,000
Bills Receivable				10,000
Trade Debtors				4,92,000
Stock				5,80,000
Furniture and Fixtures				80,000
Assets specifically pledged (as per List B estimated				
Estimated realisable value	Due to secured creditors	Deficiency ranking as unsecured	Surplus carried to last column	
₹	₹	₹	₹	
Land	5,00,000	6,00,000	1,00,000	
Estimated total assets available for preferential creditors, debenture holders secured by a floating charge and unsecured creditors				11,66,000

Summary of Gross Assets:	₹
Specifically pledged	5,00,000
Others	11,66,000
	16,66,000

Gross Liabilities ₹	Liabilities (to be deducted from surplus or added to deficiency as the case may be)		
	Estimated total assets available for Preferential Creditors, Debenture Holders secured by floating charge and other creditors carried forward		11,66,000
5,20,000	Secured creditors (as per list B) to the extent to which claims are estimated to be covered by assets specifically pledged		
32,000	Preferential Creditors (as per list C)		32,000
	Estimated balance of assets available for debenture holders secured by a floating charge and unsecured creditors		11,34,000
5,00,000	Debenture holders secured by a floating charge (as per list D)	5,00,000	
3,750	Interest due for 1 month (july, 2010) @ 9% p.a.	3,750	5,03,750
	Estimated surplus as regards debenture holders		6,30,250
6,90,000	Unsecured creditors (as per list E)		6,90,000
------------ 17,25,750	Estimated deficiency as regards creditors, being the difference between gross liabilities and gross assets		59,750
	Issued and called up capital:		
	20,000 10% Preference shares of ₹ 10 each fully paid (as per list F)		2,00,000
	50,000 equity shares of ₹ 10 each fully paid (as per list G)		5,00,000
	Estimated Deficiency as regards contributories (as per list H)		7,59,750

DEFICIENCY ACCOUNT (LIST H)

Particulars	Amount	Particulars		Amount
TO EXCESS OF ASSET OVER CAPITAL	1,00,000	BY NET TRADING LOSSES AFTER DEPRICIATION , TAXATION ETC		5,87,750
TO NET TRADING ASSSET	4,50,.000			
TO PROFITS AND INCOME OTHER THAN TRADING PROFITS	1,40,000	BY LOSSES OTHER THAN TRADING LOSSES		
TO DEFICENCY	7,59,750	SEPECULATION LOSS	50,000	
		PENALTY IMPOSED BY EXISCE AUTORITIES	3,50,000	4,00,000

		BY ASTIMATED LOSSES NOW WRITTEN OFF		
		B/R	6,000	
		DEBTORS	1,56,000	
		STOCK	2,40,000	
		CONTIGENT LIABILTY	60,000	4,62,000
	14,49,750			14,49,750

LIQUIDQTORS FINAL STATEMENT OF ACCOUNTS

The main job of the liquidator is to collect the assets of the company & realise them & distribute the money realised among right claimants. For this purpose he maintains a cash book for recording the receipts & payments & is required to submit an abstract of the cash book to the court in case of compulsory winding up & to the company in case of voluntary winding up. The liquidator is also required to prepare an account known as the Liquidator's Final Statement of accounts after the affairs of the company are fully wound up.

FORMAT OF LIQIDATOR'S FINAL STATEMENT OF ACCOUNT

Receipts	Amount	Payments	Amount
To Assets Realised :-		By Legal Charges	
– Cash at Bank		By Liquidation Expenses	
– Cash in Hand		By Liquidator Remuneration	
– Marketable Securities		By Preferential Creditors	
– Bills Receivable		By Debenture-holders (having	
– Trade Debtors		a floating charge on the	
– Stock in trade		assets of the co.)	
– Freehold property		By Unsecured Creditors	
– Plant and Machinery		By Preference Shareholders	
– Furniture and Fittings		By Equity Shareholders	
To Surplus from Securities held by Secured Creditors			
To Proceeds of calls made on contributories			

Illustration No. 2

The position of Valueless Ltd. on its liquidation is as under:

Issued and paid up Capital:

5,000 10% preference shares of ₹ 100 each fully paid.

7,000 Equity shares of ₹ 100 each fully paid.

6,000 Equity shares of ₹ 50 each ₹ 30 per share paid.

Calls in Arrears are ₹ 20,000 and Calls received in Advance ₹ 17,000. Preference Dividends are in arrears for one year. Amount left with the liquidator after discharging all liabilities is ₹ 8,27,000. Articles of Association of the company provide for payment of preference dividend arrears in priority to return of equity capital. You are required to prepare the Liquidators final statement of account.

Solution

LIQUIDATOR FINAL STATEMENT OF ACCOUNT

Receipt	***Amount in ₹***	***Payment***	***Amount in ₹***
Cash	8,27,000	Calls in advance	17,000
Realisation from calls in arrears	20,000	Preference dividend	50,000
		Preference shareholders	5,00,000
		Equity share holders of Rs 100 each (₹ 40 per share)	2,80,000
	8,47,000		8,47,000

Working Note

		₹
Cash account balance		8,27,000
Less: Payment for dividend	50,000	
Preference shareholders	5,00,000	
Calls in advance	17,000	5,67,000
		2,60,000
Add: Calls in arrears		20,000
		2,80,000
Add: Amount to be received from equity shareholders of ₹ 50 each (6,000 X 20)		1,20,000
Amount disposable		4,00,000

Number of equivalent equity shares:

7,000 shares of ₹ 100 each = 14,000 shares of ₹ 50 each

6,000 shares of ₹ 50 each = 6,000 shares of ₹ 50 each

= 20,000 shares of ₹ 50 each

Final payment to equity shareholders = $\frac{\text{Total number of equivalent equity shares}}{\text{Amount left for distribution}}$

= ₹ 4,00,000 / 20,000 shares

= ₹ 20 per share to equity shareholders of ₹ 50 each.

Therefore for equity shareholders of ₹ 100 each , the amount payable would be

= ₹ 40 per share.

Calls in advance would be paid first for paying the shareholders on prorata basis. Equity shareholders of ₹ 50 each have to pay ₹ 20 and receive ₹ 20 each. As a result, they would be getting nothing in return.

B-List Contributories

On the appointment of Liquidator, director's position will stand automatically vacated and the shareholders will be referred to as contributories. Shareholders who have transferred that partly paid shares within one year earlier to date of winding up will be placed in "B" List. Such contributories will be referred to as "B" List of contributories. Liquidator is expected to dispose the assets off to pay off liabilities. In case the disposal of assets was not sufficient to discharge the liabilities, then the liquidator can claim from "A" List of contributories towards their unpaid capital towards the company. If "A" List of contributories are not meeting the liabilities, then liquidator can fall upon "B" List of contributories to recover money towards unpaid portion of the capital. The liquidator can fall upon only against transfer of partly paid shares effected during within one year earlier to the date of winding up and transmission of shares will not come under this purview. If there were to be more than one such contributories, then the liability will be fixed against that many contributories in the ratio in which they are expected to contribute towards the capital. In no case, such fixation of liabilities can exceed the statutory liability (towards unpaid capital).

Illustration No. 3

Z limited has gone into liquidation on 10th may, 2012. The details of members, who have ceased to be member within one year 'B' contributories, are given below. The debts that could not be paid out of realization of assets and contribution from present members ('A' contributories) are also given their date-wise break up. Shares are of ₹ 10 each and ₹ 6 are paid up.

Shareholders	*No of shares transferred*	*Date of transfer*	*Proportionate unpaid debts*
			₹
X	1000	20-04-2011	3000
Y	1200	15-05-2011	5000
Z	1500	18-09-2011	9200
W	800	24-12-2011	10500
M	500	12-03-2012	11000

Determine the amount realisable from each person.

Solution

X has ceased to be members more than a year ago from the date of winding up; hence he is not liable as a contributory. The under given table clears the position of each one's liability

Statement of liability of B list contributories

Creditors outstanding on date ceasing to be member	*Q 1200 shares*	*R 1500 shares*	*S 800 shares*	*T 500 shares*	*Amount to be paid to creditors*
	₹	₹	₹	₹	₹
(1) 5000	1500	1875	1000	625	5000
(2) 4,200		2250	1200	750	4200
(3) 1,300			800	500	1300
(4) 500				500	125
Total(a)	1500	4125	3000	2375	10625
Maximum liability on	4800	6000	3200	2000	

shares held @ 4 per share				
(C) Amount to be paid, (a) or (b) whichever is less	1500	4125	3000	2000

LESSONS ROUND UP

– Liquidation or winding up is a Legal term and refers to the procedure through which the affairs of the company are wound up by law.

– As per Section 425 (1) of the Companies Act, a company can be liquidated in any of the following three ways:

1. Compulsory winding up the court
2. Voluntary winding up the members
3. Winding up under the supervision of court

– On winding up of a company an officer called a liquidator is appointed & he takes over the administration of the company. He may be appointed by High Court, members or by the creditors as the case may be. The powers of the board of directors will cease & will now vest the liquidator.

– The Liquidator of the company make the payment from amount received from the assets not specifically pledged & the amounts contributed by the contributories in the following order:

(a) Expenses of winding up including the liquidators remuneration

(b) Creditors secured by the floating charge on the assets of the company

(c) Preferential creditors

(d) Unsecured creditors

The surplus, if any, amongst the contributories (i.e. preference shareholders & equity shareholders) according to their respective rights & interests.

– As per Section 530 of the Companies Act , All revenues, taxes, cesses & rates payable to the government or local authority due within 12 months before the date of winding up & 4 months salary & wages due to the employees of the company due within 12 months before the date of winding up is treated as preferential creditors for the purpose of payment . All accrued holiday remuneration payable to an employee due to termination of his employment is treated as preferential

– The officers and directors of a company under liquidation must submit a statement of affairs within 21 days of the Tribunal order showing the assets of the company, Its debts and liabilities, the names, residences and occupations of its creditors, stating separately the amount of secured and unsecured debts and in the case of secured debts, particulars of the securities given, whether by company or its officers, their value and dates on which they were given, the debt due to the company and the names, residences and occupations of the persons from whom the amount likely to be realised on account thereof and such further or other information as may be prescribed, or as the official liquidator may require.

– The liquidator of a company is required to prepare an account known as the Liquidator's Final Statement of accounts after the affairs of the company are fully wound up. In this accounts, the details of amount received from realisation of assets and amount paid to different parties is given.

– in case of liquidation of companies, the parties who have transferred that partly paid shares within one

year earlier to date of winding up are called "B" List contributories and in case the If "A" List of contributories are not meeting the liabilities, then liquidator can fall upon "B" List of contributories to recover money towards unpaid portion of the capital

SELF TEST QUESTIONS

1. What is meant by liquidation or winding up of a joint stock company?
2. Enumerate the grounds on which a company may be wound up by the court.
3. Distinguish between :-
   (i) Compulsory winding up and Voluntary winding up.
   (ii) Member's voluntary winding up and creditors' voluntary winding up.
4. Enumerate preferential payments in case of winding up of a joint stock company
5. Distinguish between statement of Affairs and Deficiency/surplus Account prepared on winding up of a company.
6. What do you understand by liquidator's final statement of account?
7. Who is Receiver for Debenture holders in winding up of a company?
8. What is meant by ₹B' List of contributories? What is the liability of contributories included in this list?
9. The following particulars relate to Kamakhya Limited which has gone into voluntary liquidation.

   Share capital issued:

   10,000 Preference shares of ₹100 each fully paid up.

   50,000 Equity shares of ₹10 each fully paid up.

   30,000 Equity shares of ₹10 each, ₹8 paid up.

   Assets realized ₹20,00,000 excluding the amount realized by sale of securities held by partly secured creditors.

	₹
Preferential creditors	50,000
Unsecured creditors	18,00,000
Partly secured creditors (Assets realized ₹3,20,000)	3,50,000
Debenture holders having floating charge on all assets of the company	6,00,000
Expenses of liquidation	10,000

   A call of ₹2 per share on the partly paid equity shares was duly received except in case of one shareholder owning 1,000 shares.

   Prepare the Liquidator's Statement of Account allowing for his remuneration @ 2½% on all assets realized excluding call money received and 2% on the amount paid to unsecured creditors including preferential creditors. Also calculate the percentage of amount paid to the unsecured creditors to the total unsecured

10. The position of Vinayaka Ltd. on its liquidation is as under:

   Issued and paid up Capital:

3,000 10% preference shares of ₹ 100 each fully paid.

3,000 Equity shares of ₹ 100 each fully paid.

1,000 Equity shares of ₹ 50 each ₹ 30 per share paid.

Calls in Arrears are ₹ 10,000 and Calls received in Advance ₹ 5,000. Preference Dividends are in arrears for one year. Amount left with the liquidator after discharging all liabilities is ₹ 4,13,000. Articles of Association of the company provide for payment of preference dividend arrears in priority to return of equity capital. You are required to prepare the Liquidators final statement of account.

11. Following is the details given in connection of winding up of Aaradhya limited. In a winding up of the company, certain creditors remained unpaid. The following persons had transferred their holding sometime before winding up :

Name	**Date of Transfer**	**No. of Shares**	**Amount due to creditors transferred on the date of transfer**
	2011		**₹**
P	January 1	1,000	7,500
Q	February	15 400	12,500
S	March 15	700	18,000
T	March 31	900	21,000
U	April 5	1,000	30,000

The shares were of ₹ 100 each, ₹ 80 being called up and paid up on the date of transfers.

A member, R, who held 200 shares died on 28th February, 2011 when the amount due to creditors was ₹ 15,000. His shares were transmitted to his son X. Z was the transferee of shares held by T. Z paid ₹ 20 per share as calls in advance immediately on becoming a member.

The liquidation of the company commenced on 1st February, 2012 when the liquidator made a call on the present and the past contributories to pay the amount. You are asked to quantify the maximum liability of the transferors of shares mentioned in the above table, when the transferees :

(i) pay the amount due as "present" member contributories;

(ii) do not pay the amount due as "present" member contributories.

Also quantity the liability of X to whom shares were transmitted on the demise of his father R.

12. Shri A.B. Govindan is appointed liquidator of a company in voluntary liquidation on 1st Julv, 2001 and the following balances are extracted from the books on that date : –

	₹		₹
Capital:		Machinery	30,000
8,000 shares of ₹ 10 each	80,000	Leasehold Properties	40,000
Debentures	50,000	Stock-in-trade	1,000
Bank Overdraft	18,000	Book Debts	60,000
Liabilities for Purchases	20,000	Investments	6,000
Provision for Bad Debts	10,000	Calls in arrear	5,000

		Cash in hand	1,000
		Profit and Loss Account	35,000
	1,78,000		1,78,000

Prepare a statement of affairs to be submitted to the meeting of the creditors. The machinery is valued at ₹ 60,000, the Leasehold Properties at ₹ 73,000, investments at ₹ 4,000, Stock in Trade at ₹ 2,000; bad debts are ₹ 2,000, doubtful debts are ₹ 4,000 estimated to realise ₹ 2,000. The Bank Overdrafts is secured by deposit of title deeds of Leasehold Properties. Preferential creditors for taxes and wages are ₹ 1,000. Telephone rent owing is ₹ 80.

13. The following particulars relate to a limited company which has gone into voluntary liquidation. You are required to prepare the Liquidator's Final Account, allowing for his remuneration @ 2% on the amount realised, and 2% on the amount distributed among unsecured creditors other than preferential creditors :

	₹
Preferential Creditors	10,000
Unsecured Creditors ….. …………………………………..……	32,000
Debentures ………………………………………………………..	10,000

The assets realised the following sums:

Land and Buildings..	20,000
Plant and Machinery	18,650
Fixtures and Fittings …..............................	1,000

The liquidation expenses amounted to ₹ 1,000.

14. The books of A Ltd. at 31st March, 2012 contained the following balances :

	₹		₹
Share Capital:		Plant & Machinery	60,000
20,000 shares of ₹ 10 each	2,00,000	Stock	40,000
Sundry Creditors	1,50,000	Patent Rights & Trade Marks	1,60,000
		Sundry Debtors	60,000
		Cash	250
		Preliminary Expenses	5,000
		Profit & Loss Account	24,750
	3,50,000		3,50,000

The following scheme of reconstruction was submitted to the shareholders and creditors: –

The company to go into voluntary liquidation and a new company, with a nominal capital of ₹ 4,00,000, to be formed to take over all the assets from the liquidator on the following terms: –

(a) Preferential creditors for ₹ 5,000 to be paid in full.

(b) Unsecured creditors to have the option of receiving cash to the extent of 50% in full settlement of their claims or par value in 14% Debentures in the new company.

(c) 20,000 shares of ₹ 10 each, ₹ 5 per share paid up, to be distributed pro rata to shareholders of the old company.

(d) The new company to pay the costs of liquidation.

One-half of the unsecured creditors exercised their option to be paid in cash, and the funds for this and for payment of the liquidation expenses (which amounted to ₹ 3,000) were obtained by calling up the balance of ₹ 5 per share.

Three shareholders holding 1,500 shares dissented, and required their interests to be purchased. The price of ₹ 3 was agreed and was paid to the liquidator by one of the assenting shareholders in return for the transfer of such shares.

Lesson 8

Corporate Financial Reporting

LESSON OUTLINE

- Concept of Corporate Financial Reporting
- Various Requirements of Corporate Reporting
- Management Discussion Analysis
- Disclosure on Notes to Accounts
- Value Added Statements and its Advantages
- Extracts of Value Added Statements
- Economic Value Added (EVA) and its Advantages
- Market Value Added and its advantages
- Shareholders' Value Added and its Advantages

LEARNING OBJECTIVES

Corporate financial reporting is a series of activities that allows companies to record operating data and report accurate financial statement at a periodic intervals. The scope of corporate financial reporting is not confined to report the financial results but it is something more. In tune of changes in the regulatory framework and economic environment, the face of corporate financial reporting has also changed. Today, it is difficult to separate corporate financial reporting from corporate governance. There are two reasons for this. First, shareholders have the right to receive information timely on the economic consequences of transactions entered into by the company and other events on the financial position and performance of the company.

In this lesson various requirement of corporate financial reporting has been discussed. After going through this lesson, the student will able to understand :

- Various Requirements of Corporate Financial Reporting as per existing regulatory framework.
- Meaning of Value Added Statement and its application.
- Meaning of Economic Value Added and its applications.
- Meaning of Market Value Added and its applications.
- Meaning of Shareholder's Value Added and its applications.

Financial reporting includes not only financial statements but also non financial disclosures such as Management Discussion Analysis, Director's Report etc.

INTRODUCTION

Corporate financial reporting is a series of activities that allows companies to record operating data and report accurate financial statements at periodic interval i.e. the end of each quarter, accounting year. Understandings of the conceptual bases of the corporate financing reporting system and preparation of financial statements are essential for a Company Secretary.

Concept of Corporate Financial Reporting

Accounting is a process to identify measure and communicate economic information to permit informed judgments and decisions by the user of the information. Its function is to provide quantitative information, primarily financial in name, about economic entities, that is intended to be useful in making economic decisions and related choice among alternative course of action. Financial reporting may be defined as communication of published financial statement and related information from a business enterprise to all users. It is the reporting of accounting information of an entity to a user or group of users. It contains booth qualitative and quantitative information.

The Financial report made to the management is generally known as internal reporting, while financial reporting made to the shareholder investors/management is known as external reporting. The internal reporting is a part of management information system and the uses MIS reporting for the purpose of analysis and as an aid in decision making process.

The management of a corporate is ultimately responsible for the generation of accounting information. The accountability of a company has two distinct aspects – legal and social. Under legal requirements a company has to supply certain information to the various users through annual reports and under the social obligation, a company has to provide additional information to various user groups

Various Requirements of Corporate Reporting in India

In accounting, Corporate Reporting is a very hot topic now days. Various statues have prescribed certain statements to be disclosed periodically by a corporate entity. The purpose of such mandate is to convey a true and fair view of the operating results and financial position to the users of financial reports. Within a corporate context, financial reporting covers four types of accounting data sets. These include a balance sheet, a statement of profit and loss, a statement of cash flows

Balance Sheet

A corporate balance sheet is also known as a statement of financial condition or statement of financial position. It provides information about a company's assets, liabilities and equity capital. Assets are economic resources that a company owns. Liabilities are debts an organization must repay. Equity capital represents funds that financial market participants invest in a company.

Statement of Profit and Loss (Income Statement)

An organization's income statement is an important report on which investors, financial analysts and corporate business partners rely to estimate a company's economic health. This statement provides data on a firm's expenses and revenues, indicating whether the firm is profitable or not.

Cash Flow Statement

A cash flow statement indicates liquidity movements within a company's operations. This report gives the details of the company's cash payments and receipts over a period of time. The statement indicates (in this order): cash flows from operating activities, cash flows from investing activities and cash flows from financing activities.

Beside the above three statement a company needs to disclose various other information/statements which are discussed herein

Director's Report

The report of the Board of Directors must be attached to every balance sheet presented at the annual general meeting. The report must contain information regarding the following matters

1. The state of affairs of the company, Review of its operating information.
2. The amount, if any, which it proposes to carry to any reserves in such balance sheet
3. The amount of dividend recommended
4. Details of any 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 balance sheet relates and the date of the report, conservation of energy, technology absorption, foreign exchange earnings and outgo.
5. Director's responsibility statement that directors confirms the adoption of applicable accounting standards, use of prudent accounting policies in preparation of financial statement, use of utmost care in preparing financial statement and safeguarding the assets of company and preparation of accounts on a going concern basis.
6. Management discussion and analysis report (discussed separately)
7. Corporate governance report
8. Details necessary for a proper understanding of the state of the company's affairs and which are not, in the Board's opinion, harmful to the business of the company or of any of its subsidiaries, in respect of changes which have occurred during the financial year in the nature of company's business, in the company's subsidiaries or in the nature of the business carried on by them and generally in the classes of business in which the company has an interest.

DISCLOSURE OF SIGNIFICANT ACCOUNTING POLICIES

To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed. Such disclosure should form part of the financial statements. It would be helpful to the reader of financial statements if they are all disclosed as such in one place instead of being scattered over several statements, schedules and notes.

In respect of reporting of accounting policies company need to follow following principles.

1. All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.
2. The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place.
3. 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 later periods should be disclosed. In the case of a change in accounting policies which has a 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. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.
4. If the fundamental accounting assumptions, viz. Going Concern, Consistency and Accrual are followed

in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

DISCLOSURE OF NOTES ON ACCOUNTS

The notes to the accounts mean a series of notes that are referred to in the main body of the financial statements. These are the additional information given at the end of financial statements. Notes to financial statements help in explaining specific items in the financial statements as well as provide a more comprehensive assessment of a company's financial condition. The financial accounts are not completed without the notes on accounts.

The notes of accounts give a individual statement about a particular line statement of financial statement. For example, if the balance sheet of a company shows the decrease in reserve and surplus of the company. One may be able to get the reasons of decrease in the share capital of the company from notes on accounts only. The notes of accounts of a company are integral part of the financial statement and without referring notes on accounts, the user may get mis-leaded.

DEVELOPMENT IN CORPORATE FINANCIAL REPORTING

Investors, world over, are currently demanding more shareholder value than just high returns. Maximising shareholders value has always been the ultimate aim of every company. Investors are very keen in assessing the corporate financial performance that correlate with shareholders wealth particularly the market price of a share. Traditional performance measures like return on investment, earnings per share, etc., have been used as the most important measure of shareholder value creation. But in the recent years, value based measures which measure performance in terms of change in value has received a lot of attention. There are several value based measures such as Cash Flow Return on Investment (CFROI), Shareholder Value Added (SVA), Economic Value Added (EVA), Market Value Added (MVA) and Cash Value Added (CVA) are extensively. Here we would be discussing about 'Value added statement' 'economic value added' 'market value added' and 'shareholder value added'

CHARACTERISTICS OF CORPORATE FINANCIAL REPORTING

Relevance: Information is relevant when it influences the economic decisions of users by helping them to evaluate past, present, and future events to confirm/correct their past evaluations. The relevance of information is affected by its nature and materiality (which is always the threshold for relevance). Information overload, on the other hand, can obfuscate information, making it hard to sift through the relevant nuggets and making interpretation difficult.

Reliability: Information should be free from material errors and bias. The key aspects of reliability are faithful representation, priority of substance over form, neutrality, prudence, and completeness.

Comparability: Information should be presented in a consistent manner over time and consistent between entities to enable users to make significant comparisons.

Understandability: Information should be readily understandable by users who are expected to have a reasonable knowledge of business, economies and accounting and a willingness to study the information with reasonable diligence.

The process of producing useful information includes a number of decision points, which may constrain the amount of information provided. These include:

– *Timelines*: A delay in reporting may improve reliability at the cost of relevance.

– *Benefit* v. *Cost*: Benefits derived from information should normally exceed the cost of providing it.

– *Balancing of Qualitative Characteristic*s: To meet the objectives of financial statements and make them

adequate for a particular environment, providers of information must achieve an appropriate balance among qualitative characteristics. The aim is to achieve a balance among characteristics in order to meet the objective of financial statements.

In the context of fair presentation, it is better to disclose no information than to disclose misleading information.

OBJECTIVES OF CORPORATE FINANCIAL REPORTING

The objectives of financial reporting given by Financial Accounting Standard Board (FASB) are summarized as follows:

1. Financial reporting should provide information that is useful to investors and creditors and other users in making rational investment, credit and similar decisions. The information should be useful to both, the present and potential investors.
2. Financial reporting 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 event, and circumstances that change resources and claims to those resources.
3. Financial reporting should provide information about the enterprise's financial performance during a period. Investors and creditors often use information about the past to help in assessing the prospects of an enterprise.
4. Financial reporting should provide information about how management of an enterprise obtains and spends cash, its borrowing and repayment of borrowing, capital transactions including cash dividends and other distributions of enterprise resources to owners, and other factors that may affect an enterprise's liquidity or solvency.
5. Financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibilities to owners (shareholders) for the use of enterprise resource entrusted to it.
6. Financial reporting should provide information that is useful to management and directors in making decisions in the interest of owners

VALUE ADDED STATEMENT

Introduction

Financial reporting has traditionally been concerned with the income statement, balance sheet and cash flow statement. Over the years, there have been initiatives to expand the financial reporting package. One of these was that the Corporate Report of then Accounting Standard Steering Committee of Britain suggested the inclusion of a value added statement (VAS) in 1975

Value added can be defined as the value created by the activities of a firm and its employees, that is, sales less the cost of bought in goods and services. The value added statement (VAS) reports on the calculation of value added and its allocation among the stakeholders in the company.

The value added statement (VAS) is a voluntary disclosure and adds little information to that contained in the income statement. During the last two decades various theories have been used to explain voluntary and social disclosures. The fact that the VAS has attained such widespread publication despite being a relatively marginal disclosure, gives an early indication that the VAS is not a neutral corporate social disclosure but that it could be used to benefit those publishing it. VAS is used to alter perceptions about the company and in this way to manage stakeholder expectations.

Definition and background of value added and the value added statement (VAS)

The concept of value added was initially used in 1790 in the first North American Census of Production (Gillchrist 1970). Trenche Cox, a treasury official, whose techniques have since been adopted by most industrial nations in the calculation of Gross National Product (GNP), was responsible for realising that value added would avoid double counting.

Value added has also been defined in the economic literature by Ruggles and Ruggles:

The value added by a firm, i.e. the value created by the activities of the firm and its employees, can be measured by the difference between the market value of the goods that have been turned out by the firm and the cost of those goods and materials purchased from other producers. This measure will exclude the contribution made by other producers to the total value of the firm's production, so that it is essentially equal to the market value created by this firm. (1965, 50)

The VAS is therefore based on an economic definition of value added and calculates value added in accordance with the calculation of GNP.

Suojanen (1954) suggested the value added concept for income measurement, as a way for management to fulfill their accounting duty to the various interest groups by providing more information that was not possible from the income statement and balance sheet. This makes him one of the first writers to use the value added concept in terms of accounting for the results of an enterprise.

In general words, ***"value added can be defined as wealth generated by the entity through the collective efforts of capital providers, management and employees***".

Distribution of Gross Value addition

As per the concept of Value added statement, gross value added is distribute to employees in form of salaries and wages, to government in form of taxes and duties, to financer in form of interest, to shareholders in form of dividend and balance remained in business in form of retained earning including depreciation.

Value Added Statement:

A simplified financial statement that shows how much wealth has been created by a company. A value added statement calculates total output by adding sales, changes in stock, and other incomes, then subtracting depreciation, interest, taxation, dividends, and the amounts paid to suppliers and employees.

Such value added can be taken to represent in monetary terms the net output of an enterprise. This is the difference between the total value of its output and the value of the inputs of materials and services obtained from other enterprises. The value added is seen to be due to the combined efforts of capital, management and employees, and the statement shows how the value added has been distributed to each of these factors.

Advantages of Value Added Statement –

1. It is an alternative performance measure to profit and therefore helps in the comparison of the performance of the company. Value added is superior performance measure because it pays attention on inputs which are under the control of the management.

2. By employing various productivity measures like value added per rupee of capital employed, value added per rupee sales, value added per employee etc., it helps in judging the productivity of the company.

3. Resource allocation decisions are normally based on the concept of maximizing profit but value added statement provides a better alternative by focusing on other factors rather than just profit.

4. It also helps in devising the incentives schemes for the employees of the company in a better way.
5. It reflects a broader view of the company's objectives and responsibilities rather than just focusing only on the small aspects about the company

Limitation of Value added Statement

There is a duality associated with the VAS in that it reports on the calculation of value added and its application among the stakeholders in the company. Many inconsistencies are found in practice in both the calculation and presentation of value added in the VAS. These inconsistencies make the statement confusing, non-comparable and unverifiable. The main areas of inconsistencies include, but are not limited to, the following:

1. The treatment of depreciation resulting in gross and net value added;
2. The treatment of taxes like pay-as-you-earn, fringe benefits and other benefits in the employees' share of value added;
3. The timing of recognition of value added - production or sales;
4. The treatment of taxes such as VAT /GST and deferred tax; and
5. The treatment of non-operating items.

This has resulted in a company having more than one possible value added figure and that the allocation of value added between the various stakeholders can be presented in different ways.

FORMAT OF VALUE ADDED STATEMENT

ABC Company Ltd.

Value Added Statement (Report or Vertical Form)

for the year ended 31st March ....

Particulars	*Amount (₹)*
A. Generation of Value Added:	
Sales/Turnover (Including excise duties and sales tax excluding	
Returns, rebates & discounts etc.)	xxx
± Stock of semi-finished and finished goods	xxx
Production value	xxx
Add: Income from services	xxx
Less : Bought-in-goods and services purchased from outsiders	xxx
Gross Value Added (GVA)	xxx
Less : Depreciation and deferred Revenue expenses	xxx
Net Value Added (NVA)	xxx

B. Application of Value Added:

Receipt by Workers/Employees	xxx
Receipt by Providers of Loan Capital	xxx
Receipt by Government	xxx
Receipt by Owners	xxx
Net Value Added (NVA)	xxx

EXTRACTS OF VALUE ADDED STATEMENT INFOSYS ANNUAL REPORT 2011-12

VALUE ADDED STATEMENT

₹ in crore, except as otherwise stated

	2012	% of VA	2011	%of VA	Growth (%)
Income	33,734		27,501		22.7
Less : Operating expenses excluding personnel costs					
Software development and business process management expenses	2,634		2,083		
Selling and marketing expenses	397		294		
General and administration expenses	1,647		1,304		
Value Added from operations	29,056		23,820		22.0
Other income (including exceptional items)	1,904		1,211		
Total Value Added	30,960		25,031		23.7
Distribution of Value Added					
– Human resources					
Salaries and bonus	18,340	59.2	14,856	59.4	23.5
– Providers of capital					
Dividend(1)	2,699	8.7	3,445	13.8	(21.7)
Minority interest	–	–	–	–	–
Interest on debt	–	–	–	–	–
– Taxes					
Corporate income taxes	3,367	10.9	2,490	9.9	35.2
Dividend tax(1)	438	1.4	568	2.3	(22.9)
– Income retained in business					
Depreciation and amortization	937	3.0	862	3.4	8.7

Retained in business	5,179	16.8	2,810	11.2	84.3
Total	30,960	100.0	25,031	100.0	23.7

Note : The figures above are based on IFRS financial statements.

[(1)] *Considered on accrual basis*

EXTRACTS OF VALUE ADDED STATEMENT OF BHARAT PETROLEUM CORPORATION LIMITED 2010-2011

₹ in Crores

	2010-11	2009-10
HOW VALUE IS GENERATED		
Value of Production (Refinery)	71,660	55,153
Less : Direct Materials Consumed	(63,304)	(50,825)
Added Value	8,356	4,328
Marketing Operations	3,180	5,453
Value added by Manufacturing & Trading Operations	11,536	9,781
Add : Other Income and prior period items	1,745	2,185
Total Value Generated	13,281	11,966

₹ in Crores

	2010-11	2009-10
HOW VALUE IS DISTRIBUTED		
– *Operations*		
Operating & Service Costs	5,162	5,509
– *Employees' Benefits*		
Salaries, Wages & Bonus	1,507	1,606
Other Benefits	1,296	535
– *Providers of Capital*		
Interest on Borrowings	1,101	1,011
Dividend	577	579
Income Tax	866	828
Re-Investment in Business		
Depreciation	1,655	1,242
Deferred Tax	148	(303)
Retained Profit	969	959
Total Value distributed	13,281	11,966

ECONOMIC VALUE ADDED

A concept critical in evaluating the performance of any business is economic value added. In generic terms, value added refers to the additional or incremental value created by an activity or a business venture. Economic value added is a refinement of this concept – it measures the economic rather than accounting profit created by a business after the cost of all resources including both debt and equity capital have been taken into account.

Economic value added (EVA) is a financial measure of what economists sometimes refer to as economic profit or economic rent. The difference between economic profit and accounting profit is essentially the cost of equity capital – an accountant does not subtract a cost of equity capital in the computation of profit, so in fact an accountant's measure of income or profit is in essence the residual return to that equity capital since all other costs have been deducted from the revenue stream. In contrast, an economist charges for all resources in his computation of profit – including an opportunity cost for the equity capital invested in the business – so an economist's definition and computation of the profit is net above the cost of all resources.

How to calculate Economic Value Added (EVA)

Note that, as in the traditional computation of earnings, interest on debt capital is subtracted from operating earnings (earnings before interest and taxes (EBIT)) to obtain net income Then, an opportunity cost on equity capital is subtracted to obtain EVA. The opportunity cost on equity capital is computed as the equity or net worth of the business times a rate of return that reflects the rate required by investors in the business. This required rate is in reality an opportunity cost measured by the rate of return that could be obtained on equity funds if they were invested elsewhere. A positive EVA means the firm is generating a return to invested capital that exceeds the direct (i.e. interest) and opportunity cost of that invested capital; a negative EVA means that the firm did not generate a sufficient return to cover the cost of its debt and equity capital.

The under given tables gives a view for how to calculate 'Economic Value Added (EVA)'

Earnings before Interest and Taxes (EBIT)	xxx
Less : Interest	xxx
Net Income	xxx
Less : Cost of Equity Capital	xxx
Economic Value Added (EVA)	xxx

Expressed as a formula:

EVA = "Net Operating Profit after Taxes" – (Equity Capital X % Cost of Equity Capital).

Illustration

Balance Sheet of ABC Limited
as at 31st March, 2012

	₹
I. EQUITY AND LIABILITIES	
1. Shareholder's Funds	
Equity	40,00,000
2. Non-Current Liabilities	
Long Term Debt	60,00,000
3. Current Liabilities	

(a) Account Payables	2,08,000
(b) Bank Overdrafts	4,84,000
TOTAL	**1,06,92,000**
II ASSETS	
1. Non-current assets	
(a) Fixed Assets	1,00,00,000
2. Current Assets	
(a) Inventories	
(i) Raw Material	86,400
(ii) Finished Goods	1,71,360
(b) Account receivable	4,29,300
(c) Cash	4,940
TOTAL	**1,06,92,000**

Statement of Profit of ABC Limited

Sales	28,62,000
Less: Operating Expenses	11,48,400
EBIT	17,13,600
Less: Tax Expenses	6,85,440
NOPAT	10,28,160

The average rate of return on similar types of companies is 20% while risk free return is 12.5%. Rate of return as charged by bank is 18% and the tax rate is 40%. .

Calculate Economic Value Added.

Solution

Step 1: Calculation of Capital Employed

Equity	40, 00,000
Long Term Debt	60, 00,000
Bank Overdrafts	4,84,000
Total capital employed	1,04,84,000

Step 2: Calculation of Weighted Average Cost of Capital (WACC)

	Amount	*Expected Return*
Equity	40,00,000	8,00,000
Long Term Debt	60,00,000	4,50,000
Bank Overdrafts	4,84,000	52,272
Total capital employed	1,04,84,000	13,02,272

WACC = 13,02,272/1,04,84,000

= 12.42%

Step 3:

Economic Value Added = NOPAT - Weighted average cost of capital* Capital Employed

= ₹10,28,160-₹13,02,272

= ₹2,74,112

What insight does EVA provide about financial performance of a business?

First, like any financial measure, the trend may be more valuable than the absolute value of EVA. Even if EVA is positive, a declining EVA suggests that financial performance is deteriorating over time, and if this trend continues EVA will become negative and financial performance unacceptable. A negative EVA indicates that the firm is not compensating its capital resources adequately, and corrective action should be considered if this negative EVA persists over time.

Corrective action to improve EVA

1. First, operating performance with respect to operating profit margins or asset turnover ratios could be improved to generate more revenue without using more capital.
2. Second, the capital invested in the business might be reduced by selling under-utilized assets; this strategy will simultaneously improve operating performance through a higher asset turnover ratio, as well as a reduced capital charge against those earnings because of a reduced debt or equity capital investment.
3. Third, redeploy the capital invested to projects and activities that have higher operating performance than the current projects or investments are exhibiting.
4. And fourth, if the business is not highly leveraged, change the capital structure by substituting lower cost debt for higher cost equity. Although this last strategy will decrease net income because of the higher interest cost, it will improve the EVA of the business because the total cost of debt and equity is reduced, and EVA measures the value created after all costs of capital (debt and equity) have been taken into account.

Advantages of EVA Analysis

1. In various cases, company pay bonuses to the employees on the basis of EVA generated. Since a higher EVA implies higher bonuses to the employees, it promotes the employees for working hard for generating higher revenue.
2. Using EVA , company can evaluate the projects independently and hence decide on whether to execute the project or not
3. It helps the company in monitoring the problem areas and hence taking corrective action to resolve those problems.
4. Unlike accounting profit, such as EBIT, Net Income and EPS, EVA is based on the idea that a business must cover both the operating costs as well as the capital costs and hence it presents a better and true picture of the company to the owners, creditors, employees, shareholders and all other interested parties.
5. It also helps the owners of the company to identify the best person to run the company effectively and efficiently.

However there are some disadvantages of EVA like it is difficult to compute and also it does not take into account inflation into its calculation. Therefore company should take into account above advantages and disadvantages before deciding whether to implement EVA or not

MARKET VALUE ADDED

Value based management and shareholder value analysis is well known concepts since but with the change of time newer related concepts such as MVA have got importance.

Market value added is the difference between the Company's market and book value of shares. According to Stern Stewart, if the total market value of a company is more than the amount of capital invested in it, the company has managed to create shareholder value. If the market value is less than capital invested, the company has destroyed shareholder value.

Market Value Added = Company's total Market Value – Capital Invested

With the simplifying assumption that market and book value of debt are equal, this is the same as Market Value Added = Market Value of equity – Book value of equity

Book value of equity refers to all equity equivalent items like reserves, retained earnings and provisions. In other words, in this context, all the items that are not debt (interest bearing or noninterest bearing) are classified as equity.

Market value added (MVATM) is identical in meaning with the market–to–book ratio. The difference is only that MVA is an absolute measure and market–to–book ratio is a relative measure. If MVA is positive, that means that market–to– book ratio is less than one. According to Stewart, Market value added tells us how much value the company has added to, or subtracted from, its shareholders investment. Successful companies add their MVA and thus increase the value of capital invested in the company. Unsuccessful companies decrease the value of the capital originally invested in the company.

Whether a company succeeds in creating MVA or not, depends on its rate of return. If a company's rate of return exceeds its cost of capital, the company will sell on the stock market with premium compared to the original capital. On the other hand, companies that have rate of return smaller than their cost of capital sell with discount compared to the original capital invested in company. Whether a company has positive or negative MVA depends on the rate of return compared to the cost of capital.

Market value added can also be defined in relation to Economic Value Added (EVATM). EVA measures whether the operating profit is enough compared to the total cost of capital employed. Stewart defines EVA as the surplus of Net Operating Profit after Taxes (NOPAT) after adjusting for capital cost, where NOPAT = Profit after depreciation and taxes but before interest costs and Capital Cost = Weighted average cost of capital X capital employed or EVA = (ROI – WACC) x Capital employed.

He further defines the connection between EVA and MVA as: Market Value Added = Present Value of All future EVA By increasing EVA, a company increases its market value added or in other words increases the difference between Company's value and the amount of capital invested in it.

The relationship of MVA with EVA has its implication on valuation. By rearranging the formula, market value of equity can be defined as:

Market value of equity = Book value of equity + Present value of all future EVA.

SHAREHOLDER VALUE ADDED (SVA)

Shareholder Value Added (SVA) represents the economic profits generated by a business above and beyond the minimum return required by all providers of capital. "Value" is added when the overall net economic cash flow of the business exceeds the economic cost of all the capital employed to produce the operating profit. Therefore, SVA integrates financial statements of the business (profit and loss, balance sheet and cash flow) into one meaningful measure.

The SVA approach is a methodology which recognises that equity holders as well as debt financiers need to be

compensated for the bearing of investment risk. The SVA methodology is a highly flexible approach to assist management in the decision making process. Its applications include performance monitoring, capital budgeting, output pricing and market valuation of the entity.

BENEFITS OF ADOPTING SVA

To create value, management must have an understanding of the variables that drive the value of the business. An organisation cannot act directly on value. It has to act on factors it can influence, such as client satisfaction, cost, capital expenditures, the debt / equity mix and so forth. Through an understanding of these drivers of value, management is able to establish a consistent dialogue, both internally and with the Shareholder, regarding what needs to be accomplished to create value. The benefits of moving towards SVA include:

1. Overall, value-based performance measures will result in greater accountability for the investment of new capital, as well as for the use of existing investments.
2. Organisation will have the opportunity to apply a meaningful private sector benchmark to evaluate performance.
3. Managers will be provided with an improved focus on maximizing shareholder value.

DRAWBACKS OF ADOPTING SVA

1. A limitation in the use of SVA as a performance measure is that, by nature, it is an aggregate measure. In order to analyse the underlying causes of any changes in calculated value between years, it is necessary to fully comprehend the value drivers and activities specific to a given firm.
2. There may be certain enterprises which are subject to any degree of price regulation then it may not be possible for management to adjust output prices to achieve a commercial return in response to upward movements in input prices. Such a situation may result in SVA being reduced even though there may have been no decrease in overall efficiency.
3. Similarly, a reduction in direct Government funding would result in a decrease in SVA.
4. Combined with the use of traditional accounting measures, a thorough knowledge of the value drivers of the business will assist in determining the underlying causes of fluctuations in the value added measure.
5. Again, the use of SVA is not a substitute for detailed analysis of business drivers, rather it is an additional measurement tool with an economic foundation

LESSON ROUND UP

- Financial reporting includes not only financial statements but also other means of communicating information that relates to the information provided by the accounting system.
- The end product of accounting process should be such that it generates:
  - information useful in investment and credit decisions,
  - information useful in assessing cash flow prospects (amount, timing, and uncertainly), and
  - information about enterprise resources, claims to those resources and changes therein.
- The Value Added Statement (VAS) is a voluntary disclosure and adds little information to that contained in the income statement. It calculates total output by adding sales, changes in stock, and other incomes, then subtracting depreciation, interest, taxation, dividends, and the amounts paid to suppliers and employees.
- Economic value added (EVA) measures the economic rather than accounting profit created by a

business after the cost of all resources including both debt and equity capital have been taken into account.

EVA = "Net Operating Profit after Taxes" – (Equity Capital X % Cost of Equity Capital).

– Market value added (MVA) is the difference between the Company's market and book value of shares.

Market Value Added = Company's total Market Value – Capital Invested

– Shareholder Value Added (SVA) represents the economic profits generated by a business above and beyond the minimum return required by all providers of capital.

SELF TEST QUESTIONS

1. Discuss the concept of Corporate Financial Reporting and its requirements in India.
2. What are the objectives of corporate financial reporting?
3. What is Value Added Statement (VAS)? State the merit and demerit of VAS.
4. What do you mean by Economic Value Added? How is EVA related to valuation?
5. Discuss about the Shareholder Value Added (SVA) and its benefits and drawbacks.
6. Write Short Notes on:
   (a) Market Value of Equity
   (b) Limitations of Value Added Statement

Lesson 9

Accounting Standards

LESSON OUTLINE

- Introduction
- Meaning of Accounting Standards
- Objective of Accounting Standards
- Formation of Accounting Standards Board
- Composition of Accounting Standards Board
- Objectives & functions of Accounting Standards Board
- Scope of Accounting Standards
- Procedure for issuing in Accounting Standards
- Compliances with the Accounting Standards
- Applicability of Accounting Standards under Companies Act, 2013
- Accounting Standards issued
- IFRS
- Conversion of Indian Accouting Standard with IFRS
- Lesson Round Up
- Self Test Question

LEARNING OBJECTIVES

Accounting is the language of any business. The Accounting is looked upon to provide analysis of assets, financial stability, financial performance, record-keeping and more. To provide accurate and reliable information financial statements must be clearly understandable and comparable so that stakeholders may compare the performance of one business with the another similar business. Thus all general purpose financial statements should be prepared in accordance with the same uniform guidelines. That is the purpose of accounting standards. The objectives of this lesson is to make student learn about basics of accounting standards.

After studying this lesson, one will able to:

- Understand the meaning and significance of accounting standards.
- Appreciate the need for accounting standards.
- Explain the scope of accounting standards.
- Understand the procedure of issuing accounting standards.
- Familiarize with the Accounting Standards (AS)
- Understand the various International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS).

"Accounting Standard, a mode of conduct imposed on accountant by custom, law or professional body."

INTRODUCTION

Accounting Standards have assumed great significance in today's environment, which is constantly evolving and changing. Accounting Standards act as pillars of sound financial reporting system of a country, which is an integral and important part of good corporate governance and provides the shareholders and other stakeholders' useful information about the entity to make their economic and financial decisions. To strengthen the financial reporting system existing in the country, Accounting Standards are formulated or revised from time to time.

MEANING OF ACCOUNTING STANDARDS

Accounting Standards (ASs) are written policy documents issued by expert accounting body or by government or any other regulatory body. Accounting Standards covers the aspects of recognition, measurements, treatment, presentation and disclosure of accounting transactions in the financial statements. Thus, accounting standards are guidelines for financial accounting, as how firms prepare and present its business income and expense, assets and liabilities.

According to section 2(2) of the Companies Act 2013 "accounting standards" means the standards of accounting or any addendum thereto for companies or class of companies referred to in section 133.

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.

Objective of Accounting Standards

- To harmonise different accounting policies and used in a country.
- To reduce the accounting alternatives in the preparation of financial statements
- To ensure comparability of financial statements of different enterprises
- To call for disclosures beyond that required by the law.

Formation of the Accounting Standards Board

The Institute of Chartered Accountants of India (ICAI) constituted the Accounting Standards Board (ASB) on 21st April, 1977) to harmonise the diverse accounting policies and practices in use in India. ASB of the ICAI has been issuing accounting standards since then. It has issued 32 Accounting Standards and 29 Accounting Standards Interpretations so far. "AS 8- Accounting for Research and Development" has been withdrawn, therefore there are 31 Accounting Standards in effect currently. ASB takes into consideration the applicable laws, customs, usages and business environment prevailing in the country. It also gives due consideration to International Accounting Standards (IASs) and tries to integrate them, to the extent possible, in the light of conditions and practices prevailing in India.

Composition of the Accounting Standards Board

The composition of the ASB is fairly broad-based and ensures participation of all interest-groups in the standard-setting process. Apart from the elected members of the Council of the ICAI nominated on the ASB, the following are represented on the ASB:

(i) Nominee of the Central Government representing the Department of Company Affairs on the Council of the ICAI

(ii) Nominee of the Central Government representing the Office of the Comptroller and Auditor General of India on the Council of the ICAI

(iii) Nominee of the Central Government representing the Central Board of Direct Taxes on the Council of the ICAI

(iv) Representative of the Institute of Cost and Works Accountants of India

(v) Representative of the Institute of Company Secretaries of India

(vi) Representatives of Industry Associations (1 from Associated Preface to the Statements of Accounting Standards 3 Chambers of Commerce and Industry (ASSOCHAM), 1 from Confederation of Indian Industry (CII) and 1 from Federation of Indian Chambers of Commerce and Industry (FICCI)

(vii) Representative of Reserve Bank of India

(viii) Representative of Securities and Exchange Board of India

(ix) Representative of Controller General of Accounts

(x) Representative of Central Board of Excise and Customs

(xi) Representatives of Academic Institutions (1 from Universities and 1 from Indian Institutes of Management)

(xii) Representative of Financial Institutions

(xiii) Eminent professionals co-opted by the ICAI (they may be in practice or in industry, government, education, etc.)

(xiv) Chairman of the Research Committee and the Chairman of the Expert Advisory Committee of the ICAI, if they are not otherwise members of the Accounting Standards Board

(xv) Representative(s) of any other body, as considered appropriate by the ICAI

Objectives and Functions of the Accounting Standards Board

The following are the objectives of the Accounting Standards Board:

(i) To conceive of and suggest areas in which Accounting Standards need to be developed.

(ii) To formulate Accounting Standards with a view to assisting the Council of the ICAI in evolving and establishing Accounting Standards in India.

(iii) To examine how far the relevant International Accounting Standard/International Financial Reporting Standard can be adapted while formulating the Accounting Standard and to adapt the same.

(iv) To review, at regular intervals, the Accounting Standards from the point of view of acceptance or changed conditions, and, if necessary, revise the same.

(v) To provide, from time to time, interpretations and guidance on Accounting Standards.

(vi) To carry out such other functions relating to Accounting Standards.

The main function of the ASB is to formulate Accounting Standards so that such standards may be established by the ICAI in India. While formulating the Accounting Standards, the ASB will take into consideration the applicable laws, customs, usages and business environment prevailing in India.

The ICAI, being a full-fledged member of the International Federation of Accountants (IFAC), is expected, inter alia, to actively promote the International Accounting Standards Board's (IASB) pronouncements in the country with a view to facilitate global harmonisation of accounting standards. Accordingly, while formulating the Accounting Standards, the ASB will give due consideration to International Accounting Standards (IASs) issued by the International Accounting Standards Committee (predecessor body to IASB) or International Financial Reporting Standards (IFRSs) issued by the IASB, as the case may be, and try to integrate them, to the extent possible, in the light of the conditions and practices prevailing in India.

The Accounting Standards are issued under the authority of the Council of the ICAI. The ASB has also been entrusted with the responsibility of propagating the Accounting Standards and of persuading the concerned parties to adopt them in the preparation and presentation of financial statements. The ASB will provide interpretations and guidance on issues arising from Accounting Standards. The ASB also reviews the Accounting Standards at periodical intervals and, if necessary, revise the same.

Scope of Accounting Standards

(i) The Accounting Standards which are issued are in conformity with the provisions of the applicable laws, customs, usages and business environment in India. However, if a particular Accounting Standard is found to be not in conformity with law, the provisions of the said law will prevail and the financial statements should be prepared in conformity with such law.

(ii) The Accounting Standards by their very nature cannot and do not override the local regulations which govern the preparation and presentation of financial statements in the country. However, the ICAI will determine the extent of disclosure to be made in financial statements and the auditor's report thereon. Such disclosure may be by way of appropriate notes explaining the treatment of particular items. Such explanatory notes will be only in the nature of clarification and therefore need not be treated as adverse comments on the related financial statements.

(iii) The Accounting Standards are intended to apply only to items which are material. Any limitations with regard to the applicability of a specific Accounting Standard will be made clear by the ICAI from time to time. The date from which a particular Standard will come into effect, as well as the class of enterprises to which it will apply, will also be specified by the ICAI. However, no standard will have retroactive application, unless otherwise stated.

(iv) In formulation of Accounting Standards, the emphasis would be on laying down accounting principles and not detailed rules for application and implementation thereof.

Procedure for Issuing an Accounting Standard

Broadly, the following procedure is adopted for formulating Accounting Standards:

(i) The ASB determines the broad areas in which Accounting Standards need to be formulated and the priority in regard to the selection thereof.

(ii) In the preparation of Accounting Standards, the ASB will be assisted by Study Groups constituted to consider specific subjects.

(iii) The draft of the proposed standard will normally include the following:

- Objective of the Standard,
- Scope of the Standard,
- Definitions of the terms used in the Standard,
- Recognition and measurement principles, wherever applicable,
- Presentation and disclosure requirements.

(iv) The ASB will consider the preliminary draft prepared by the Study Group and if any revision of the draft is required on the basis of deliberations, the ASB will make the same.

(v) The Exposure Draft of the proposed Standard will be issued for comments by the members of the Institute and the public. The Exposure Draft will specifically be sent to specified bodies (as listed above), stock exchanges, and other interest groups, as appropriate.

(vi) After taking into consideration the comments received, the draft of the proposed Standard will be finalised by the ASB and submitted to the Council of the ICAI.

(vii) The Council of the ICAI will consider the final draft of the proposed Standard, and if found necessary, modify the same in consultation with the ASB. The Accounting Standard on the relevant subject will then be issued by the ICAI.

(viii) For a substantive revision of an Accounting Standard, the procedure followed for formulation of a new Accounting Standard, as detailed above, will be followed.

(ix) Subsequent to issuance of an Accounting Standard, some aspect(s) may require revision which are not substantive in nature. For this purpose, the ICAI may make limited revision to an Accounting Standard. The procedure followed for the limited revision will substantially be the same as that to be followed for formulation of an Accounting Standard, ensuring that sufficient opportunity is given to various interest groups and general public to react to the proposal for limited revision.

Compliance with the Accounting Standards

The Accounting Standards will be mandatory from the respective date(s) mentioned in the Accounting Standard(s). The mandatory status of an Accounting Standard implies that while discharging their attest functions, it will be the duty of the members of the Institute to examine whether the Accounting Standard is complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the Accounting Standard, it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviation.

Ensuring compliance with the Accounting Standards while preparing the financial statements is the responsibility of the management of the enterprise. Statutes governing certain enterprises require of the enterprises that the financial statements should be prepared in compliance with the Accounting Standards, e.g., the Companies Act, 2013 and the Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000.

Financial Statements cannot be described as complying with the Accounting Standards unless they comply with all the requirements of each applicable Standard.

Applicability of Accounting Standards under Companies Act 2013

Section 129 (1) of the Companies Act, 2013, the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III: Provided that the items contained in such financial statements shall be in accordance with the accounting standards.

Section 129 (5) of the Companies Act, 2013, without prejudice to sub-section (1), where the financial statements of a company do not comply with the accounting standards referred to in sub-section (1), the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviation.

According to section 132 (1), the Central Government may, by notification, constitute a National Financial Reporting Authority to provide for matters relating to accounting and auditing standards under this Act.

According to section 132 (2) Notwithstanding anything contained in any other law for the time being in force, the National Financial Reporting Authority shall—

(a) make recommendations to the Central Government on the formulation and laying down of accounting and auditing policies and standards for adoption by companies or class of companies or their auditors, as the case may be;

(b) monitor and enforce the compliance with accounting standards and auditing standards in such manner as may be prescribed;

(c) oversee the quality of service of the professions associated with ensuring compliance with such standards, and suggest measures required for improvement in quality of service and such other related matters as may be prescribed; and

Section 133-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.

Section 134 (5) of the Companies Act, 2013, prescribes that the Directors' Responsibility Statement shall state that in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures.

Section 143 (2): The auditor shall make a report to the members of the company on the accounts examined by him and on every financial statement which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made there under or under any order made under sub-section (11) and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

Section 143(3) The auditor's report shall also state (e) whether, in his opinion, the financial statements comply with the accounting standards;

Accounting Standards issued

The following are the Accounting Standards issued by Accounting Standard Board :

Accounting Standard (AS-1)	Disclosure of Accounting Policies
Accounting Standard (AS-2)	Valuation of Inventories
Accounting Standard (AS-3)	Cash Flow Statement
Accounting Standard (AS-4)	Contingencies and Events Occurring after the Balance Sheet Date
Accounting Standard (AS-5)	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
Accounting Standard (AS-6)	Depreciation Accounting
Accounting Standard (AS-7)	Construction Contracts
Accounting Standard (AS-9)	Revenue Recognition
Accounting Standard (AS-10)	Accounting for Fixed Assets
Accounting Standard (AS-11)	The Effects of Changes in Foreign Exchange Rates
Accounting Standard (AS-12)	Accounting for Government Grants
Accounting Standard (AS-12)	Accounting for Investments
Accounting Standard (AS-14)	Accounting for Amalgamations
Accounting Standard (AS-15)	Employee Benefits
Accounting Standard (AS-16)	Borrowing Costs
Accounting Standard (AS-17)	Segment Reporting

Accounting Standard (AS-18)	Related Party Disclosures
Accounting Standard (AS-19)	Leases
Accounting Standard (AS-20)	Earnings Per Share
Accounting Standard (AS-21)	Consolidated Financial Statements
Accounting Standard (AS-22)	Accounting for Taxes on Income.
Accounting Standard (AS-23)	Accounting for Investments in Associates.
Accounting Standard (AS-24)	Discontinuing Operations.
Accounting Standard (AS-25)	Interim Financial Reporting.
Accounting Standard (AS-26)	Intangible Assets.
Accounting Standard (AS-27)	Financial Reporting of Interest in Joint Ventures
Accounting Standard (AS-28)	Impairment of Assets
Accounting Standard (AS-29)	Provisions, Contingent Liabilities and Contingent Assets.
Accounting Standard (AS-30)	Financial Instruments: Recognition and Measurement
Accounting Standard (AS-31)	Financial Instruments: Presentation
Accounting Standard (AS-32)	Financial Instruments: Disclosures

AS-1 – Disclosure of Accounting Policies

This standard deals with the disclosure of significant accounting policies followed in the preparation and presentation of financial statements. The purpose of this standard is to promote better understanding of financial statements by establishing the disclosure of significant accounting policies in the financial statements and the manner of doing so. Compliance with this standard should go a long way in facilitating a more meaningful comparison between financial statements of different enterprises.

The views presented in the statements of an enterprise of its state of affairs and of the profit or loss account can be significantly affected as the accounting policies followed vary from enterprise to enterprise.

All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed. The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place. 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 later periods should be disclosed. In the case of a change in accounting policies which has a 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. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. If the fundamental accounting assumptions, viz. going concern, consistency and accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed. The primary consideration is that the financial statements should give a true and fair view of the firm's income and financial position.

AS-2 – Valuation of Inventories

Inventories generally constitute the second largest item after fixed assets, in the financial statements particularly

of manufacturing organisations. The value attached to inventories can materially affect the operating results and the financial position. However, different basis of valuing inventories are used by different businesses and even by different undertakings within the same trade or industry. The primary issue in accounting for inventories is the determination of the value at which inventories are carried in the financial statements until the related revenues are recognised.

Inventories are defined as assets (a) held for sale in the ordinary course of business; (b) in the process of production for such sale; or (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services. Inventories are thus classified as goods purchased and held for resale; finished goods produced or work-in-progress being produced by the enterprise and include materials, maintenance supplies, consumables and loose tools to be used in the production process. Net realizable value is the estimated selling price in the ordinary course of business less the estimated cost of completion and the estimated costs necessary to make the sale.

The standard specifies that inventories should be valued at the lower of cost or net realizable value. The cost of inventories means the historical cost and comprises (i) all costs of purchase, (ii) cost of conversion and (iii) other costs incurred to bring the inventories to their present location and condition. However, the following costs are excluded from the cost of inventories and are treated as expenses of the period in which they are incurred: (i) abnormal amounts of wasted materials, labour or other production costs; (ii) storage costs; (iii) administrative overheads that do not contribute to bringing the inventories to their present location and condition and (iv) selling and distribution costs.

The standard specifies the following cost formula for determining the historical cost of inventories: (i) Specific identification cost (ii) First-In-First Out and (iii) Weighted average cost.

Net realizable value should be used for valuing inventories that are damaged or that have become wholly or partially obsolete or if their selling price has declined. The practice of writing down inventories below cost to net realizable value is consistent with the view that assets should be carried in excess of amounts expected to be realised from their sale or use. When there has been a decline in the price of materials and it is estimated that the cost of finished products will exceed net realisable value, the materials are written down to net realizable value. In such case, the replacement cost of materials may be the best available measure for their net realizable value.

The standard specifies that the following disclosures should be made in the financial statements: (a) the accounting policies adopted in measuring inventories; including the cost formulas used; and (b) the total carrying amount of inventories and its classification appropriate to the enterprise.

AS-3 – Cash Flow Statements

Accounting Standard-3 recommends that listed companies and other industrial commercial and business enterprises will have to provide to their shareholders and public in general, as the case may be, a cash flow statement along with balance sheet and income statement. Cash flow statement provides information that enables users to evaluate the changes in net assets of an enterprise, its financial structure and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. The standard lays down the procedures and guidelines for the preparation and presentation of cash flow statements. It states that the statement should report cash flows during the period classified by operating, investing and financing activities. Cash flows from operating activities may be reported using either (a) direct method whereby major classes of gross cash receipts and gross cash payments are disclosed; or (b) indirect method, whereby net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments and items of income or expenses associated with investing or financing cash flows. An enterprise should report separately major classes of gross receipts and gross payments arising from investing and financing activities except for certain cash flows which may be reported on a net basis. Cash flows arising from the following operating, investing or financing activities may be reported on a net

basis: (a) cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the enterprise, (b) cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short. Cash flows arising from each of the following activities of a financial enterprise may also be reported on a net basis: (a) cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date; (b) the placement of deposits with and withdrawal of deposits from other financial enterprises and (c) cash advances and loans made to customers and the repayment of those advances and loans.

Cash flows arising from transactions in a foreign currency should be recorded in an enterprise's reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and foreign currency at the date of the cash flow. The cash flows associated with extra ordinary item should be classified as arising from operating, investing and financing activities as appropriate and separately disclosed. This treatment would enable the users to understand their nature and effect on the present and future cash flows of the enterprise. Cash flows from interest and dividends received and paid should each be disclosed separately. Cash flows arising from taxes and income should be separately disclosed and should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities. Investing and financing transactions that do not require the use of cash or cash equivalents should be excluded from the 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. An enterprise needs to disclose the components of cash and cash equivalents and should present a reconciliation of the amounts in its cash flow statement with the equivalent items reported in the balance sheet.

AS- 4 – Contingencies* and Events Occurring after the Balance Sheet Date

*(Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory, all the relevant portions of this Standard that deal with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by other Indian Accounting Standards.)

Events that occur between the balance sheet date and the date on which the financial statements are prepared are referred to as events occurring after the balance sheet date. Such events are classified into two categories: (i) events occurring after balance sheet date that provide further evidence to the conditions which were prevailing on the balance sheet date and (ii) events occurring after the balance sheet date that are indicative of the conditions which occur subsequent to the balance sheet date.

The standard requires adjustment of assets and liabilities in the case of events of the first type and only disclosure in the case of events of the second type. However, dividends declared after the balance sheet date have to be adjusted in the accounts. Proper disclosure of events and their financial effect must be made in the financial statements.

AS-5 – Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

The standard ensures uniform classification and disclosure of certain items so that profit and loss statement may be prepared on uniform basis and thereby facilitating inter-period and inter-firm comparisons. The standard recommends that all items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period. While arriving at the net profit, extraordinary items and the effects of changes in accounting estimates should also be incorporated. The profit and loss statement should disclose clearly the profit or loss from ordinary activities and extraordinary activities. Extraordinary items should be disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived. However, such amounts are part of the net profit or loss for the period. When the items of income and expense within profit or loss from ordinary activities are of such size, nature or the incidence of their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

The standard requires that the nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived. The effect of a change in an accounting estimate should be included in the determination of net profit or loss in (a) in the period of the change, if the change affects the period only or (b) the period of the change and future periods, if the change affects both. A change in an accounting policy should be made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise. A more appropriate presentation of events or transactions in the financial statements occurs when the new accounting policy results in more relevant or reliable information about the financial positions, performance or cash flows of the enterprise. Any change in an accounting policy which has a material effect should be disclosed in the financial statements.

AS-6 – Depreciation Accounting

This accounting standard makes recommendation in respect of accounting treatment of matters such as allocation of depreciable amount, estimation of useful life of a depreciable asset, change in the depreciation policy, change of historical cost of depreciable asset, revaluation of depreciable asset etc. The standard recommends that depreciation on depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset. The depreciation method selected should be applied consistently from period to period. A change in one method of providing depreciation to another method should be made only if the adoption of the new method is required by statute or for compliance with the accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of financial statements. When a change in the method of depreciation is made depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. The depreciation method should be selected on the basis of expected physical wear and tear of assets, obsolescence, legal or statutory limits on use of the asset. If any depreciable asset is disposed of, discarded or demolished or destroyed, the net surplus or deficiency should be disclosed in the financial statements. The following information should be disclosed in the financial statement: (i) historical cost or other amount substituted for historical cost of each class of depreciable asset; (ii) total depreciation for the period for each class of assets; (iii) the related accumulated depreciation; (iv) depreciation methods used; and (v) depreciable rates or the useful life of the assets, if they are different from the principal rates specified in Schedule XIV.

AS-7 – Construction Contracts

The objective of this Accounting Standard is to prescribe the accounting treatment of revenue and costs associated with construction contracts. The Standard prescribes only percentage of completion method for recognising the revenue, which justifies the accrual system of accounting.

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

Construction contracts are formulated in a number of ways which for the purposes of this standard are classified as fixed price contracts and cost plus contracts. Some construction contracts may be a mix of both a fixed price contract and a cost plus contract.

Combination and Segmenting Construction Contracts

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

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

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

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

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

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

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

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

A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset should be treated as a separate construction contract when:

(a) the asset differs significantly in design, technology or function from the asset covered by the original contract; or

(b) the price of the asset is negotiated without regard to the original contract price.

Contract Revenue

Contract Revenue should comprise the initial amount of revenue e agreed as per contract and variations in contract work, claims and incentive payments.

Contract Costs

Contract costs should comprise:

(a) costs that relate directly to the specific contract;

(b) costs that are attributable to contract activity in general and can be allocated to the contract; and

(c) such other costs as are specifically chargeable to the customer under the terms of the contract.

Recognition of Contract Revenue and Expenses

When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. Any expected loss on the construction contract should be recognised immediately as an expense.

The recognition of revenue and expense by reference to the stage of completion of a contract is often referred to as percentage of completion method. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed. This method provides useful information on the extent of contract activity and performance during a period.

Recognition of Expected Losses

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

An enterprise should disclose:

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

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

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

AS-8 – Accounting for Research and Development

Note: Withdrawn pursuant to AS 26 becoming mandatory.

AS-9 – Revenue Recognition

This standard deals with the basis for recognition of revenue in the statement of profit and loss of an enterprise. It lays down the conditions to recognise revenue by sale of goods, rendering of services, resources yielding interest, royalties and dividends. Revenue should be recognised for sale of goods or services only when the collection is reasonably assured and (i) the property in goods is transferred from seller to buyer (ii) there is no uncertainty regarding the amount of consideration that will be realised from sale of goods. In the case of services rendered either completed service contract method or proportionate service contract method may be adopted for revenue recognition. In the case of revenue by way of interest, the credit is taken on a time proportion basis taking into account the amount outstanding and the rate applicable. In the case of royalties, revenue is recognised on approval basis in accordance with the terms of the relevant agreement. The revenue is recognised for dividend once the right to receive dividend is established.

AS-10 – Accounting for Fixed Assets

Financial statements disclose information regarding fixed assets such as land and building, plant and machinery, vehicles, furniture and fittings, goodwill, patents, trade marks and designs etc. This standard deals with accounting for these fixed assets. The cost of fixed asset should comprise its purchase price and any attributable cost of bringing the asset to its working condition for its intended use. Any trade discounts and rebates are deducted in arriving at the purchase price. Finance cost relating to borrowed funds upto the completion of construction or acquisition of assets are also included in the cost of asset. Administrative and other general overhead expenses are usually excluded from the cost of fixed assets. In case of self constructed assets, only direct costs are included in the cost of the asset. In an exchange of asset, the cost of assets given up should be taken as the value of new asset. Sometimes, market value of such assets is also taken when circumstances permit. 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. Fixed asset should be eliminated from the financial statements on disposal or when no further benefit is expected from its use.

On revaluation of assets in books, the asset at net value is revalued and similar increase in gross value is made without changing depreciation figure. When a fixed asset is revalued upwards, accumulated depreciation existing at the date of revaluation should not be credited to profit and loss account. An increase in net book value arising on revaluation of fixed assets should be credited directly to owner’s interest under revaluation reserve and should not be used for any purpose except to write off decrease in value of assets. The following information should be disclosed in the financial statements:

(i) Gross and net book values of fixed assets at the beginning and at the end of the accounting period-showing additions, disposals, acquisition etc.

(ii) Proper disclosure should also be made regarding expenditures incurred in the course of construction or acquisition.

(iii) Information in respect of revalued assets should include revalued amount substituted for historical cost of fixed assets, the method adopted to compute the revalued amounts, the nature of indices used, the year of any appraisal made and whether an external valuer was involved etc.

AS-11 – The Effects of Changes in Foreign Exchange Rates

This Standard should be applied in accounting for transactions and balances in foreign currencies and in translating the financial statements of foreign operations.

A foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction.

At each balance sheet date reporting should be made as follows:

(a) foreign currency monetary items should be reported using the closing rate.

(b) non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction; and

(c) non-monetary items which are carried at fair value or other similar valuation denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined.

Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise. However, exchange differences arising on a monetary item that, in substance, forms part of an enterprise's net investment in a non-integral foreign operation should be accumulated in a foreign currency translation reserve in the enterprise's financial statements until the disposal of the net investment, at which time they should be recognised as income or as expenses. On the disposal of a non-integral foreign operation, the cumulative amount of the exchange differences which have been deferred and which relate to that operation should be recognised as income or as expenses in the same period in which the gain or loss on disposal is recognised.

The method used to translate the financial statements of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise. For this purpose, foreign operations are classified as either "integral foreign operations" or "non-integral foreign operations".

When there is a change in the classification of a foreign operation, the translation procedures applicable to the revised classification should be applied from the date of the change in the classification.

An enterprise may enter into a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date of a transaction. The premium or discount arising at the inception of such a forward exchange contract should be amortised as expense or income over the life of the contract. Exchange differences on such a contract should be recognised in the statement of profit and loss in the reporting period in which the exchange rates change. Any profit or loss arising on cancellation or renewal of such a forward exchange contract should be recognised as income or as expense for the period.

An enterprise should disclose:

(a) the amount of exchange differences included in the net profit or loss for the period; and

(b) net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

AS-12 – Accounting for Government Grants

Government grants are assistance by Government in cash or kind to an enterprise for past or future compliances with certain conditions. Such grants are sometimes called by other names such as subsidies, cash incentives, duty drawback etc. There are two approaches to the treatment of Government grants. The first one is 'capital

approach' under which a grant is treated as part of the shareholders' funds and the second is the 'income approach' under which a grant is taken to income over one or more periods. Government grants related to specific fixed assets should be presented in the balance sheet by showing the grant as deduction from the gross value of the assets. Where the grant covers the total cost of the assets, the assets should be shown in the balance sheet at a nominal value. Alternatively, the grant may be treated as deferred income and allocated in the profit and loss account over the useful life of the assets. Grants related to non-depreciable asset should be credited to capital reserve.

Government grants related to revenue should be recognised on a systematic basis in the profit and loss account over the periods necessary to match them with related costs which they are intended to compensate. Government grants of the nature of promoters' contribution should be credited to capital reserve and treated as a part of shareholders' funds. The standard recommends the following disclosures in the financial statements: (i) the accounting policy adopted for government grants, including the methods of presentation of financial statements; (ii) the nature and extent of government grants recognised in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

AS-13 – Accounting for Investments

The standard deals with accounting for investments in the financial statement of enterprises and related disclosures. Investments are assets held by an enterprise for earning income by way of dividends, interest and rentals for capital appreciation or for other benefits to the investing enterprise. Assets held as stock-in-trade are not investments. An enterprise should disclose current investments and long-term investments distinctly in its financial statements. The cost of an investment should include acquisition charges such as brokerage, fees and duties. If an investment is acquired, or partly acquired, by issue of shares or other securities, the acquisition cost should be the fair value of the securities issued. If an investment is acquired in exchange for another asset, the acquisition cost of the investment should be determined by reference to the fair value of asset given up.

Investments classified as current investments should be stated at lower of cost and fair value while long-term investments be stated at cost with provision for diminution to recognise a decline. Any reduction in the carrying amount and any reversals of such reductions should be charged or credited to the profit and loss statement. On disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited in the profit and loss statement. When disposing of a part of the holding of an individual investment, the carrying amount should be allocated to that part and is to be determined on the basis of the average carrying amount of the total holding of the investment. The standard requires the disclosure of accounting policies for determination of carrying amounts of investments, classification of investments, the amount included in the income statement in respect of interest, dividends, rentals on investments, profits and losses on sale of current and long-term investments.

AS-14 – Accounting for Amalgamations

This standard deals with accounting for amalgamations and treatment of any resultant goodwill or reserves. The standard classifies amalgamation into two categories i.e. (i) amalgamation in the nature of merger and (ii) amalgamation in the nature of purchase. In the first category where there is genuine pooling not merely of assets and liabilities of the amalgamating companies but also of the shareholders' interests and of the business of these companies. In the second category are those amalgamations which are in effect a mode by which one company acquires another company and as a consequence, the shareholders of the company which is acquired, normally do not continue to have proportionate share in the equity of the combined company. Also the business of the company which is acquired is not intended to be continued.

When an amalgamation is in the nature of merger, it should be accounted for under the pooling of interest method and an amalgamation in the nature of purchase, the method is designated as purchase method. In preparing transferee company's financial statements under pooling interest method, the assets, liabilities and

reserves (whether capital or revenue or arising on revaluation) of the transferor company should be recorded at their existing carrying amounts and in the same form as at the date of the amalgamation. The difference between the amount recorded as share capital issued and the amount of the share capital of the transferor company should be adjusted in reserves. In preparing the transferee company's financial statements, under purchase method, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts, or alternatively, the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. The reserves whether capital or revenue or arising on revaluation of the transferor company other than the statutory reserves, should not be included in the financial statements of the transferee company. Any excess of the amount of consideration over the value of net assets of the transferor company acquired by the transferee company should be recognised in the balance sheet of the transferee company as goodwill and if the amount of consideration is lower than the net value of assets, the difference is to be treated as capital reserve.

AS-15 – Employee Benefits

This Standard prescribes accounting and disclosure for all employee benefits, except employee share-based payments.

The Standard specifies the following four categories of employee benefits:

(i) *Short-term employee benefits*, such as wages, salaries and social security contributions (e.g., contribution to an insurance company by an employer to pay for medical care of its employees), paid annual leave, profit- sharing and bonuses (if payable within twelve months of the end of the period) and non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees. The Standard requires that an enterprise should recognise the undiscounted amount of short-term employee benefits when an employee has rendered service in exchange for those benefits.

(ii) *Post-employment benefits,* such as gratuity, pension, other retirement benefits, post-employment life insurance and post-employment medical care. These are classified as either defined contribution plans or defined benefit plans depending on the economic substance of the plan. Under defined contribution plans, the enterprise's obligation is limited to the amount that it agrees to contribute to the fund and in consequence, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall on the employee. All other post-employment benefit plans are defined benefit plans. Accounting for defined benefit plans is complex because actuarial assumptions are required to measure the obligation and the expense and there is a possibility of actuarial gains and losses. Moreover, the obligations are measured on a discount basis since they may be settled in many years after the employees render the related service. Defined benefit plans may be unfunded, or they may be wholly or partly funded by contributions by an enterprise.

(iii) *Other long-term employee benefits,* including long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation. The Standard requires a simplified method of accounting for other long-term employee benefits than for post-employment benefits by requiring that past service cost should be recognised immediately

(iv) *Termination benefits*. Termination benefits are employee benefits payable as a result of either: an enterprise's decision to terminate an employee's employment before the normal retirement date; or an employee's decision to accept voluntary redundancy in exchange for those benefits (voluntary retirement).

AS-16 – Borrowing Cost

Borrowing costs are interest and other costs incurred by an enterprise in connection with borrowing of funds e.g. interest and commitment charges on bank borrowings and other short-term and long-term borrowings; amortization

of discounts or premiums relating to borrowings; amortization of ancillary costs incurred in connection with the arrangement of borrowings etc.

Borrowing costs that are directly attributable to the acquisition, construction or production of qualifying asset should be capitalised as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred. To the extent that funds are borrowed especially for the purpose of obtaining a qualifying asset, the amount of borrowing cost eligible for capitalization on that asset should be determined as the actual borrowing costs incurred on that borrowing. To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization should be determined by applying a capitalization rate to the expenditure on that asset. The capitalization rate would be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalized during a period should not exceed the amount of borrowing costs incurred during that period. When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realizable value, the carrying amount is written down or written off in accordance with requirements of other accounting demands. In certain circumstances, the amount of the written down or written off is written back in accordance with those of other accounting standards.

Capitalisation of borrowing costs should be suspended during the extended period in which active development is interrupted. Capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalization of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete. The financial statements should disclose (a) the accounting policy adopted for borrowing costs and (b) the amount of borrowing costs capitalized during the period.

AS-17 – Segment Reporting

The objective of this standard is to establish principles for reporting financial information, about the different types of products and services an enterprise produces and the different geographical areas in which it operates. The standard is applied in presenting general purpose financial statements. The dominant source and nature of risks and returns of an enterprise should govern whether its primary segment reporting format will be business segments or geographical segments. If the risks and returns of an enterprise are affected predominantly by differences in the products and services it produces, its primary format for reporting segment information should be business segments, with secondary information reported geographically. Similarly, if the risks and returns of the enterprise are affected predominantly by the fact that it operates in different countries or other geographical areas; its primary format for reporting segment information should be geographical segments, with secondary information reported for groups or related products and services.

Internal organisation and management structure of an enterprise and its system of internal financial reporting to the board of directors and the chief executive officer should normally be the basis for identifying the predominant source and nature of risks and differing rates of return facing the enterprise. Business and geographical segments of an enterprise for external reporting purposes should be those organizational units for which information is reported to the board of directors and to the chief executive officer for the purpose of evaluating the units performance and for making decisions about future allocation of resources.

A business segment or geographical segment should be identified as a reportable segment if (a) its revenue from sales to external customers and from transactions with other segment is 10 per cent or more of the total revenue, external and internal of all segments; or (b) its segment result, whether profit or loss is 10 per cent or more of (i) the combined result of all segments in profits or (ii) the combined results of all segments in loss which is greater in absolute amount; or (c) its segment assets are 10 per cent or more of the total assets of all segments.

A segment identified as a reportable segment in the immediately preceeding period because it satisfied the relevant 10 per cent thresholds should continue to be a reportable segment for the current period notwithstanding that its revenue result and asset all no longer meet the 10 per cent thresholds. If a segment is identified as a reportable segment in the current period because it satisfies the relevant 10 per cent thresholds, preceeding period segment data that is presented for comparative purposes should, unless it is impracticable to do so, be restated to reflect the newly reportable segment as a separate segment, even if that segment did not satisfy the 10 per cent thresholds in the preceeding period.

Segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole. Assets and liabilities that relate jointly to two or more segments if, and only if, their related revenues and expenses also are allocated to those segments.

AS-18 – Related Party Disclosures

This standard is applied in reporting related party relationships and transactions between a reporting enterprise and its related parties. Related partly disclosure requirements do not apply in circumstances where providing such disclosure would conflict with the reporting enterprise’s duties of confidentiality as specifically required in terms of a statute or by any regulator. It is stated that no disclosure is required in consolidated financial statements in respect of intra-group transactions. Also no disclosure is required in the financial statement of state controlled enterprises as regards related party relationship with other state controlled enterprises and transactions with such enterprises.

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

(i) the name of the transacting related party;

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

(iii) description of the nature of the transactions;

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

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

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

(vii) the amounts written off or written back in the period in respect of debts due from or to related parties. Items of a similar nature may be disclosed in aggregate by type of related party.

AS-19 – Leases

The objective of this standard is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures in relation to finance leases and operating leases. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership, title may or may not eventually be transferred. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incident to ownership.

Leases in the Financial Statement of Lessees

(a) *Financial Leases:* In this case at the inception of a financial lease, the lessee should recognise the lease as an asset and a liability. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the stand point of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the stand point of

the lessee. The lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability of each period. Also a finance lease gives rise to a depreciation expense for the asset as well as finance expense for each accounting period. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term or its useful life whichever is shorter.

(b) *Operating Leases:* Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

Leases in the Financial Statements of Lessors

(a) *Finance Leases:* The lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease. The recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the net investment of the lessor outstanding in respect of the finance lease.

(b) *Operating Leases:* The lessor should present an asset given under operating lease in its balance sheet under fixed assets. The lease income from operating leases should be recognised in the statement of profit and loss on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished. The depreciation on leased assets should be on a basis consistent with the normal depreciation policy of the lessor company.

Sale and lease back transaction

If a sale and lease back transaction results in a finance lease, any excess or deficiency of sales proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of a seller lessee, instead it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset. If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately.

AS-20 – Earnings Per Share

Earning per share (EPS) is a financial ratio that gives the information regarding earnings available to each equity share. This accounting standard gives computational methodology for determination and presentation of earnings per share. An enterprise should present basic and diluted earning per share on the face of the statement of profit and loss account for each class of equity shares that has a different right to share in the net profit for the period. An enterprise should present basic and diluted earning per share with equal prominence for all periods presented. The standard also requires that an enterprise to present basic and diluted earnings per share even if the amount disclosed are negative i.e. a loss per share.

Basic earning per share should be calculated by dividing the net profit or loss for the period attributable to equity shareholders by the weighted average number of equity shares outstanding during the period. For the purpose of calculating basic earnings per share, the net profit or loss for the period attributable to equity shareholders should be the net profit or loss for the period after deducting preference dividends and any attributable tax thereto. For the purpose of calculating basic earnings per share, the number of equity shares should be the weighted average number of equity shares outstanding during the period. The weighted average number of equity shares outstanding during the period reflects the fact that the amount of shareholders' capital may have varied during the period as a result of a larger or lesser number of shares outstanding at any time. It is the number of equity shares outstanding at the beginning of the period, adjusted by the number of equity shares bought back or issued during the period multiplied by the time-weighin factor.

Diluted earnings per share is calculated when there are potential equity shares in the capital structure of the enterprise. Potential equity share are those financial instruments which entitle the holder to the right of equity shares like convertible debentures, convertible preference shares, options warrants etc. For the purpose of calculating diluted earnings per share, the net profit or loss for the period attributable to equity shareholders and the weighted average number of shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares.

The weighted average number of equity shares outstanding during the period is increased by the weighted average number of additional equity shares which would have been outstanding assuming the conversion of all dilutive potential equity shares.

Potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would decrease net profit per share from continuing ordinary operations. Potential equity shares are anti-dilutive when their conversion to equity shares would increase earnings per share from continuing ordinary activities or decrease loss per share from continuing ordinary activities. The effects of anti-dilutive potential equity shares are ignored in calculating diluted earnings per share.

An enterprise should also disclose the following:

(i) The amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to the net profit or loss for the period;

(ii) The weighted average number of equity shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other; and

(iii) The nominal value of shares along with the earnings per share figures.

AS-21 – Consolidated Financial Statements

The objective of this standard is to lay down principles and procedures for preparation and presentation of consolidated financial statements and for accounting for investments in subsidiaries in separate financial statements. Consolidated financial statements are presented by a parent (also known as holding enterprise) to provide financial information about the economic activities of its group. Consolidated financial statements are the financial statements of a group presented as those of a single enterprise.

Consolidated financial statements normally include consolidated balance sheet, consolidated statement of profit and loss, and notes, other statements and explanatory material that form an integral part thereof. Consolidated cash flow statement is presented in case a parent presents its own cash flow statement. The consolidated financial statements are presented, to the extent possible, in the same format as that adopted by the parent for its separate financial statements. In preparing consolidated financial statements, the financial statements (balance sheet and profit and loss account) of the parent and its subsidiaries should be combined on a line by line basis by adding together like items of assets, liabilities, incomes and expenses.

For the purpose of consolidation the financial statements are required to 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 the consolidated financial statements, then the items in which different accounting policies have been followed should be disclosed.

Minority interests should be presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. The following disclosures should also be made in consolidated financial statements:

(i) a list of all subsidiaries including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held;

(ii) where applicable:

- the nature of the relationship between the parent and a subsidiary, if the parent does not own, directly or indirectly through subsidiaries, more than one-half of the voting power of the subsidiary;
- the effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date, the results for the reporting period and on the corresponding amounts for the preceding period; and
- the names of the subsidiary(ies) of which reporting date(s) is/are different from that of the parent and the difference in reporting dates.

AS-22 – Accounting for Taxes on Income

This Accounting Standard prescribes the accounting treatment for taxes on income. Traditionally amount of tax payable is determined on the profit/ loss computed as per income-tax laws. According to this accounting standard, tax on income is determined on the principle of accrual concept. According to this concept, tax should be accounted in the period in which corresponding revenue and expenses are accounted; in simple words tax shall be accounted on accrual basis; not on liability to pay basis.

This Standard should be applied in accounting for taxes on income. Accounting income (loss) is the net profit or loss for a period, as reported in the statement of profit and loss, before deducting income tax expense or adding income tax saving. Accounting income is determined based on generally accepted accounting principles to reflect a true and fair view of operations of an enterprise.

Taxable income (tax loss) is the amount of the income (loss) for a period, determined in accordance with the tax laws, based upon which income tax payable (recoverable) is determined. Tax expense (tax saving) is the aggregate of current tax and deferred tax charged or credited to the statement of profit and loss for the period.

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

The differences between taxable income and accounting income can be classified into permanent differences and timing differences. Permanent differences are those differences between taxable income and accounting income which originate in one period and do not reverse subsequently. Timing differences are those differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods. Timing differences arise because the period in which some items of revenue and expenses are included in taxable income do not coincide with the period in which such items of revenue and expenses are included or considered in arriving at accounting income.

Tax expense for the period, comprising current tax and deferred tax, should be included in the determination of the net profit or loss for the period. Deferred tax should be recognized for all the timing differences, subject to the consideration of prudence in respect of deferred tax assets.

The following disclosure procedure should be followed:

(i) An enterprise should offset assets and liabilities representing current tax if the enterprise:

(a) has a legally enforceable right to set off the recognized amounts; and

(b) intends to settle the asset and the liability on a net basis.

(ii) An enterprise should offset deferred tax assets and deferred tax liabilities if:

(a) the enterprise has a legally enforceable right to set off assets against liabilities representing current tax; and

(b) the deferred tax assets and the deferred tax liabilities relate to taxes on income levied by the same governing taxation laws.

(iii) Deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period. Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet of the enterprise, separately from current assets and current liabilities.

(iv) The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balances should be disclosed in the notes to accounts.

(v) The nature of the evidence supporting the recognition of deferred tax assets should be disclosed, if an enterprise has unabsorbed depreciation or carry forward of losses under tax laws.

AS-23 – Accounting for Investments in Associates in Consolidated Financial Statements

An associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor. Significant influence may be gained by share ownership, statute or agreement.

The existence of significant influence by an investor is identified in one or more of the following criteria:

– Representation on the board of directors.

– Participation in policy making processes.

– Material transactions between the investor and the investee.

– Interchange of managerial personnel.

– Provision of essential technical information.

Where an associate presents consolidated financial statements, the results and net assets to be taken into account are those reported in that associate's consolidated financial statements.

The carrying amount of investment in an associate should be reduced to recognize a decline, other than temporary, in the value of the investment, such reduction being determined and made for each investment individually.

The investor should also disclose in its financial statements the following:

(i) An appropriate description of associates including the proportion of ownership interest.

(ii) Investments in associates accounted for using the equity method should be classified as long-term investments and disclosed separately in the consolidated balance sheet. The investor's share of the profits or losses of such investments should be disclosed separately in the consolidated statement of profit and loss. The investor's share of any extraordinary or prior period items should also be separately disclosed.

(iii) The name(s) of the associate(s) of which reporting date(s) is/are different from that of the financial statements of an investor and the differences in reporting dates.

(iv) In case an associate uses accounting policies other than those adopted for the consolidated financial statements for like transactions and events in similar circumstances and it is not practicable to make appropriate adjustments to the associate's financial statements, the fact should be disclosed along with a brief description of the differences in the accounting policies.

AS-24 – Discontinuing Operations

As per the standard, discontinuing operation is a component of an enterprise:

(a) that the enterprise, pursuant to a single plan, is:

(i) disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders; or

(ii) disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually; or

(iii) terminating through abandonment; and

(b) that represents a separate major line of business or geographical area of operations; and

(c) that can be distinguished operationally and for financial reporting purposes.

With respect to a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs earlier:

(i) Entering into an agreement to sell substantially all of the assets of the discontinuing operation.

(ii) Approving and announcing of the discontinuance plan.

An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event occurs:

(i) A description of the discontinuing operation(s);

(ii) The business or geographical segment(s) :

(iii) The date and nature of the initial disclosure event;

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

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

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

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

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

When an enterprise disposes of assets or settles liabilities attributable to a discontinuing operation or enters into binding agreements for the sale of such assets or the settlement of such liabilities, the following informations are to be disclosed:

(i) Amount of gain or loss recognized on the disposal of assets or settlement of liabilities and related income tax; and

(ii) Net selling price from the sale of those net assets for which the enterprise has entered into binding sale agreements, the expected timing of receipt of those cash flows and the carrying amount of those net assets.

AS-25 – Interim Financial Reporting

An interim financial report means a financial report containing either a complete set of financial statements or a set of condensed financial statements for an interim period.

An interim financial report should include, at a minimum, the following components:

(i) Condensed balance sheet;

(ii) Condensed statement of profit and loss;

(iii) Condensed cash flow statement; and

(iv) Selected explanatory notes.

An enterprise should apply the same accounting policies in the interim financial statements as are applied in the annual financial statements. If an enterprise opts to prepare and present a complete set of financial statements in the interim financial reporting, it should be prepared in the format and as per the contents and requirements of annual financial statements.

The following minimum disclosure of notes and explanatory statements should be made in the interim financial report.

(i) A statement that the same accounting policies are followed in the interim financial statements as those followed in the most recent annual financial statements or, if those policies have been changed, a description of the nature and effect of the change.

(ii) Explanatory comments about the seasonality of interim operations.

(iii) Unusual factors that affected assets, liabilities, equity, net income and cash flows.

(iv) The effects of changes in estimates.

(v) Change in debt and equity through issuance, buy-back and repayments.

(vi) Details of dividend payment.

(vii) Segment revenue, segment capital employed and segment result for business segments or geographical segments, whichever is the primary basis of segment reporting.

(viii) The effect of changes in the composition of the enterprise during the interim period, such as amalgamations, acquisition or disposal of subsidiaries and long-term investments, restructurings, and discontinuing operations.

(ix) Material changes in contingent liabilities since the last annual balance sheet date.

Interim reports should include interim financial statements for the following periods:

(a) Balance sheet as of the current interim period and a comparative balance sheet as of the end of the immediately preceding financial year;

(b) Statements of profit and loss for the current interim period and cumulatively for the current financial year to date, with comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year;

(c) Cash flow statement cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

In deciding how to recognize, measure, classify, or disclose an item for interim financial reporting purposes, materiality should be assessed in relation to the interim period financial data. In making assessments of materiality, it should be recognized that interim measurements may rely on estimates to a greater extent than measurements of annual financial data

An enterprise should apply the same accounting policies in its interim financial statements as are applied in its

annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an enterprise's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis.

Revenues that are received seasonally or occasionally within a financial year should not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the enterprise's financial year. However costs that are incurred unevenly during an enterprise's financial year should be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.

AS-26 – Intangible Assets

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

An intangible asset should be recognised if, and only if:

(a) it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and

(b) the cost of the asset can be measured reliably.

An enterprise should assess the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset. As per the Standard an intangible asset should initially be measured at cost.

Internally generated goodwill should not be recognized as an asset. Intangible asset arising from research (or from the research phase of an internal project) should not be recognized as an asset. Expenditure on research (or on the research phase of an internal project) should be recognized as an expense when it is incurred.

An intangible asset arising from development (or from the development phase of an internal project) should be recognized if, and only if, an enterprise can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale;

(b) its intention to complete the intangible asset and use or sell it;

(c) its ability to use or sell the intangible asset;

(d) how the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and

(f) its ability to measure the expenditure attributable to the intangible asset during its development reliably.

This Accounting Standard takes the view that expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognized as intangible assets.

Expenditure on an intangible item that was initially recognized as an expense by a reporting enterprise in previous annual financial statements or interim financial reports should not be recognized as part of the cost of an intangible asset at a later date.

Enterprises may incur expenditure on intangible assets after these intangibles are recognized/recorded in the

book. The standard prescribes the conditions when such expenses should be capitalized and included in the cost of intangible assets.

(a) Subsequent expenses increase the future economic benefits of intangible assets;

(b) Subsequent expenses can be measured and attributed to the asset reliably.

If these conditions are not met, the subsequent expenses after initial recognition shall be expensed and not be capitalized.

After initial recognition, an intangible asset should be carried at its cost less any accumulated amortisation and an accumulated impairment losses.

The Accounting Standard states that the depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.

If control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless:

(a) the legal rights are renewable; and

(b) renewal is virtually certain.

The amortisation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. The amortistion charge for each period should be recognized as an expense unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset.

The residual value of an intangible asset should be assumed to be zero unless:

(a) there is a commitment by a third party to purchase the asset at the end of its useful life; or

(b) there is an active market for the asset and;

  (i) residual value can be determined by reference to that market; and

  (ii) it is probable that such a market will exist at the end of the asset's useful life.

The amortisation period and the amortisation method should be reviewed at least at each financial year end.

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

(a) The useful lives or the amortisation rates used;

(b) The amoritistion methods used;

(c) The gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period;

(d) A reconciliation of the carrying amount at the beginning and end of the period.

AS- 27 – Financial Reporting of Interests in Joint Ventures

A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

In respect of its interests in jointly controlled operations, a venturer should recognize in its separate financial statements and consequently in its consolidated financial statements:

(a) the assets that it controls and the liabilities that it incurs; and

(b) the expenses that it incurs and its shares of the income that it earns from the joint venture.

This Accounting Standard requires that the venturer should recognize the following in its separate financial statements, and consequently in its consolidated financial statements:

– Its share of the jointly controlled assets giving the details of each class of assets;

– Any liabilities, which it has incurred;

– Its share of any liabilities incurred jointly with the other venturers;

– Any income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and

– Any expenses which it has incurred in respect of its interest in the joint venture.

If venturer is required to prepare consolidated financial statements, then the interest in a jointly controlled entity should be reported as per proportionate consolidation. Method and procedure of consolidation are similar as prescribed by AS-21 of consolidation of accounts of holding and subsidiary, other requirements of consolidation as mentioned in AS-21 are to be followed.

When a venturer contributes or sells assets to a joint venture, recognition of any portion of a gain or loss from the transaction should reflect the substance of the transaction. While the assets are retained by the joint venture, and provided the venturer has transferred the significant risks and rewards of ownership, the venturer should recognize only that portion of the gain or loss, which is attributable to the interests of the other venturers. The venturer should recognize the full amount of any loss when the contribution or sale provides evidence of a reduction in the net realizable value of current assets or an impairment loss.

When a venturer purchases assets from a joint venture, the venturer should not recognize its share of the profits of the joint venture from the transaction until it resells the assets to an independent party. A venturer should recognize its share of the losses resulting from these transactions in the same way as profits except that losses should be recognized immediately when they represent a reduction in the net realizable value of current assets or an impairment loss.

In case of transactions between a venturer and joint venture in the form of a jointly controlled entity, the above recognition should be applied only in the preparation and presentation of consolidated financial statements and not in the preparation and presentation of separate financial statements of the venturer. Operators or managers of a joint venture should account for any fees in accordance with Accounting Standard (AS) 9, Revenue Recognition

A venturer should disclose the following information in its separate financial statements as well as in consolidated financial statements.

(i) The aggregate amount of the following contingent liabilities, unless the probability of loss is remote, separately from the amount of other contingent liabilities:

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

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

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

(ii) The aggregate amount of the following commitments in respect of its interests in joint ventures separately from other commitments:

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

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

(iii) A list of all joint ventures and description of interests in significant joint ventures.

(iv) In respect of jointly controlled entities, the proportion of ownership interest, name and country of incorporation or residence.

(v) The aggregate amounts of each of the assets, liabilities, income and expenses related to its interests in the jointly controlled entitles.

AS-28 – Impairment of Assets

The objective of this Standard is to prescribe the procedures that an enterprise applies to ensure that its assets are carried at no more than their recoverable amount.

In assessing whether there is any indication that an asset may be impaired, an enterprise should consider, as a minimum the following indications:

(a) External sources of information:

(i) during the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use;

(ii) significant changes with an adverse effect on the enterprise have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the enterprise operates or in the market to which an asset is dedicated;

(iii) market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially;

(iv) the carrying amount of the net assets of the reporting enterprise is more than its market capitalisation;

(b) Internal sources of information:

(i) evidence is available of obsolescence or physical damage of an asset;

(ii) significant changes with an adverse effect on the enterprise have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include plans to discontinue or restructure the operation to which an asset belongs or to dispose of an asset before the previously expected date; and

(iii) evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

In measuring value in use the following facts should be considered:

(i) cash flow projections should be based on reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset. Greater weight should be given to external evidence;

(ii) cash flow projections should be based on the most recent financial budgets/ forecasts that have been approved by management. Projections based on these budgets/forecasts should cover a maximum period of five years, unless a longer period can be justified; and

(iii) cash flow projections beyond the period covered by the most recent budgets/ forecasts should be

estimated by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified. This growth rate should not exceed the long-term average growth rate for the products, industries, or country or countries in which the enterprise operates, or for the market in which the asset is used, unless a higher rate can be justified.

The estimates of future cash flows should include the following:

(i) projections of cash inflows from the continuing use of the asset;

(ii) projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset (including cash outflows to prepare the asset for use) and that can be directly attributed, or allocated on a reasonable and consistent basis, to the asset; and

(iii) net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life.

In testing a cash-generating unit for impairment, an enterprise should identify whether goodwill that relates to this cash-generating unit is recognised in the financial statements. If this is the case, an enterprise should:

(a) perform a 'bottom-up' test, that is, the enterprise should:

  (i) identify whether the carrying amount of goodwill can be allocated on a reasonable and consistent basis to the cash-generating unit under review; and

  (ii) then, compare the recoverable amount of the cash-generating unit under review to its carrying amount (including the carrying amount of allocated goodwill, if any) and recognise any impairment loss.

  The enterprise should perform the step at (ii) above even if none of the carrying amount of goodwill can be allocated on a reasonable and consistent basis to the cash-generating unit under review; and

(b) if, in performing the 'bottom-up' test, the enterprise could not allocate the carrying amount of goodwill on a reasonable and consistent basis to the cash-generating unit under review, the enterprise should also perform a 'top-down' test, that is, the enterprise should:

  (i) identify the smallest cash-generating unit that includes the cash-generating unit under review and to which the carrying amount of goodwill can be allocated on a reasonable and consistent basis (the 'larger' cash-generating unit); and

  (ii) then, compare the recoverable amount of the larger cash-generating unit to its carrying amount (including the carrying amount of allocated goodwill) and recognise any impairment loss.

The increased carrying amount of an asset due to a reversal of an impairment loss should not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods.

For each class of assets, the financial statements should disclose the following:

(i) the amount of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are included;

(ii) the amount of reversals of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are reversed;

(iii) the amount of impairment losses recognised directly against revaluation surplus during the period; and

(iv) the amount of reversals of impairment losses recognised directly in revaluation surplus during the period.

AS-29 – Provisions, Contingent Liabilities and Contingent Assets

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

A contingent liability is:

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

(b) a present obligation that arises from past events but is not recognised because:

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

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

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.

This Standard specifies that a provision should be recognised when:

(a) an enterprise has a present obligation as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.

An enterprise should not recognise a contingent liability or contingent asset. The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The amount of a provision should not be discounted to its present value. The 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 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.

Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision. In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.

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

Provisions should not be recognised for future operating losses.

For each class of provision, an enterprise should disclose the following :

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

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

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

(d) unused amounts reversed during the period.

In addition an enterprise should also 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, and

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

Non Manadatory Accounting Standards:

AS 30 Financial Instruments, AS 31, Financial Instruments: Presentation and AS 32, Financial Instruments: Disclosures have yet not been notified by ministry of corporate affairs. However brief description of these three standards is as given below

AS 30, 31, & 32 – FINANCIAL INSTRUMENTS

Applicability of AS 30, 31 and 32

These standards are not mandatory but earlier adoption is encouraged. It may be mentioned that it has not been adopted by NACAS and thus in case of a company an earlier adoption of these standards might not comply with certain standards like

AS-13 investment: A Company needs to consult accounting experts in such situation. Needless to mention that in case the company wishes to adopt the standard than it shall adopt the entire standard and not a part of it.

ICAI Clarification – Principle of Prudence

Under situation where an item of financial instrument is suffering from losses, than based on principle of prudence the entity shall provide for such losses through its profit and loss account.

Objectives and scope

Financial instruments are addressed in three standards: AS-31, which deals with distinguishing debt from equity and with netting; AS 30, which contains requirements for recognition and measurement; and AS-32, which deals with disclosures. The objective of the three standards is to establish requirements for all aspects of accounting for financial instruments, including distinguishing debt from equity, netting, recognition, derecognition, measurement, hedge accounting and disclosure. The scope of the standards is wide-ranging. The standards cover all types of financial instrument, including receivables, payables, investments in bonds and shares, borrowings and derivatives. They also apply to certain contracts to buy or sell non-financial assets (such as commodities) that can be net settled in cash or another financial instrument.

Nature and characteristics of financial instruments

Financial instruments include a wide range of assets and liabilities. They can mostly be exchanged for cash. They are recognised and measured according to AS-30 requirements and are disclosed in accordance with AS-32. Financial instruments represent contractual rights or obligations to receive or pay cash or other financial asset. A financial asset is cash; a contractual right to receive cash or another financial asset; a contractual right to exchange financial assets or liabilities with another entity under conditions that are potentially favourable; or an equity instrument of another entity. A financial liability is a contractual obligation to deliver cash or another financial asset or to exchange financial instruments with another entity under conditions that are potentially unfavourable. An equity instrument is any contract that evidences a residual interest in the entity's assets after deducting all its liabilities. A derivative is a financial instrument that derives its value from an underlying price or

index, requires little or no initial investment and is settled at a future date. In some cases contracts to receive or deliver a company's own equity can also be derivatives.

Embedded derivatives in host contracts

Some financial instruments and other contracts combine, in a single contract, both a derivative element and a non-derivative element. The derivative part of the contract is referred to as an 'embedded derivative' and its effect is that some of the cash flows of the contract will vary in a similar way to a standalone derivative. For example, the principal amount of a bond may vary with changes in a stock market index. In this case, the embedded derivative is an equity derivative on the relevant stock market index.

Embedded derivatives that are not 'closely related' to the rest of the contract are separated and accounted for as if they were stand-alone derivatives (i.e., measured at fair value, generally with changes in fair value recognised in profit or loss). An embedded derivative is not closely related if its economic characteristics and risks are different from those of the rest of the contract. AS-30 sets out examples to help determine when this test is (and is not) met. Analysing contracts for potential embedded derivatives and accounting for them is one of the more challenging aspects of AS-30.

Classification of financial instruments

The way that financial instruments are classified under AS-30 drives how they are subsequently measured and where changes in measurement are accounted for.

There are four classes of financial asset under AS-30: available for sale, held to maturity, loans and receivables, and fair value through profit or loss. The factors taken into account in classifying financial assets include:

- The cashflows arising from the instrument — are they fixed or determinable? Does the instrument have a maturity date?
- Are the assets held for trading; does management intend to hold the instruments to maturity?
- Is the instrument a derivative or does it contain an embedded derivative?
- Is the instrument quoted on an active market?
- Has management designated the instrument into a particular classification at inception?

Financial liabilities are classified as fair value through profit or loss if they are so designated (subject to various conditions) or if they are held for trading. Otherwise they are classed as 'other liabilities'. Financial assets and liabilities are measured either at fair value or at amortised cost, depending on this classification. Changes are taken to either the income statement or directly to equity.

Financial liabilities and equity

The classification of a financial instrument by the issuer as either a liability (debt) or equity can have a significant impact on an entity's reported earnings, its borrowing capacity, and debt-to-equity and other ratios that could affect the entity's debt covenants. The substance of the contractual arrangements of a financial instrument, rather than its legal form, governs its classification. This means, for example, that since a preference share redeemable (puttable) by the holder is economically the same as a bond, it is accounted for in the same way as the bond. Therefore, the redeemable preference share is treated as a liability rather than equity, even though legally it is a share of the issuer. The critical feature of debt is that under the terms of the instrument the issuer is, or can be, required to deliver either cash or another financial asset to the holder and cannot avoid this obligation. For example, a debenture, under which the issuer is required to make interest payments and redeem the debenture for cash, is a financial liability. An instrument is classified as equity when it represents a residual interest in the issuer's assets after deducting all its liabilities. Ordinary shares or common stock, where all the payments are at the discretion of the issuer, are examples of equity of the issuer. A special exception exists to the general principal of classification for certain subordinated redeemable (puttable) instruments that participate

in the *pro rata* net assets of the entity. Where specific criteria are met such instruments would be classified as equity of the issuer. Some instruments contain features of both debt and equity. For these instruments, an analysis of the terms of each instrument in light of the detailed classification requirements will be necessary. Such instruments, such as bonds that are convertible into a fixed number of equity shares either mandatorily or at the holder's option, must be split into debt and equity (being the option to convert) components. A financial instrument, including a derivative, is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. The classification of contracts that will or may be settled in the entity's own equity instruments is dependent on whether there is variability in either the number of own equity delivered and/or variability in the amount of cash or other financial assets received, or whether both are fixed. The treatment of interest, dividends, losses and gains in the income statement follows the classification of the related instrument. So, if a preference share is classified as debt, its coupon is shown as interest. But the dividend payments on an instrument that is treated as equity are shown as a distribution.

Recognition and derecognition

Recognition

Recognition issues for financial assets and financial liabilities tend to be straight forward. An entity recognises a financial asset or a financial liability at the time it becomes a party to a contract.

Derecognition

Derecognition is the term used for ceasing to recognise a financial asset or financial liability on an entity's balance sheet. The rules here are more complex.

Assets

An entity that holds a financial asset may raise finance using the asset as security for the finance, or as the primary source of cash flows from which to repay the finance. The derecognition requirements of AS 30 determine whether the transaction is a sale of the financial assets (and, therefore, the entity ceases to recognise the assets) or whether finance secured on the assets has been raised (and the entity recognises a liability for any proceeds received). This evaluation might be straightforward. For example, it is clear with little or no analysis that a financial asset is derecognised in an unconditional transfer of it to an unconsolidated third party with no risks and rewards of the asset being retained. Conversely, it is clear that derecognition is not allowed where an asset has been transferred, but it is clear that substantially all the risks and rewards of the asset have been retained through the terms of the agreement. However, in many other cases, the analysis is more complex. Securitisation and debt factoring are examples of more complex transactions where derecognition will need careful consideration.

Liabilities

An entity may only cease to recognize (derecognise) a financial liability when it is extinguished — that is, when the obligation is discharged, cancelled or expired, or when the debtor is legally released from the liability by law or by the creditor agreeing to such a release.

Measurement of financial assets and liabilities

Under AS 30, all financial instruments are measured initially at fair value. The fair value of a financial instrument is normally the transaction price — that is, the amount of the consideration given or received. However, in some circumstances, the transaction price may not be indicative of fair value. In that situation, an appropriate fair value is determined using data from current observable transactions in the same instrument or based on a valuation technique whose variables include only data from observable markets.

The measurement of financial instruments after initial recognition depends on their initial classification. All financial assets are measured at fair value except for loans and receivables, held-to-maturity assets and, in

rare circumstances, unquoted equity instruments whose fair values cannot be measured reliably or derivatives linked to and which must be settled by the delivery of such unquoted equity instruments that cannot be measured reliably. Loans and receivables and held-to-maturity financial assets are measured at amortised cost. The amortised cost of a financial asset or liability is measured using the 'effective interest method'. Available-for-sale financial assets are measured at fair value with changes in fair value recognised in equity. For available-for-sale debt securities, interest is recognised in income using the 'effective interest method'. Available-for-sale equity securities dividends are recognised in income as the holder becomes entitled to them. Derivatives (including separated embedded derivatives) are measured at fair value. All fair value gains and losses are recognised in profit or loss except where they qualify as hedging instruments in cash flow hedges. Financial liabilities are measured at amortised cost using the effective interest method unless they are measured at fair value through profit or loss. Financial assets and liabilities that are designated as hedged items may require further adjustments under the hedge accounting requirements. All financial assets, except those measured at fair value through profit or loss, are subject to review for impairment. Therefore, where there is objective evidence that such a financial asset may be impaired, the impairment loss is calculated and recognised in profit or loss.

Hedge accounting

'Hedging' is the process of using a financial instrument (usually a derivative) to mitigate all or some of the risk of a hedged item. 'Hedge accounting' changes the timing of recognition of gains and losses on either the hedged item or the hedging instrument so that both are recognised in profit or loss in the same accounting period. To qualify for hedge accounting, an entity (a) at the inception of the hedge, formally designates and documents a hedge relationship between a qualifying hedging instrument and a qualifying hedged item; and (b) both at inception and on an ongoing basis, demonstrates that the hedge is highly effective.

There are three types of hedge relationship

- Fair value hedge: a hedge of the exposure to changes in the fair value of a recognised asset or liability, or a firm commitment.
- Cash flow hedge: a hedge of the exposure to variability in cash flows of a recognised asset or liability, a firm commitment or a highly probable forecast transaction.
- Net investment hedge: a hedge of the foreign currency risk on a net investment in a foreign operation.

For a fair value hedge, the hedged item is adjusted for the gain or loss attributable to the hedged risk. That element is included in the income statement where it will offset the gain or loss on the hedging instrument. For a cash flow hedge, gains and losses on the hedging instrument, to the extent it is an effective hedge, are initially included in equity. They are reclassified to the profit or loss when the hedged item affects the income statement. If the hedged item is the forecast acquisition of a non-financial asset or liability, the entity may choose an accounting policy of adjusting the carrying amount of the non-financial asset or liability for the hedging gain or loss at acquisition.

Hedges of a net investment in a foreign operation are accounted for similarly to cash flow hedges.

Presentation and disclosure

There have been significant developments in risk management concepts and practices in recent years. New techniques have evolved for measuring and managing exposures to risks arising from financial instruments. The need for more relevant information and improved transparency about an entity's exposures arising from financial instruments and how those risks are managed has become greater. Financial statement users and other investors need such information to make more informed judgements about risks that entities run from the use of financial instruments and their associated returns. However, the disclosures in IAS 30 (disclosure requirements for banks and similar financial institutions) and AS 31 were no longer in keeping with such developments, and there was a need to revise and enhance the disclosure framework for risks arising from

financial instruments. AS 32, 'Financial instruments: disclosures', was issued to address this need. AS 32 sets out disclosure requirements that are intended to enable users to evaluate the significance of financial instruments for an entity's financial position and performance and to understand the nature and extent of risks arising from those financial instruments to which the entity is exposed. AS 32 does not just apply to banks and financial institutions. All entities that have financial instruments are affected, even simple instruments such as borrowings, accounts payable and receivable, cash and investments.

INTERNATIONAL ACCOUNTING STANDARDS (IAS)/ INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

IFRS are now becoming the global financial reporting language. The importance of IFRS has grown significantly in the recent times. However the concept of IFRS is not new. Back in the year 1973, the professional accountancy bodies of developed economies such as USA, London, Germany, Japan, France etc. recognised the need to harmonize the accounting principles and standards followed by different countries and formed International Accounting Standards Committee (IASC). IASC is a not for profit corporation incorporated in USA and operates from London. It took the responsibility of harmonizing accounting practices followed worldwide by issuing International Accounting Standards (IAS). These IAS were adopted by many multinational companies and endorsed by many countries as their own standards. Most of the nations adopted these international standards but modified them according to their situations and environment prevailing in their own country. With the passage of time several country level accounting principles emerged and there were many gaps between these local generally accepted accounting principles and the IAS. So, in the year 2001, international fraternity of accountants decided to revise the whole framework. In 2001, IASC was renamed as International Accounting Standards board (IASB).

The accounting standards issued by IASB are known as International Financial Reporting Standards (IFRS). IFRS is a set of international accounting standards stating how particular types of transactions and other events should be reported in financial statements. IFRS are nothing but principles-based standards, interpretations and the framework adopted by the International Accounting Standards Board (IASB). International Financial Reporting Standards comprise of:

– *9-International Financial Reporting Standards (IFRS)—standards issued after 2001 by IASB.*

– *29-International Accounting Standards (IAS)—standards issued before 2001by IASC which are still valid.*

– *16-Interpretations issued by International Financial Reporting Interpretations Committee (IFRIC) after 2001.*

– *11–interpretations issued by Standing Interpretations* Committee *(SIC) before 2001.*

However, in practice IFRS is interchangeably used to denote individual accounting standards issued by IASB as well as International accounting principles collectively. Following are some of the advantages of IFRS:

– *Facilitate increased comparability of financial information between companies operating in different countries.*

– *The financial reporting process would become more transparent.*

– *The standardization of accounting methodology provides creditors and investors with the ability to analyze businesses around the world using the same financial methods.*

– *It would also permit international capital to flow more freely.*

– *It would give investors a better understanding to the financial statements and assess the investment opportunities in other countries.*

– *It would also benefit the accounting professionals as they will be able to sell their services in the different parts of the world.*

All these benefits of IFRS have prompted many countries to pursue convergence of national accounting standards with IFRS. India has also decided to facilitate the convergence of the Indian accounting standards with IFRS and in this direction all existing accounting standards are being revised and converged with corresponding IAS/ IFRS. Convergence of entire world towards IFRS would benefit the corporate sector, investors, regulators and facilitate economic growth as a whole.

The following International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS) issued by the IASB which are in force:

IAS-1	Presentation of Financial Statements
IAS-2	Inventories
IAS-7	Cash Flow Statements
IAS-8	Accounting Policies, Changes in Accounting Estimates and Errors
IAS-10	Events After the Balance Sheet Date
IAS-11	Construction Contracts
IAS-12	Income Taxes
IAS-14	Segment Reporting
IAS-16	Property, Plant and Equipment
IAS-17	Leases
IAS-18	Revenue
IAS-19	Employee Benefits
IAS-20	Accounting for Government Grants and Disclosure of Government Assistance
IAS-21	The Effects of Changes in Foreign Exchange Rates
IAS-23	Borrowing Costs
IAS-24	Related Party Disclosures
IAS-26	Accounting and Reporting by Retirement Benefit Plans
IAS-27	Consolidated and Separate Financial Statements
IAS-28	Investments in Associates
IAS-29	Financial Reporting in Hyperinflationary Economies
IAS-31	Interests in Joint Ventures
IAS-33	Earnings Per Share
IAS-34	Interim Financial Reporting
IAS-36	Impairment of Assets

IAS-37	Provisions, Contingent Liabilities and Contingent Assets
IAS-38	Intangible Assets
IAS-39	Financial Instruments: Recognition and Measurement
IAS-40	Investment Property
IAS-41	Agriculture
IFRS-1	First-time Adoption of International Financial Reporting Standards
IFRS-2	Share-based Payment
IFRS-3	Business Combinations
IFRS-4	Insurance Contracts
IFRS-5	Non-current Assets Held for Sale and Discounted Operations
IFRS-6	Exploration for and Evaluation of Mineral Resources
IFRS-7	Financial Instrument: Disclosures
IFRS-8	Operating Segments
IFRS-9	Financial Instruments

A brief description of the above International Accounting Standards and International Financial Reporting Standards is given below:

IAS-1 – Presentation of Financial Statements

The standard prescribes the minimum structure and content, including certain information required on the face of the financial statements. There are four basic financial statements:

(i) Balance sheet

(ii) Income statement

(iii) Cash flow statement

(iv) Statement showing changes in equity.

The statement shows (a) each item of income and expense, gain or loss, which, as required by other IASC Standards, is recognised directly in equity, and the total of these items, certain foreign currency translation gains and losses and changes in fair values of financial instruments and (b) net profit or loss for the period. Owners' investments and withdrawals of capital and other movements in retained earnings and equity capital are shown in the notes.

IAS-2 – Inventories

Inventories should be valued at the lower of cost and net realisable value. Net realisable value is selling price less cost to complete the inventory and sell it. Cost includes all costs to bring the inventories to their present condition and location. If specific cost is not determinable, the benchmark treatment is to use FIFO or weighted average. An allowed alternative is LIFO, but then there should be disclosure of the lower of (i) net realisable value and (ii) FIFO, weighted average or current cost. The cost of inventory is recognised as an expense in the period in which the related revenue is recognised. If inventory is written down to net realisable value, the write-down is charged to expense. Any reversal of such a write-down in a later period is credited to income by reducing that period's cost of goods sold.

IAS-7 – Cash Flow Statements

The cash flow statement is a required basic financial statement. It explains changes in cash and cash equivalents during a period. Cash equivalents are short-term, highly liquid investments subject to insignificant risk of changes in value. Cash flow statement should classify changes in cash and cash equivalents into operating, investing, and financial activities.

IAS-8 – Accounting Policies, Changes in Accounting Estimates and Errors

An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless a Standard or an Interpretation specifically requires or permits categorisation of items for which different policies may be appropriate. An entity shall change an accounting policy only if the change (a) is required by a Standard or an Interpretation; or (b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

IAS-10 – Events After the Balance Sheet Date

An entity shall adjust the amounts recognized in its financial statements to reflect adjusting events after the balance sheet date. Further an entity shall not adjust the amounts recognized in its financial statements to reflect non-adjusting events after the balance sheet. If an entity declares dividends to holders of equity instruments after the balance sheet date, the entity shall not recognize those dividends as a liability at the balance sheet date. An entity shall not prepare its financial statements on a going concern basis if management determines after the balance sheet date either that it intends to liquidate the entity or to cease trading, or it has no realistic alternative but to do so.

IAS-11 – Construction Contracts

If the total revenue, past and future costs, and the stage of completion of a contract can be measured or estimated reliably, revenues and costs should be recognised by stage of completion (the "percentage-of-completion method"). The expected losses should be recognised immediately. If the outcome cannot be measured reliably, costs should be expensed, and revenues should be recognised to the extent that costs are recoverable ("cost recovery method").

IAS-12 – Income Taxes

It provides, among other things:

(i) Accrue deferred tax liability for nearly all taxable temporary differences.

(ii) Accrue deferred tax asset for nearly all deductible temporary differences if it is probable a tax benefit will be realised.

(iii) Accrue unused tax losses and tax credits if it is probable that they will be realised.

(iv) Use tax rates expected at settlement.

(v) Current and deferred tax assets and liabilities are measured using the tax rate applicable to undistributed profits.

(vi) Non-deductible goodwill: no deferred tax.

(vii) Unremitted earnings of subsidiaries, associates, and joint ventures: Do not accrue tax.

(viii) Capital gains: Accrue tax at expected rate.

(ix) Do not "gross up" government grants or other assets or liabilities whose initial recognition differs from initial tax base.

IAS-14 – Segment Reporting

Basis of Segment Reporting:

(i) Public companies must report information along product and service lines and along geographical lines.

(ii) One basis of segmentation is primary, the other is secondary.

(iii) Segment accounting policies the same as consolidated.

IAS-16 – Property, Plant and Equipment

The cost of an item of property, plant and equipment should be recognised as an asset if, and only if, (a) it is probable that future economic benefits associated with the item will flow to the entity; and (b) the cost of the item can be measured reliably. An item of property, plant and equipment that qualifies for recognition, as an asset should shall be measured at its cost. An entity shall choose either the cost model or the revaluation model as its accounting policy and shall apply that policy to an entire class of property, plant and equipment. If an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued. If an asset's carrying amount is increased as a result of revaluation, the increase shall be credited directly to equity under the heading of revaluation surplus. If an asset's carrying amount is decreased as a result of revaluation, the decrease shall be recognized in profit or loss. However, the decrease shall be debited directly to equity under the heading revaluation surplus in respect of that asset.

IAS-17 – Leases

A lease is classified as finance lease if it transfers substantially all risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership. At the commencement of the lease term, lessees shall recognize finance leases as assets and liabilities in their balance sheets at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease. Any initial direct costs of the lessee are added to the amount recognized as an asset. Finance lease gives rise to depreciation expense for depreciable assets as well as finance expense for each accounting period. Lease payments under operating lease shall be recognized as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

IAS-18 – Revenue

Revenue should be measured at fair value of consideration received or receivable. Usually this is the inflow of cash. Discounting is needed if the inflow of cash is significantly deferred without interest. If dissimilar goods or services are exchanged (as in barter transactions), revenue is the fair value of the goods or services received or, if this is not reliably measurable, the fair value of the goods or services given up.

Revenue should be recognised when:

(i) significant risks and rewards of ownership are transferred to the buyer;

(ii) managerial involvement and control have passed;

(iii) the amount of revenue can be measured reliably;

(iv) it is probable that economic benefits will flow to the enterprise; and

(v) the costs of the transaction (including future costs) can be measured reliably.

IAS-19 – Employee Benefits

Post-employment Benefits including Pensions

Defined Contribution Plans: Contribution of a period should be recognised as expenses.

Defined Benefits Plans: Current service cost should be recognised as an expense.

Other Employee Benefits: Including vacations, holidays, accumulating sick pay, retiree medical and life insurance, etc.

IAS-20 – Accounting for Government Grants and Disclosure of Government Assistance

Grants should not be credited directly to equity. They should be recognised as income in a way matched with the related costs. Grants related to assets should be deducted from the cost or treated as deferred income.

IAS-21 – The Effects of Changes in Foreign Exchange Rates

A foreign currency transaction shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction. Reporting at subsequent balance sheet date should be: (a) foreign currency monetary items shall be translated using the closing rate; (b) non-monetary items that are measured in terms of historical cost in a foreign currency shall be translated using the exchange rate at the date of the transaction; and (c) non monetary items that are measured at fair value in a foreign currency shall be translated using the exchange rates at the date when the fair value was determined. Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements shall be recognized in profit and loss in the period in which they arise. When a gain or loss on a non-monetary item is recognized directly in equity, any exchange component of that gain or loss shall be recognized directly in equity. Conversely, when a gain or loss on a monetary item is recognized in profit or loss, any exchange component of that gain or loss shall be recognized in profit or loss.

IAS-23 – Borrowing Costs

The benchmark treatment is to treat borrowing costs as expenses. The allowed alternative is to capitalise those directly attributable to construction. If capitalised and funds are specifically borrowed, the borrowing costs should be calculated after any investment income on temporary investment of the borrowings. If funds are borrowed generally, then a capitalisation rate should be used based on the weighted average of borrowing costs for general borrowings outstanding during the period. Borrowing costs capitalised should not exceed those actually incurred. Capitalisation begins when expenditures and borrowing costs are being incurred and construction of the asset is in progress. Capitalisation suspends if construction is suspended for an extended period, and ends when substantially all activities are complete.

IAS-24 – Related Party Disclosures

This standard requires disclosure of related party transactions and outstanding balances in the separate financial statements of a parent, venturer or investor. A party is related to an entity if: (a) directly or indirectly through one or more intermediaries, the party: (i) controls, is controlled by, or is under common control with, the entity which includes parents, subsidiaries and fellow subsidiaries: (ii) has an interest in the entity that gives it significant influence over the entity; or (iii) has joint control over the entity; (b) the party is an associate; (c) the party is a joint venture in which the entity is a venturer; (d) the party is a member of the key management personnel; (e) the party is close member of the family; (f) the party is controlled, jointly controlled or significantly influenced; (g) the party is a post –employment benefit plan for the benefit of employees of the entity.

IAS-26 – Accounting and Reporting by Retirement Benefit Plans

The standard applies to accounting and reporting by retirement benefit plans. It establishes separate standards for reporting by defined benefit plans and by defined contribution plans.

IAS-27 – Consolidated and Separate Financial Statements

Consolidated financial statements are the financial statements of a group presented as those of a single economic activity. Consolidated financial statements shall include all subsidiaries of the parent. Intra-group balances, transactions, income and expenses shall be eliminated in full. The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements shall be prepared as on the same reporting date. When the reporting dates are different, the subsidiary prepares additional financial statements as on the same date. Consolidated financial statements shall be prepared using uniform accounting policies for like transactions. Minority interests shall be presented in the consolidated balance sheet within equity, separately from the parent shareholders' equity.

IAS-28 – Investments in Associates

An associate is an entity, including an unincorporated entity such as partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture. An investment in an associate shall be accounted for using the equity method with specified exceptions. An investor shall discontinue the use of equity method from the date that it ceases to have significant influence over an associate. The investor in applying equity method uses the most recent available financial statements of the associate. When the reporting dates of the investor and the associate are different, the associates prepares, for the use of the investor, financial statements as of the same date as the financial statements of the investor. The investor's financial statements shall be prepared using uniform accounting policies for like transactions and events in similar circumstances.

IAS-29 – Financial Reporting in Hyperinflationary Economies

Hyperinflation is indicated if cumulative inflation over three years is 100 per cent or more (among other factors). In such a circumstance, financial statements should be presented in a measuring unit that is current at the balance sheet date. Comparative amounts for prior periods are also restated into the measuring unit at the current balance sheet date. Any gain or loss on the net monetary position arising from the restatement of amounts into the measuring unit current at the balance sheet date should be included in net income and separately disclosed.

IAS-31 – Interests in Joint Ventures

A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control. These are of three types:

(i) *Jointly controlled operations*: It should be recognised by the venturer by including the assets and liabilities that it controls and the expenses that it incurs and its share of the income that it earns from the sale of goods or services by the venture.

(ii) *Jointly controlled assets*: It should be recognised as follows:

(a) its share of the jointly controlled assets, classified according to the nature of the assets;

(b) any liability that it has incurred;

(c) its share of any liabilities incurred jointly with the other venturers in relation to the joint venture;

(d) any income from the sale or use of its share of output of the joint venture;

(e) any expenses that it incurred in respect of its interest in the joint venture.

(iii) *Jointly controlled entities*: It may maintain its own accounting records and prepares and presents financial statements in the same way as other entities in conformity with International Financial Reporting Standard.

IAS-33 – Earnings Per Share

It is applicable only to public companies. An entity shall calculate basic earnings per share for profit or loss attributable to ordinary equity holders. Basic earning per share shall be calculated by dividing profit or loss attributable to ordinary equity holders by the weighted average number of ordinary shares. An entity shall calculate diluted earnings per share amounts for profit or loss attributable to ordinary equity holders of the parent entity and, if presented, profit or loss from continuing operations attributable to those equity holders. For the purpose of calculating diluted earnings per share, an entity shall adjust profit or loss attributable to ordinary equity holders of the parent equity, and the weighted average number of shares outstanding, for the effects of all dilutive potential ordinary shares. Potential ordinary shares shall be treated as dilutive when, and only when, their conversion to ordinary shares would decrease earnings per share or increase loss per share from continuing operations.

An entity shall present on the face of the income statement basic and diluted earnings per share profit or loss from continuing operations attributable to the ordinary equity holders of the parent entity and for profit or loss attributable to the ordinary equity holders of the parent entity for the period for each class of ordinary shares that has a different right to share in profit for the period.

IAS-34 – Interim Financial Reporting

The standard defines the minimum content of an interim financial report as a condensed balance sheet, condensed income statement, condensed cash flow statement, condensed statement showing changes in equity, and selected explanatory notes.

Interim financial statements, complete or condensed, must cover the following periods:

(i) a balance sheet at the end of the current interim period, and comparative as of the end of the most recent full financial year;

(ii) income statements for the current interim period and cumulative for the current financial year to date, with comparative statements for the comparable interim periods of the immediately preceding financial year;

(iii) a statement of changes in equity cumulatively for the current financial year to date and comparative for the same year-to-date period of the prior year; and

(iv) a cash flow statement cumulatively for the current financial year to date and comparative for the same year-to-date period of the prior financial year.

Enterprises are required to apply the same accounting policies in their interim financial reports as in their latest annual financial statements

IAS-36 – Impairment of Assets

Impairment of assets, deals mainly with accounting for impairment of goodwill, intangible assets and property, plant and equipment. The standard includes requirements for identifying an impaired asset, measuring its recoverable amount, recognising or reversing any resulting impairment loss, and disclosing information on impairment losses or reversals of impairment losses. An impairment loss should be recognised whenever the recoverable amount of an asset is less than its carrying amount.

IAS-37 – Provisions, Contingent Liabilities and Contingent Assets

The standard set out three specific applications of these general requirements:

(a) a provision should not be recognised for future operating losses;

(b) a provision should be recognised for an onerous;

(c) a provision for restructuring costs should be recognised only when an enterprise has a detailed formal plan for the restructuring and has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

IAS-38 – Intangible Assets

The standard states that:

(i) an intangible asset should be recognised, in the financial statements, if, and only if:

  (a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the enterprise; and

  (b) the cost of the asset can be measured reliably.

(ii) An entity shall assess the probability of expected future economic benefits using reasonable and supportive assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset.

(iii) Internally generated goodwill shall not be recognized as an asset.

(iv) No intangible asset arising from research shall be recognized.

(v) An intangible asset arising from development shall be recognized subject to specified conditions.

(vi) Expenditure on an intangible item that was initially recognized as an expense shall not be recognized as part of the cost of an intangible asset at a latter date.

(vii) The accounting for an intangible asset is based on its useful life.

(viii) An intangible asset shall be derecognised on disposal or when no future economic benefits are expected from its use or disposal.

IAS-39 – Financial Instruments: Recognition and Measurement

Under this standard an entity shall recognize a financial asset or financial liability on the balance sheet when and only when, the entity becomes a party to the contractual provisions of the instrument. An entity shall derecognise a financial asset when, the contractual rights to the cash flows from the financial asset expire or it transfers the financial asset. On derecognition of a financial asset in its entirety, the difference between the carrying amount and the sum of (a) the consideration received and (b) any cumulative gain or loss that had been recognized directly in equity shall be recognized in profit or loss.

When a financial asset or liability is recognized initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial assets or financial liability. After initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method.

IAS-40 – Investment Property

Investment property shall be recognized as an asset when it is probable that the future economic benefits that are associated with the investment property will flow to the entity, and the cost of investment property can be measured reliably. An investment property shall be measured initially at its cost. Transaction cost shall also be included in the initial measurement.

For accounting purpose an enterprise must choose either:

(i) *a fair value model*: Investment property should be measured at fair value and changes in fair value should be recognised in the income statement; or

(ii) *a cost model*: Investment property should be measured at depreciated cost (less any accumulated impairment losses).

An investment property shall be derecognised on disposal or when the investment property is permanently withdrawn from use and no future economic benefits are expected from its disposal.

IAS-41 – Agriculture

This standard prescribes the accounting treatment, financial statement presentation and disclosures related to agricultural activity. Biological assets should be measured at their fair value less estimated point-of-sale costs, except where fair value cannot be measured reliably. Agricultural produce harvested from an enterprise's biological assets should be measured at its fair value less estimated point-of-sale costs at the point of harvest. If an active market exists for a biological asset or agricultural produce, the quoted price in that market is the appropriate basis for determining the fair value of that asset. If an active market does not exist, an enterprise uses market-determined prices or values when available. A gain or loss arising on initial recognition of biological assets and from the change in fair value less estimated point-of- sale costs of biological assets should be included in net profit or loss for the period in which it arises. If a government grant related to a biological asset measured at its fair value less estimated point-of-sale costs is conditional, including where a government grant requires an enterprise not to engage in specified agricultural activity, an enterprise should recognise the government grant as income when the conditions attaching to the government grant are met.

IFRS-1 – First–time Adoption of International Financial Reporting Standards

The objective of this IFRS is to ensure that an entity's first IFRS financial statement and its financial reports for part of the period covered by those financial statements, contain high quality information that: (a) is transparent for users and comparable over all periods presented; (b) provides a suitable starting point for accounting under International Financial Reporting Standards; and (c) can be generated at a cost that does not exceed the benefits to users.

An entity shall use the accounting policies in its opening IFRS balance sheet and throughout all periods presented in its first IFRS financial statements. An entity's estimates under IFRS at the date of transition to IFRS shall be consistent with estimates made for the same date under previous GAAP, unless there is objective evidence that those estimates were in error. An entity shall explain how the transition from previous GAAP to IFRSs affected its reported financial position, financial performance and cash flows.

IFRS-2 – Share-based Payment

Entities often grant shares or share option to employees or other parties. An entity shall recognize the goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are rendered. The entity shall recognize a corresponding increase in equity if the goods or services were received in an equity- settled share-based payment transaction, or a liability if the goods or services were acquired in cash settled share based payment transaction. When the goods or services received or acquired in a share-based payment transaction do not qualify for recognition as assets, they shall be recognized as expenses. For equity settled share based payment transactions, the entity shall measure the goods or services received, and the corresponding increase in equity directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. For cash-settled share-based payment transactions, the entity shall measure the goods or services acquired and the liability incurred at the fair value of the liability. For share-based payment transactions in which the terms of the arrangement provide either the entity or the counterparty with the choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments, the entity shall account for that transaction, or the components of that transaction, as a cash-settled share-based payment

transaction if, and to the extent that, the entity has incurred a liability to settle in cash or other assets, or as an equity-settled share-based payment transaction if, and to the extent that, no such liability has been incurred.

IFRS-3 – Business Combinations

The objective of this IFRS is to specify the financial reporting by an entity when it undertakes a business combination. The acquirer is the combining entity that obtains control of the other combining entities or businesses. The acquirer shall measure the cost of a business combination as the aggregate of:

(a) the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree; plus; (b) any costs directly attributable to the business combination.

The acquirer shall at the acquisition date: (a) recognize goodwill acquired in a business combination as an asset; and (b) initially measure that goodwill at its cost, being the excess of the cost of the business combination over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities.

IFRS-4 – Insurance Contracts

The objective of this IFRS is to specify the financial reporting for insurance contracts by any entity that issues such contracts until the Board completes the second phase of its project on insurance contracts.

An insurer shall assess at each reporting date whether it's recognized insurance liabilities are adequate, using current, estimates of future cash flows under its insurance contracts. If that assessment shows that the carrying amount of its insurance liabilities is inadequate in the light of the estimated future cash flows, the entire deficiency shall be recognized in profit or loss. An insurer shall disclose information that identifies and explains the amounts in its financial statements arising from insurance contracts. An insurer shall disclose information that helps users to understand the amount, timing and uncertainty of future cash flows from insurance contracts.

IFRS-5 – Non-current Assets held for Sale and Discontinued Operations

The objective of this IFRS is to specify the accounting for assets held for sale, and the presentation and disclosure of discontinued operations. An entity shall classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. An entity shall measure a non-current asset (or disposal group) classified as held for sale at the lower of its carrying amount and fair value less costs to sell. An entity shall present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations and disposals of non-current assets (or disposal groups).

IFRS-6 – Exploration for and Evaluation and Mineral resources

The object of this IFRS is to specify the financial reporting for the exploration for and evaluation of mineral resources. Exploration and evaluation assets shall be assessed for impairment when facts and circumstances suggest that the carrying amount of an exploration and evaluation asset may exceed its recoverable amount. An entity shall determine an accounting policy for allocating exploration and evaluation assets to cash-generating units or groups of cash-generating units for the purpose of assessing such assets for impairment. An entity shall disclose information that identifies and explains the amounts recognized in its financial statements arising from the exploration for and evaluation of mineral resources.

IFRS-7 – Financial Instruments: Disclosures

IFRS 7 deals with the disclosure requirements in relation to all risks arising from financial instruments (with limited exemptions), and applies to any entity that holds financial instruments. The level of disclosure required depends on the extent of the entity's use of financial instruments and its exposure to financial risk.

IFRS-8 – Operating Segments

IFRS 8 applies to the separate or individual financial statements of an entity whose debt or equity instruments are traded in a public market; or that files, or is in the process of filing, its (consolidated) financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market.

IFRS 8 requires an entity to report financial and descriptive information about its reportable segments. An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

IFRS-9 – Financial Instruments

An entity shall recognize a financial asset in its statement of financial position when and only when, the entity becomes party to the contractual provisions of the instrument. A financial asset shall be measured at amortised cost when the asset is held with in a business model whose objective is to hold assets in order to collect contractual cash flows and the contractual terms of the financial asset give rise to specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. A Financial asset shall be measured at fair value unless it is measured at amortised cost.

CONVERGENCE OF INDIAN ACCOUNTING STANDARS WITH INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

International Financial Reporting Standards are now becoming universal reporting language. In tune with the global trend the Government of India decided to facilitate the convergence of the Indian Accounting Standards with IFRS by 1st April 2011. In this direction all the existing Indian Accounting Standards are being revised and converged with corresponding to International Accounting Standards/ International Financial Reporting Standards. These converged Accounting Standards shall be known as Ind AS. As a result of this there shall be two separate sets of Accounting Standards. The first set would comprise the Indian Accounting Standards, which are converged with the IFRS and shall be applicable to the specified class of companies in a phased manner. The specified classes of companies would be – Road Map I – Phase **I –** (i) NSE-Nifty 50 and BSE-Sensex 30 companies; (ii) Companies listed in overseas stock exchanges; (iii) Companies with net worth above ₹ 1000 crore: Phase **II**: Companies whether listed or not having a net worth exceeding ₹ 500 crore but not above ₹ 1000 crore; Phase **III**:- Listed companies having a net worth of ₹ 500 crore or less; Road Map **II**- Phase **I**: All insurance companies; Phase **II**: (a) NSE-Nifty 50 or BSE- Sensex 30 NBFCs. and NBFCs, listed or not, having a net worth above ₹ 1000 crore; (b) Scheduled commercial banks and urban co-operative banks with net worth net worth above ₹ 300 crore; Phase **III**: Urban co-operative banks having a net worth in excess of ₹ 200 crore but not exceeding 300 crore

The second set would comprise the existing Indian Accounting Standards and would be applicable to other companies, including Small and Medium Companies (SMC).

The Ministry of Corporate Affairs has notified convergence of 35 Indian Accounting Standards with International Financial Reporting Standards (henceforth called IND AS) on February 25, 2011. The following are the IND AS notified corresponding International Accounting Standards(IAS)/ International Financial Reporting Standards (IFRS):

IND AS	*Converged Standards*	*Corresponding IAS/IFRS*
IND AS 1	Presentation of Financial Statements	IAS 1
IND AS 2	Inventories	IAS 2
IND AS 7	Statement of Cash Flows	IAS 7

IND AS 8	Accounting Policies, Changes in Accounting Estimates and Errors	IAS 8
IND AS 10	Events after the Reporting Period	IAS 10
IND AS 11	Construction Contracts	IAS 11
IND AS 12	Income Taxes	IAS 12
IND AS 16	Property, Plant and Equipment	IAS 16
IND AS 17	Leases	IAS 17
IND AS 18	Revenue	IAS 18
IND AS 19	Employee Benefits	IAS 19
IND AS 20	Accounting for Government Grants and Disclosure of Government Assistance	IAS 20
IND AS 21	The Effects of Changes in Foreign Exchange Rates	IAS 21
IND AS 23	Borrowing Costs	IAS 23
IND AS 24	Related Party Disclosures	IAS 24
IND AS 27	Consolidated and Separate Financial Statements	IAS 27
IND AS 28	Investment in Associates	IAS 28
IND AS 29	Financial Reporting in Hyper Inflationary Economics	IAS 29
IND AS 31	Interest in Joint Ventures	IAS 31
IND AS 32	Financial Instruments: Presentation	IAS 32
IND AS 33	Earnings per Share	IAS 33
IND AS 34	Interim Financial Reporting	IAS 34
IND AS 36	Impairment of Assets	IAS 36
IND AS 37	Provisions and Contingent Liabilities and Contingent Assets	IAS 37
IND AS 38	Intangible Assets	IAS 38
IND AS 39	Financial Instruments: Recognition and Measurements	IAS 39
IND AS 40	Investment Property	IAS 40
IND AS 101	First Time Adoption of Financial Reporting Standards	IFRS 1
IND AS 102	Share-based Payment	IFRS 2
IND AS 103	Business Combinations	IFRS 3
IND AS 104	Insurance Contracts	IFRS 4
IND AS 105	Non Current Assets Held for Sale and Discontinued Operations	IFRS 5
IND AS 106	Exploration for and Evaluation of Mineral Resources	IFRS 6
IND AS 107	Financial Instruments: Disclosures	IFRS 7
IND AS 108	Operating Segments	IFRS 8

The date of implementation of these IND AS is yet to be notified.

LESSON ROUND-UP

- Indian Accounting Standards (AS) are prescribed by the Accounting Standard Board (ASB) of the Institute of Chartered Accountants of India which are notified by the Central Government in consultation with the National Advisory Committee on Accounting Standards.
- International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS) are issued by International Accounting Standard Board (IASB).
- Accounting standards relate to the codification of generally accepted accounting principles and are stated to be the norms of accounting policies and practices.
- The objective of setting standards is to bring about uniformity in financial reporting and to ensure consistency and comparability in the data published by enterprises.
- Accounting standards facilitate uniform preparation and reporting of general purpose financial statements published annually for the benefit of shareholders, creditors, employees and the pubic at large.
- The preparation of financial statements with adequate disclosures, as required by the accounting standards is the responsibility of the management of the organization.
- The main function of the ASB is to formulate Accounting Standards so that such standards may be established by the ICAI in India.
- The Accounting Standards are formulated under the authority of the Council of the ICAI.
- To faciliate the convergence of the Indian Accounting Standards with IFRS In this direction all the existing Indian Accounting Standards are being revised and converged with corresponding to International Accounting Standards/International Financial Reporting Standards. These converged Accounting Standards shall be known as Ind AS.
- The Ministry of Corporate Affairs has notified convergence of 35 Indian Accounting Standards with International Financial Reporting Standards (henceforth called IND AS) on February 25, 2011. These are – IND ASs 1, 2, 7, 8, 10, 11, 12, 16, 17, 18, 19, 20, 21, 23, 24, 27, 28, 29, 31, 32, 33, 34, 36, 37, 38, 39, 40, 101, 102, 103, 104, 105, 106, 107 and 108. These Accounting Standards are yet to be in force.
- As a result of this there shall be two separate sets of Accounting Standards. The first set would comprise the Indian Accounting Standards, which are converged with the IFRS and shall be applicable to the specified class of companies in a phased manner.
- The second set would comprise the existing Indian Accounting Standards and would be applicable to other companies, including Small and Medium Companies (SMC).

SELF-TEST QUESTIONS

(These are meant for re-capitulation only. Answers to these questions are not to be submitted for evaluation)

1. What do you mean by accounting standards?
2. What is the significance of accounting standards?
3. "Accounting standards can be seen as providing an important mechanism to help in the resolution of potential financial conflicts of interest between the various important groups in society". Comment.
4. Briefly explain the functioning of the Accounting Standards Board in India.
5. Explain the scope of Accounting Standards issued by ICAI.

6. Mention the procedure for issuing accounting standards by the ICAI.
7. Mention the various International Accounting Standards/International Financial Reporting Standards formulated by International Accounting Standard Board.
8. Discuss the approach for convergence of Indian Accounting Standards with IFRS.

Lesson 10

Auditing Concepts

LESSON OUTLINE

- Evolution of Auditing
- Definitions of Auditing
- Features of Auditing
- Objectives of Auditing
- Scope of Auditing
- Basic principles governing an audit
- True and fair view
- Advantages of an independent audit
- Investigation
- Audit and Investigation distinguished
- Materiality in Auditing
- Auditing Standard
- Harmonization of Indian Auditing standard with International Auditing Standard
- Brief overview of standard on Auditing in India
- Lesson Round Up
- Self Test Question

LEARNING OBJECTIVES

The subject of Auditing is as ancient as Accounting. Its traces can be found in ancient civilization such as Mesopotamia, Greece, Egypt, Rome, U.K. and India. Even the Vedas contain reference to accounts and auditing. Arthasashthra by Kautilya detailed rules for accounting and auditing of public finances. Study of Auditing practices is very important for students as it entails the basics of vouching/ scrutinizing the records, books of accounts of an entity. The objective of this lesson is to develop the basics of auditing, auditing concepts, auditing standards.

After reading this lesson, student should be able to :

1. Give a definition of Auditing
2. Understand the objective, features and scope of Auditing
3. Understand the basic principles governing an audit
4. Understand the advantages of Auditing exercise
5. Understand the auditing concepts as true and fair view, materiality
6. Understand the difference between auditing and investigation
7. Understand the auditing standard and the objectives of prescribing auditing standard.
8. Brief overview of standards as applicable in India.

"Auditing is a systematic examination of the books and records of business or other organization, in order to ascertain or verify and to report upon the facts regarding its financial operations and the result thereof.

– Prof. Montgomery-

EVOLUTION OF AUDITING

The term audit is derived from the Latin term 'audire,' which means to hear. In early days a person used to listen to the accounts read over by an accountant in order to check them. He was known as auditor. Auditing is as old as accounting and there are signs of its existence in all ancient cultures such as Mesopotamia, Greece, Egypt. Rome, U.K. and India. Arthasashthra by Kautilya detailed rules for accounting and auditing of public finances. The original objective of auditing was to detect and prevent errors and frauds. Auditing evolved and grew rapidly after the industrial revolution in the 18th century with the growth of the joint stock companies the ownership and management became separate. The shareholders who were the owners needed a report from an independent expert on the accounts of the company managed by the board of directors who were the employees. The objective of audit shifted and audit was expected to ascertain whether the accounts were true and fair rather than detection of errors and frauds.

In India the Companies Act, 1913 made audit of company accounts compulsory. With the increase in the size of the Companies and the volume of transactions the main objective of audit shifted to ascertaining whether the accounts were true and fair rather than true and correct. Hence the emphasis was not on arithmetical accuracy but on a fair representation of the financial efforts. The Companies Act, 1913 also prescribed for the first time the qualification of auditors. After the independence in year 1956, Companies Act, 1956 was implemented and detailed provisions were made in act regarding audit and auditors. This act provides provisions regarding compulsory statutory audit of companies, auditor appointment, auditor disqualifications, cost audit, appointment of cost auditors, government audit, special audit etc. The Companies Act, 1956 has been replaced with the Companies Act, 2013. Chapter X of the Companies Act, 2013 (Sections 139-148) deals with the provisions related to Audit & Auditors.

DEFINITIONS OF AUDITING

It is a bit difficult to give a precise definition of word audit in a word or two, originally its meaning and use was confined merely to cash audit and the auditor had to ascertain whether the person responsible for the maintenance of accounts had properly accounted for all the cash receipts the payment on behalf of his principle. But the word, audit, had a wide usage and it now means a through scrutiny of the books of accounts and its ultimate aim is to verify the financial position disclosed by the balance sheet and the profit and loss account of a company. The following are the some of the definitions of audit given by some writers:

Lawrence R. Dicksee-'An audit is an examination of accounting records undertaken with a view to establishing whether they correctly and completely reflect the transactions to which they purport to relate.'

Taylor and Perry - "Audit is defined as an investigation of some statements of figures involving examination of certain evidence, so as to enable an auditor to make a report on the statement.

F.R.M De Paula- "An audit denotes the examination of Balance Sheet and Profit and Loss Account prepared by others together with the books of accounts and vouchers relating there to in such a manner that the auditor may be able to satisfy himself and honestly report that, in his opinion, such Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of affairs of the particular concern according to the information and explanations given to him and as shown by the books".

Prof. Montgomery- "Auditing is a systematic examination of the books and records of business or other organization, in order to ascertain or verify and to report upon the facts regarding its financial operations and the result thereof.

Spicer & Pegler- "Audit such an examination of the books of accounts and vouchers of a business, as will enable the auditor to satisfy himself that the Balance Sheet is properly drawn up, so as to give a true and fair view of the state affairs of the business, and whether the profit and loss account gives a true and fair view of the profit or loss for the financial period according to the best of his information and explanations given to him and as shown by the books, and if not, in what respect he is not satisfied"**.**

Institute of Chartered Accountants of India (ICAI) defines Auditing as- Auditing is defined as a systematic and independent examination of data, statements, records, operations and performance of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognizes the propositions before him for examination, collect evidence, evaluates the same and on this basis formulates his judgement which is communicated through his audit report".

In the close scrutiny of the different definitions we found that there are different ways of expressing the concept auditing but having lot of similarity therein.

The meaning of an Audit contains

(i) An intelligent and critical examination of the books of accounts of business.

(ii) It is done by an independent qualified person.

(iii) It is done with the help of vouchers, documents, information and explanations received from the clients.

(iv) The auditor satisfies himself with the authenticity of the financial accounts prepared for a particular period.

FEATURES OF AUDITING

1. Audit is a systematic and scientific examination of the books of accounts of a business;
2. Audit is undertaken by an independent person or body of persons who are duly qualified for the job.
3. Audit is a verification of the results shown by the profit and loss account and the state of affairs as shown by the balance sheet.
4. Audit is a critical review of the system of accounting and internal control.
5. Audit is done with the help of vouchers, documents, information and explanations received from the authorities.
6. The auditor has to satisfy himself with the authenticity of the financial statements and report that they exhibit a true and fair view of the state of affairs of the concern.
7. The auditor has to inspect, compare, check, review, scrutinize the vouchers supporting the transactions and examine correspondence, minute books of share holders, directors, Memorandum of Association and Articles of association etc., in order to establish correctness of the books of accounts.

OBJECTIVES OF AUDITING

The objectives of auditing may be classified into two parts:

1. The primary objective
2. The secondary or incidental objective.

Primary Objective – The primary objective of the auditors is to report to the owners whether the balance sheet give a true and fair view of the company's state of affairs and the correct figure of the profit or loss for the financial year.

Secondary objective – It is also called the incidental objective as it is incidental to the satisfaction of the main objective. The incidental objectives of auditing are:

(i) Detection and prevention of frauds, and

(ii) Detection and prevention of errors.

Detection of material frauds and errors as an incidental objective of independent financial auditing flows from the main objective of determining whether or not the financial statements give a true and fair view. The statement on auditing practices issued by the Institute of Chartered Accountants of India states, an auditor should bear

in mind the possibility of the existence of frauds or errors in the accounts under audit since they may cause the financial position to be mis-stated. Fraud refers to intentional misrepresentation of financial information with the intention to deceive. Frauds can take place in the form of manipulation of accounts, misappropriation of cash and misappropriation of goods. It is of great importance for the auditor to detect any frauds, and prevent their recurrence. Errors refer to unintentional mistake in the financial information arising on account of ignorance of accounting principles i.e. principle errors, or error arising out of negligence of accounting staff i.e. clerical errors.

SCOPE OF AUDITING

Audit scope determines the time involved in audit exercise, depth of auditing, aspects to be covered etc. Audit scope depends on nature of audit, objectives of audit & terms of engagement, requirement of applicable legislations and auditing standard. However the terms of engagement cannot, restrict the scope of an audit in relation to matters which are prescribed by legislation or by the auditing standard.

The audit should be organized to cover adequately all aspects of the enterprise as far as they are relevant to the audit objectives. For example while carrying out the statutory audit, to form an opinion on the financial statements; the auditor should be reasonably satisfied as to whether the information contained in the underlying accounting records and other source data is reliable and sufficient as the basis for the preparation of the financial statements. In forming his opinion, the auditor should also decide whether the relevant information is properly disclosed in the financial statements subject to statutory requirements, where applicable.

The auditor assesses the reliability and sufficiency of the information contained in the underlying accounting records and other source data by:

A. Making a study and evaluation of accounting systems and internal controls on which he wishes to rely and testing those internal controls to determine the nature, extent and timing of other auditing procedures; and

B. Carrying out such other tests, enquiries and other verification procedures of accounting transactions and account balances as he considers appropriate in the particular circumstances.

The auditor determines whether the relevant information is properly disclosed in the financial statements by :

(a) Comparing the financial statements with the underlying accounting records and other source data to see whether they properly summarize the transactions and events recorded therein; and

(b) Considering the judgments that management has made in preparing the financial statements accordingly, the auditor assessees the selection and consistent application of accounting policies, the manner in which the information has been classified, and the adequacy of disclosure.

BASIC PRINCIPLES GOVERNING AN AUDIT

SA 200 “Basic Principals Governing an Audit”, describes the basic principles which govern the auditor’s professional responsibilities and which should be complied with wherever an audit is carried. They are described below:

(i) ***Integrity objectivity and independence*****:** An auditor should be honest, sincere, impartial and free from bias. He should be a man of high integrity and objectivity.

(ii) ***Confidentiality*****:** The auditor should respect confidentiality of information acquired during the course of his work and should not disclose the information without the prior permission of the client, unless there is a legal duty to disclose.

(iii) ***Skill and competence*:** The auditor must acquire adequate training and experience. He should be competent, skillful and keep himself abreast of the latest developments including pronouncements of ICAI on accounting and auditing matters.

(iv) ***Work performed by others***: If the auditor delegates some work to others and uses work performed by others including that of an expert, he continues to be responsible for forming and expressing his opinion on the financial information.

(v) ***Documentation*:** The auditor should document matters which are important in providing evidence to ensure that the audit was carried out in accordance with the basic principles.

(vi) ***Planning***: The auditor should plan his work to enable him to conduct the audit in an effective, efficient and timely manner. He should acquire knowledge of client's accounting system, the extent of reliance that could be placed on internal control and coordinate the work to be performed.

(vii) ***Audit evidence*:** The auditor should obtain sufficient appropriate evidences through the performance of compliance and other substantive procedures to enable him to draw reasonable conclusions to form an opinion on the financial information.

(viii) ***Accounting System and Internal Control*:** The management is responsible for maintaining an adequate accounting system incorporating various internal controls appropriate to the size and nature of business. He auditor should assure himself that the accounting system is adequate and all the information which should be recorded has been recorded. Internal control system contributes to such assurance.

(ix) **Audit conclusions and reporting**: On the basis of the audit evidence, he should review and assess the audit conclusions. He should ascertain:

1. As whether accounting policies have been consistently applied;
2. Whether financial information complies with regulations and statutory requirements; and
3. There is adequate disclosure of material matters relevant to the presentation of financial information subject to statutory requirements.

The auditor's report should contain a clear written opinion on the financial information. A clean audit report indicates the auditor's satisfaction in all respects and when a qualified, adverse or a disclaimer of opinion is to be given or reservation of opinion on any matter is to be made, the audit report should state the reasons thereof.

TRUE AND FAIR VIEW

The main object of audit is to find out whether the financial statements prepared by a company show the true and fair view of the financial state of affairs of a company and if not then in what respect they are not showing. The accounts are said to be true and fair:

1. The books of account have recorded all the business transaction correctly.
2. The books of account have been prepared according to the accepted principles of accountancy and have followed accounting standards issued by different regulatory bodies.
3. There are no errors and frauds present in the books of account.
4. The financial statements that have been prepared by the company are in conformity with the books of accounts and all mandatory provisions of companies Act and other relevant laws have been followed:
5. The profit and loss shown in the profit and loss account shows the true and fair results of entity's operations and the value of assets and liabilities appears in the balance sheet is showing the correct financial picture.
6. The books of accounts must disclose all material facts regarding revenue, expenses, assets and liabilities.

Material means important and essential. The disclosure of important matters in the accounts helps the users in taking business decisions. There should be neither suppression of vital facts nor mis-statements.

What constitutes true and fair is not defined under any law. In order to show a true and fair view the auditor should ensure that:

1. The final accounts (Trading and Profit and loss Account and Balance Sheet) agree with the books of accounts.
2. The closing stock is physically verified and valued properly.
3. Intangible assets like goodwill, patents, preliminary expenses or other deferred revenue expenses are valued and written off properly.
4. Expenses/income of Capital nature is not treated as revenue and vice versa.
5. Contingent liabilities are not treated as actual liabilities and vice versa
6. Provision is made for all known losses and liabilities
7. Transactions are recorded on accrual basis, i.e. outstanding expenses, prepaid expenses, income accrued and advance income is recorded properly
8. The exceptional or non-recurring transactions are disclosed separately in the accounts

ADVANTAGES OF AN INDEPENDENT AUDIT

The fact that audit is compulsory by law, in certain cases by itself should show that there must be some positive utility in it. The chief utility of audit lies in reliable financial statement on the basis of which the state of affairs may be easy to understand. Apart from this obvious utility, there are other advantages of audit. Some or all of these are of considerable value even to those enterprises and organization where audit is not compulsory, these advantages are given below:

1. It safeguards the financial interest of persons who are not associated with the management of the entity, whether they are partners or shareholders.
2. It acts as a moral check on the employees from committing defalcations or embezzlement.
3. Audited statements of account are helpful in setting liability for taxes, negotiating loans and for determining the purchase consideration for a business.
4. This are also use for settling trade disputes or higher wages or bonus as well as claims in respect of damage suffered by property, by fire or some other calamity.
5. An audit can also help in the detection of wastage and losses to show the different ways by which these might be checked, especially those that occur due to the absence of inadequacy of internal checks or internal control measures.
6. Audit ascertains whether the necessary books of accounts and allied records have been properly kept and helps the client in making good deficiencies or inadequacies in this respects. As an appraisal function, audit reviews the existence and operations of various controls in the organizations and reports weakness, inadequacy, etc., in them.
7. Audited accounts are of great help in the settlement of accounts at the time of admission or death of partner.
8. Government may require audited and certificated statement before it gives assistance or issues a licence for a particular trade.

INVESTIGATION

Investigation is an exercise which is carried out with a specific objective. The investigation means in-depth analysis of books of accounts, transaction, and event. Investigation exercise is voluntary in nature and used extensively by Internal and management auditors.

It is neither accounting nor auditing but a special audit limited or extended scope keeping in view the object behind it. It is intensive and comprehensive than auditing. Dicksee has defined it thus: "An investigation is an examination of accounting records for a specific purpose".

Scope of investigation

No general principle can be laid down with regard to the scope of every type of investigation. Scope of investigation, in each case, would be limited to the period or area to be covered by the investigator.

Reasons for carrying out investigation

The real objective of conducting an investigation by an auditor on behalf of his client is to provide him the desired information in the form of a report about the matter specified. Normally the objective of investigation is to collect, analyze and evaluate facts in respect of desired field of activity with a view on some special purpose as determined by the person on whose behalf the investigation is undertaken.

The common reasons of getting the investigation done are listed below:

(1) Proposed purchase of business.

(2) Proposed sale of business.

(3) Reasons for low profitability.

(4) Cause of high employee turnover.

(5) Reliability of business data.

(6) Proposed investment in particular securities.

(7) Suspected fraud.

(8) Joining in existing partnership business.

(9) Borrowing funds.

(10) Lending funds.

(11) Proposed purchase of controlling shares in a company.

(12) Suspected misfeasance against directors.

(13) Detection of undisclosed income for tax purposes.

(14) Suspected misappropriation by trustees.

AUDIT AND INVESTIGATION DISTINGUISHED

1. **Legal binding:** Audit of annual financial statements of a company is compulsory under the Companies Act, 1956. However, Investigation is not compulsory under the Companies act, 1956 but voluntary depending upon necessity.

2. **Object in view:** Audit is conducted to ascertain whether the financial statements show a true and fair view. Investigation is conducted with a particular object in view, viz to know financial position, earning capacity, prove fraud, invest capital, etc.

3. **Period covered**: Audit is conducted on annual basis. Investigation may be conducted for several years at a time, say three years.
4. **Parties for whom conducted:** Audit is conducted on behalf of shareholders (or proprietor, or partners). Investigation is usually conducted on behalf of outsiders like prospective buyers, investors, lenders, etc.
5. **Documents:** Audit is not carried out of audited financial statements. Investigation may be conducted even though the accounts have been audited.
6. **Extent of work:** Audit is normally conducted on test verification basis. Investigation is a thorough examination of books of accounts.
7. **Report:** Audit report of a company is addressed to shareholders (or proprietors or partners). Investigation report is addressed to the party on whose instruction investigation was conducted.
8. **Person performing work:** Audit is to be conducted by a person having prescribed qualification i.e. Chartered accountant, Cost accountant. No statutory qualification is prescribed for Investigation. It may be undertaken by any one.

MATERIALITY IN AUDITING

Materiality is a concept or convention within auditing and accounting relating to the importance/significance of an amount, transaction, or discrepancy. The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in conformity with an identified financial reporting framework such as Generally Accepted Accounting Principles (GAAP). The assessment of what is material is a matter of professional judgment.

Materiality can be defined as the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

SA 320 "Materiality in Planning and Performing an Audit", establishes standards on the concept of materiality and the relationship with audit risk while conducting an audit. Hence, the auditor requires more reliable evidence in support of material items. SA 320 defines material items as relatively important and relevant items, i.e., items the knowledge of which would influence the decision of the user of financial statements.

The auditor has to ensure that material items are properly and distinctly disclosed in the financial statements. The concept of materiality is fundamental to the process of accounting. It covers all the stages from recording to classification and presentation. It is very important for the auditor who has constantly to judge whether a particular item is material or not. There is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.

AUDITING STANDARD

Auditing standards refers to the code of best practices/procedures which an auditor is expected to follow during an audit to ensure consistency of findings. The auditing standard specifies a minimum level of performance. Auditing standards help the auditor in proper and optimum discharge of their profession duties. Auditing standards also promote uniformity in practice as also comparability. In India the **Auditing and Assurance Standards Board** of the Institute of Chartered Accountants of India formulates the auditing standards.

Procedure of issuing auditing standards

1. The Auditing and Assurance Standards Board identifies the areas where auditing standards need to be formulated and the priority in regard to their selection.

2. In the preparation of the auditing standards, the Board is normally, assisted by study groups comprising of a cross section of members of the Institute.

3. On the basis of the work of the study groups, an Exposure Draft of the proposed auditing standard is prepared by the Board and issued for comments of the members.

4. After taking into the comments received, the draft of the proposed auditing standard is finalized by the Board and submitted to the Council of the Institute.

5. The Council considers the final draft of the proposed auditing standard and, if necessary, modifies the same in consultation with the Board. The auditing standard is then issued under the authority of the Council.

While formulating the auditing standards, the Board also takes into consideration the applicable laws, customs, usages and business environment in the country.

INTERNATIONAL AUDITING STANDARDS

International Auditing standards are issued by the International Auditing and Assurance Standards Board (IAASB). IAASB is a body of International federation of accountants (IFAC). It is an independent standard-setting body that serves the public interest by setting high-quality international standards for auditing, assurance, and other related standards, and by facilitating the convergence of international and national auditing and assurance standards.

HARMONIZATION OF INDIAN AUDITING STANDARDS WITH INTERNATIONAL AUDITING STANDARDS

The Institute of Chartered Accountants of India (ICAI) is a founder member of the International Federation of Accountants (IFAC). It is one of the membership obligations of the Institute to actively propagate the pronouncements of the International Auditing and Assurance Standards Board (IAASB) of the IFAC to contribute towards global harmonization and acceptance of the Standards issued by the IAASB. Accordingly, while formulating Engagement and Quality Control Standards, the AASB takes into consideration the corresponding Standards, if any, issued by the IAASB. In addition, the AASB also takes into consideration the applicable laws, customs, usages and business environment prevailing in India.

With effect from 1st April, 2008, the AASB re-categorised and re-numbered the existing Auditing and Assurance Standards on the lines as followed by the IAASB. With this change, all auditing and assurance standards (AAS) were renamed as standards on Auditing (SAs)

BRIEF OVERVIEW OF AUDITING STANDARDS IN INDIA

STANDARDS ON QUALITY CONTROL (SQCS)

SQC 1: Quality control for firms that perform audits and reviews of historical financial information, and other assurance and related services engagements

Objective of SQC–1 is to provide the firm with reasonable assurance that its personnel comply with applicable professional standards as well as regulatory and legal requirements, and that reports issued by the firm or engagement partner(s) are appropriate in the circumstances

Elements of System of Quality Control

It is a primary standard which have applications for all other Standards and is all pervasive Standards in respect of quality control. This standard contains extensive requirements in relation to establishment and maintenance of a system of quality control (QC) for an auditing entity.

This standards describes the important elements of quality control system as

Leadership responsibilities for quality within the firm: The firm should establish policies and procedures designed to promote an internal culture based on recognition that quality is essential in performing engagements.

Ethical requirements: The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements

Acceptance and continuance of client relationships and specific engagements: The acceptance and continuance of Quality Control policies are designed to provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it: (a) has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity; (b) is competent to perform the engagement and has the capabilities, time and resources to do so (c) can comply with the ethical requirements.

Human resources: The Firm's policies and procedures should be designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements to enable the Firm or engagement partners to issue reports that are appropriate in the circumstances

Monitoring: The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice.

STANDARDS FOR AUDITS AND REVIEWS OF HISTORICAL FINANCIAL INFORMATION

SA 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing

This Standard establishes the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with SAs.

Ethical Requirements Relating to an Audit of Financial Statements – The auditor should apply the following fundamental principles of professional ethics relevant when conducting an audit of financial statements; (a) Integrity; (b) Objectivity; (c) Professional competence and due care; (d) Confidentiality; and (e) Professional behaviour

Professional Skepticism – Professional skepticism includes being alert to, for example; (a) Audit evidence that contradicts other audit evidence obtained;

(b) Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence; (c) Conditions that may indicate possible fraud; (d) Circumstances that suggest the need for audit procedures in addition to those required by the SAs

Professional Judgment – Professional judgment is necessary in particular regarding decisions about:

(a) Materiality and audit risk; (b) The nature, timing, and extent of audit procedures used to meet the requirements of the SAs and gather audit evidence; (c) Evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of the SAs and thereby, the overall objectives of the auditor; (d) The evaluation of management's judgments in applying the entity's applicable financial reporting framework; (e) The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements

Sufficient Appropriate Audit Evidence and Audit Risk – To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion

Sufficiency and Appropriateness of Audit Evidence – Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. Sufficiency is the measure of quantity of audit evidence whereas appropriateness is the measure of quality of audit evidence

Audit Risk – Audit risk is a function of the risks of material misstatement and detection risk. The risks of material misstatement may exist at two levels:

(a) The overall financial statement level; and (b) The assertion level for classes of transactions, account balances, and disclosures. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level

Conduct of an Audit in Accordance with SAs – The auditor shall comply with all SAs relevant to the audit. An SA is relevant to the audit when the SA is in effect and the circumstances addressed by the SA exist. The auditor shall have an understanding of the entire text of an SA, including its application and other explanatory material, to understand its objectives and to apply its requirements properly. The auditor shall not represent compliance with SAs in the auditor's report unless the auditor has complied with the requirements of this SA and all other SAs relevant to the audit

SA 210: Agreeing the Terms of Audit Engagements

The Standard deals with the auditor's responsibilities in agreeing the terms of audit engagement with management and, where appropriate, those charged with governance. SA 210 establishes certain preconditions for an audit, responsibility for which rests with management or those charged with governance. SA 210 also deals with the requirements relating to preconditions for an audit, agreement on audit engagement terms, recurring audits, acceptance of a change in the terms of the audit engagement and additional considerations in engagement acceptance. The appendices to revised SA 210 contain the illustrative example of an audit engagement letter and the factors determining the acceptability of general purpose frameworks.

SA 220: Quality Control for an Audit of Financial Statements

This Standard deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements. It also addresses, where applicable, the responsibilities of the engagement quality control reviewer. It also deals with the aspects relating to leadership responsibilities for quality on audits, relevant ethical requirements, acceptance and continuance of client relationships and audit engagement, assignment of engagement teams, engagement performance, monitoring and documentation requirements. This standard prescribes that Quality control policies and procedures should be implemented at both level — of audit firm and on individual audits.

SA 230: Audit Documentations

This Standard deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements. It also deals with the requirements of timely preparation of audit documentation; documentation of the audit procedures performed and audit evidence obtained and assembly of the final audit file. It outlines about vesting of property of working papers with the Auditor. SQC 1 read with SA 230 spells out two essential principles viz. period of maintaining working papers and assembly of audit file by the auditor.

According to SA 230, Audit Documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of audit and facilitates effective review and evaluation of audit evidence obtained and conclusions reached before finalizing auditor's report. According to this standard, retention period for audit engagements ordinarily is no shorter than ten years from the date of auditor's report, or, if later, the date of group auditor's report

SA 240: the Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

The Standard adopts a risk-based approach to auditor's responsibility relating to fraud in an audit of financial statements. It, explains how the principles enunciated in SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" and SA 330, "The Auditor's Responses to Assessed Risks" would be applied in case of consideration of fraud in an audit of financial statements.

Auditor is concerned with fraud that causes a material misstatement in financial statements. While auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for him to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error. Risk of auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

Auditor is responsible for maintaining an attitude of professional skepticism throughout the audit. Auditor shall identify and assess risks of material misstatement due to fraud at financial statement level, and at assertion level for classes of transactions, account balances and disclosures. Auditor must make appropriate inquiries of the management. Auditor must discuss with those charged with governance as they have oversight responsibility for systems for accounting risk, financial control and compliance with the law

When auditor identifies a misstatement, s/he should consider whether such a misstatement may be indicative of fraud and if there is such an indication, s/he should consider the implications of misstatement in relation to other aspects of the audit, particularly the reliability of management representations. When the auditor identifies a misstatement resulting from fraud, or a suspected fraud, s/he should consider auditor's responsibility to communicate that information to management, those charged with governance and, in some circumstances, when so required by laws and regulations, to regulatory and enforcement authorities also. The auditor should also obtain written representations from management.

The auditor should document the understanding of entity and its environment and the assessment of risks of material misstatement, responses to assessed risks of material misstatement and communications about fraud made to management, those charged with governance, regulators and others

SA 250: Consideration of Laws and Regulations in an Audit of Financial Statements

This Standard deals with the auditor's responsibility to consider laws and regulations when performing an audit of financial statements. It also deals with the effect of laws and regulations, responsibility of management for compliance with laws and regulations, responsibility of the auditor, audit procedures and reporting of identified or suspected non-compliance and documentation requirements

It is management's responsibility to ensure that entity's operations are conducted in accordance with laws and regulations. Auditor is not responsible for preventing non–compliance but he is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error.

Risk of non detection of material misstatements is higher with regard to material misstatements resulting from non–compliance with laws and regulations due to various factors. The auditor should obtain a general understanding of legal and regulatory framework applicable to the entity and he should see how it is complying with that framework. After obtaining general understanding, auditor should perform procedures to identify instances of non–compliance with these laws and regulations where non–compliance should be considered when preparing financial statements.

Auditor should obtain sufficient appropriate audit evidence about compliance with those laws and regulations generally recognised by Auditor to have an effect on determination of material amounts and disclosures in financial statements. To obtain written representations that management has disclosed all known actual or

possible non–compliance with laws and regulations whose effects should be considered when preparing financial statements.

SA 260: Communication with those Charged with Governance

This Standard deals with the auditor's responsibility to communicate with those charged with governance in relation to an audit of financial statements. It also describes the requirements regarding communication with those charged with governance and regarding matter to be communicated and documentation required. This standard also spells out the distinction between the Management and Those Charged with Governance

Auditor should communicate about Overall scope of audit; selection of/ changes in significant accounting policies; potential effect on financial statements of any significant risks and exposures, such as pending litigation; adjustments to financial statements arising out of audit that have a significant effect on entity's financial statements; material uncertainties related to events and conditions that may cast significant doubt on entity's ability to continue as a going concern, disagreements with management about matters that could be significant to entity's financial statements or auditor's report; expected modifications to auditor's report. Auditors should communicate matters of governance interest on timely basis. Auditor's communication may be made orally or in writing. In case of oral communication, auditor should document their oral communications and response thereof

SA 265: Communicating Deficiencies in Internal Control to those Charged with Governance and Management

This Standard on Auditing deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements. It defines the terms "Deficiency in internal control" and "Significant deficiency in internal control". This Standard also deals with the aspects like determination of whether deficiencies in internal control have been identified, whether it is significant deficiencies in internal control and communicating deficiencies in internal control. This standard somehow supplements the concept of 'Letter of Weakness.'

SA 299: Responsibility of Joint Auditors

This Standard deals with the professional responsibilities which the auditors undertake in accepting appointments as joint auditors. The SA, inter alia, lays down that the joint auditors should, normally, by mutual discussion, divide the audit work among themselves. The division of work among joint auditors as also the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity. The SA also states that each joint auditor is responsible only for the work allotted to him, whether or not he has prepared a separate report on the work performed by him. The SA describes the areas for which joint auditors are jointly and severally responsible. As per the SA, each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work in accordance with generally accepted audit procedures. It also deals with the reporting responsibilities of the joint auditors. This standard very specifically states that the majority opinion would not be binding upon the other joint auditor(s) The SA became effective for all audits relating to accounting periods commencing on or after April 1, 1996.

SA 300 (Revised): Planning an Audit of Financial Statements

This Standard deals with the auditor's responsibility to plan an audit of financial statements. Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Once the overall audit strategy has been established, an audit plan can be developed to address various matters identified in the overall audit strategy, considering the need to achieve the audit objectives through efficient use of auditor's resources. The auditor should consider various matters in developing the overall plan like: terms of engagement; nature and timing of reports; applicable legal or statutory requirements; accounting policies adopted by the client; identification of significant audit areas; setting of materiality levels, etc. the auditor should obtain a level of knowledge of client's business that will enable them to identify events, transactions and practices that, in their judgment, may have a significant effect on financial information. Audit plan is more detailed than overall audit

strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. In Audit planning, the auditor should involve engagement partner and other key members of engagement team also.

SA 315: Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment-

The Standard deals with the auditor's responsibility to obtain an understanding of the entity and its environment and using that understanding to identify and assess the risks of material misstatement at the financial statement level and assertion level.

SA 320: Materiality in Planning and Performing an Audit

This Standard deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. This SA also deals with the requirements of determining materiality and performance materiality when planning the audit, revision as the audit progresses and documentation requirements.

SA 330: the Auditor's Responses to Assessed Risks

This Standard on Auditing deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with SA 315 at the financial statement level and assertion level. This SA also deals with the aspects relating to overall responses to assessed risks, audit procedures responsive to the assessed risks of material misstatement at the assertion level, adequacy of presentation and disclosure, evaluating the sufficiency and appropriateness of audit evidence and documentation requirements.

SA 402: Materiality in Planning and Performing an Audit

This Standard deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organizations. SA 402 also deals with the aspects like obtaining an understanding of the services provided by a service organisation, including internal control, responding to the assessed risks of material misstatement, fraud, non-compliance with laws and regulations and uncorrected misstatements in relation to activities at the service organisation and reporting by the user auditor.

SA 450: Evaluation of Misstatements Identified During the Audit

This Standard on auditing deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. This standard defines the terms "Misstatement" and "Uncorrected misstatements" and also deals with the aspects like accumulation of identified misstatements, consideration of identified misstatements as the audit progresses, communication and correction of misstatements, evaluating the effect of uncorrected misstatements, written representation and documentation.

SA 500: Audit Evidence

This Standard is quite detailed in terms of audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. This SA also deals with the requirements of obtaining sufficient appropriate audit evidence, how information to be used as audit evidence, how to select items for testing to obtain audit evidence and procedures in case of inconsistency in, or doubts over reliability of, audit evidence.

SA 501: Audit Evidence – Specific Considerations for Selected Items

The Standard deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence in accordance with SA 330, SA 500 and other relevant SAs, with respect to certain aspects of inventory, litigation and claims involving the entity, and segment information in an audit of financial statements. This standard also deals with the requirements and application of the aspects relating to inventory, litigation and claims and segment information.

SA 505: External Confirmations

The Standard deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of SA 330. It also deals with the requirements and application of the aspects relating to external confirmation procedures, management's refusal to allow the auditor to send a confirmation request, results of the external confirmation procedures, negative confirmations and evaluating the evidence obtained.

SA 510: Initial Audit Engagements – Opening Balances

The Standard establishes the principles regarding audit of opening balances in case of initial engagements, i.e., when the financial statements are audited for the first time or when the financial statements for the preceding period were audited by another auditor. This SA also deals with the audit procedures and audit conclusions and reporting requirements in case of initial audit engagements.

SA 520: Analytical Procedures

This Standard deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements. Revised SA 520 also deals with the requirements and application of the aspects relating to substantive analytical procedures, analytical procedures that assist when forming an overall conclusion and investigating results of analytical procedures.

SA 530: Audit Sampling

The Standard applies when the auditor has decided to use audit sampling in performing audit procedures. It also deals with the auditor's use of statistical and non-statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details, and evaluating the results from the sample. This SA also deals with the requirements relating to sample design, size and selection of items for testing, performing audit procedures, nature and cause of deviations and misstatements, projecting misstatements and evaluating results of audit sampling.

SA 540: Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

This Standard deals with the auditor's responsibilities regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how SA 315 and SA 330 and other SAs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.

SA 550: Related Parties

This Standard deals with the auditor's responsibilities regarding related party relationship and transactions when performing an audit of financial statements. This standard also deals with the risk assessment procedures and related activities, identification and assessment of the risks of material misstatement associated with related party relationships and transactions, responses to the risks of material misstatement associated with related

party relationships and transactions and evaluation of the accounting for and disclosure of identified related party relationships and transactions etc.

SA 560: Subsequent Events

The Standard deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. SA 560 also deals with the events occurring between the date of the financial statements and the date of the auditor's report, facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued and facts which become known to the auditor after the financial statements have been issued.

SA 570 Going Concern

The Standard details the auditor's responsibility in the audit of financial statements with respect to management's use of the going concern assumption in the preparation and presentation of the financial statements. SA 570 requires the auditor to inquire of management as to its knowledge of events or conditions beyond the period of management's assessment that may cast significant doubt on the entity's ability to continue as a going concern. SA 570 also deals with the requirements of risk assessment procedures and related activities, evaluating management's assessment, additional procedures, audit conclusions and reporting, use of going concern assumption etc. The standard also discusses the principles when mitigating factors are present vis-à-vis Going Concern of the enterprise.

SA 580: Written Representations

The Standard details the terms of the duties and objectives of the auditors regarding the acknowledgement by the management that it is fulfilling its responsibility relating to preparation and presentation of financial statements and internal controls, the various forms of management representations, situations where management representations are unreliable or where the management refuses to provide requested representations. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

SA 600: Using the Work of another Auditor

This SA discusses the procedures to be applied in situations where an independent auditor reporting on the financial statements of an entity, uses the work of an independent auditor with respect to the financial statements of one or more divisions or branches included in the financial statement of the entity. The Statement also discusses the principal auditor's responsibility in relation to his use of the work of other auditor.

SA 610: Using the work of Internal Auditors:

This Standard deals with the external auditor's responsibilities regarding the work of internal auditors. This SA also defines the terms "Internal audit function" and "Internal auditors". SA 610 also deals with the aspects like determining whether and to what extent to use the work of the internal auditors, using specific work of the internal auditors and documentation.

SA 620: Using the Work of an Auditor's Expert

SA 620 deals with the auditor's responsibilities regarding the use of an individual or organisation's work in a field of expertise other than accounting or auditing, when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence. SA 620 also deals with the requirements and application of the aspects relating to determining the need for an auditor's expert, nature, timing and extent of audit procedures, the competence, capabilities and objectivity of the auditor's expert, obtaining an understanding of the field of expertise of the auditor's expert, agreement with the auditor's expert, evaluating the adequacy of the auditor's expert's and reference to the auditor's expert in the auditor's report. This standard should be read in conjunction with SA 500 because Expert's opinion also serves as audit evidence in appropriate cases.

SA 700: Forming an Opinion and Reporting on Financial Statements

SA 700 deals with the auditor's responsibilities to form an opinion on the financial statements and the form and content of the auditor's report issued as a result of an audit of financial statements. SA 700 also deals with the requirements relating to forming an opinion on the financial statements, form of opinion, auditor's report, supplementary information presented with the financial statements and the application guidance of these aspects. Appendix to revised SA 700 also contains the Illustrative Formats of Auditors' Reports on Financial Statements.

SA 705: Modifications to the Opinion in the Independent Auditor's Report

This Standard on Auditing (SA) deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700 (Revised), the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary. The objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that are necessary when:

(a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

SA 706: Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

This standard on Auditing deals with additional communication in the auditor's report when the auditor considers it necessary to: Draw users' attention to a matter or matters presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements; or Draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report. Other Standards on Auditing (SAs) may contain specific requirements for the auditor to include Emphasis of Matter paragraphs or Other Matter paragraphs in the auditor's report. In those circumstances, the requirements in this SA regarding the form and placement of such paragraphs apply. The objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:

(a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or

(b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

SA 710: Comparative Information

SA 710 deals with the auditor's responsibilities regarding comparative information in an audit of financial statements. This SA defines the terms 'Corresponding figures', Comparative information' and 'Comparative financial statements'. SA 710 also deals with the requirements and application of the aspects relating to audit procedures and audit reporting relating to Corresponding Figures and Comparative Financial Statements.

***SA 720:* The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements-**This Standard on Auditing (SA) deals with the auditor's responsibility regarding other information in documents containing audited financial statements and the auditor's report thereon. As per SA 720 the objective of the auditor is to respond appropriately when documents containing audited financial statements and the auditor's report thereon include other information that could undermine the credibility of those financial statements and the auditor's report. This SA also deals with the requirements related to reading other information, material inconsistencies and material misstatements of fact.

SA 800: Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks

This SA deals with special considerations in the application of those SAs to an audit of financial statements prepared in accordance with a special purpose framework. It does not override the requirements of the other SAs; nor does it purport to deal with all special considerations that may be relevant in the circumstances of the engagement. The objective of the auditor, when applying SAs in an audit of financial statements prepared in accordance with a special purpose framework, is to address appropriately the special considerations that are relevant to:

(a) The acceptance of the engagement;

(b) The planning and performance of that engagement; and

(c) Forming an opinion and reporting on the financial statements.

SA 805: Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement

This SA deals with special considerations in the application of those SAs to an audit of a single financial statement or of a specific element, account or item of a financial statement. The single financial statement or the specific element, account or item of a financial statement may be prepared in accordance with a general or special purpose framework. If prepared in accordance with a special purpose framework, SA 800 also applies to the audit. It does not apply to the report of a component auditor, issued as a result of work performed on the financial information of a component at the request of a group engagement team for purposes of an audit of group financial statements. Further it does not override the requirements of the other SAs; nor does it purport to deal with all special considerations that may be relevant in the circumstances of the engagement.

SA 810: Engagements to Report on Summary Financial Statements

SA 810 deals with the auditor's responsibilities when undertaking an engagement to report on summary financial statements derived from financial statements audited in accordance with SAs by that same auditor

LESSON ROUND-UP

– The term audit is derived from the Latin term 'audire,' which means to hear.

– Auditing is as old as accounting and there are signs of its existence in all ancient cultures such as Mesopotamia, Greece, Egypt. Rome, U.K. and India.

– The Companies Act, 2013 has detailed provisions regarding Audit and Auditors. This Act provides provisions regarding compulsory Statutory Audit of companies, Auditor appointment, Auditor disqualifications, Cost Audit, appointment of cost auditors, government audit, special audit etc.

– **Institute of Chartered Accountants of India (ICAI) defines Auditing as-** Auditing is defined as a systematic and independent examination of data, statements, records, operations and performance of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognizes the propositions before him for examination, collect evidence, evaluates the same and on this basis formulates his judgement which is communicated through his audit report".

– The primary objective of the auditor is to report to the owners whether the balance sheet gives a true and fair view of the Company's state of affairs and the profit and loss A/c gives a correct figure of profit of loss for the financial year. The incidental objectives of auditing are detection and prevention of Frauds, and Detection and prevention of Errors.

– Audit scope determines the time involved in audit exercise, depth of auditing, aspects to be covered

etc. Audit scope depends on nature of audit, objectives of audit & terms of engagement, requirement of applicable legislations and auditing standard

– SA 200 "Basic Principals Governing an Audit", describes the basic principles which govern the auditor's professional responsibilities and which should be complied with wherever an audit is carried. They are *Integrity objectivity and independence, Confidentiality, Skill and competence, work performed by others, documentation Planning, audit evidence, Accounting System and Internal Control, Audit conclusions and reporting*

– Investigation is an exercise which is carried out with a specific objective. The investigation means in-depth analysis of books of accounts, transaction, and event. Investigation exercise is voluntary in nature and used extensively by Internal and management auditors.

– Materiality is a concept or convention within auditing and accounting relating to the importance/significance of an amount, transaction, or discrepancy. ***Materiality can be defined as the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.***

– Auditing standards refers to the code of best practices/procedures which an auditor is expected to follow during an audit to ensure consistency of findings. The auditing standard specifies a minimum level of performance. In India, Auditing standards are being issued by the Institute of Chartered Accountants of India.

– International Auditing standards are issued by the International Auditing and Assurance Standards Board (IAASB). IAASB is a body of International federation of accountants (IFAC)

SELF-TEST QUESTIONS

(These are meant for re-capitulation only. Answers to these questions are not to be submitted for evaluation)

1. Explain the term Auditing, Its objective and Scope.
2. What is the meaning of term auditing? State the advantages of Auditing.
3. What is the term 'true and Fait View' in Auditing?
4. Explain the concept of materiality in auditing.
5. What is the meaning of term investigation? Explain the difference between audit and investigation?
6. Explain the basic principles governing an audit in brief.
7. State the meaning and objectives of Auditing Standard?
8. State in brief about SA 620- using the work of an auditor's expert.
9. Write a short note on harmonization of Indian auditing standards with international auditing standards.

Lesson 11

Types of Company Audit

LESSON OUTLINE

- Audit of Companies under the Companies Act,2013
  - Statutory Audit
    - Appointment
    - Appointment of first auditor
    - Filling of casual vacancy
    - Remuneration, Powers & Duties of auditors
    - Branch audit
    - Fraud reporting by auditors
    - Penal provisions
  - Internal Audit
  - Secretarial Audit
  - Cost Audit
- Joint Audit
- CAG Audit
- Lesson Round Up
- Self Test Question

LEARNING OBJECTIVES

Auditing is a very important role in a company. Since a company is owned by shareholders and managed by their representatives i.e. Board of directors, it is auditing which provide a base for the shareholders to rely on the financials of a company. In a company, financial audit and cost audit (for manufacturing company) are statutory while Internal Audit, management audit, operational audit are non mandatory in nature. The objective of this lesson is to create understanding about various forms of audit in a company.

After reading this lesson student will be able to understand

- About statutory auditor of a company.
- Qualification to become a statutory auditor of a company. Disqualification for a statutory auditor.
- Requirement about the number of audits, rights and duties of auditor.
- Cost Audit, Internal audit, joint audit and branch audit
- Provisions relating to special audit and government audit.

Auditing is a means of evaluating the effectiveness of a company's internal controls. Mining an effective system of internal control is vital for achieving a company's business objectives, obtaining reliable financial reporting on its operations, preventing fraud and misappropriation of the assets and minimizing its cost of capital. Both Internal and Statutory Auditor contribute to a company's auditing system in different but important ways.

AUDIT OF COMPANIES UNDER THE COMPANIES ACT 2013

The Companies Act, 2013 is focused on transparency and disclosure. In the new Act, attempt has been made to cover each aspect of corporate functioning under audit by prescribing various types of audits like internal audit and secretarial audit. The various types of audits prescribed under the Companies Act, 2013 are:

- Statutory Audit
- Internal Audit
- Secretarial Audit
- Cost Audit

Statutory Audit

Sections 139 to 147 under chapter X of the Companies Act 2013 along with the Companies (Audit and Auditors) Rules, 2014 contain provisions regarding audit and auditors.

- Section 139 contains provision regarding Appointment of auditors.
- Removal, resignation of auditor and giving of special notice is provided in Section 140.
- Section 141 prescribes eligibility, qualifications and disqualifications of auditors.
- Section 142 deals with the provisions of Remuneration of auditors.
- Powers and duties of auditors and auditing standards is provided in Section 143.
- Section 144 provides a list of certain services which auditor is not to render.
- Section 145 deals with signing of Audit Reports.
- Section 146 deals with Auditors to atteng General Meeting
- Section 147 deals with punishment for contravention

Appointment of Auditors

The provisions of sub-section 1 of section 139 dealing with appointment of auditors can be briefly stated as under.

- Every company shall, at the first annual general meeting, appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.
- The company shall place the matter relating to such appointment for ratification by members at every annual general meeting.
- Before the appointment of auditor is made, the written consent of the auditor to such appointment, and a certificate from him or it that the appointment, if made, shall be in accordance with the conditions as may be prescribed, shall be obtained from the auditor.
- The certificate shall also indicate whether the auditor satisfies the criteria provided in section 141.
- The company shall inform the auditor concerned of his or its appointment, and also file a notice of such appointment with the Registrar within fifteen days of the meeting in which the auditor is appointed.
- The “appointment” includes reappointment.

Manner and procedure of selection and appointment of auditors

A company shall follow the procedure prescribed under the Rule 3 of the Companies (Audit and Auditors) Rules, 2014 for the selection and appointment of auditors under section 139(1).

- A company that is required to constitute an Audit Committee under section 177, such committee and where such committee is not required, the Board, shall take into consideration the qualifications and experience of the individual or the firm proposed to be considered for appointment as auditor and whether such qualifications and experience are commensurate with the size and requirements of the company.
- While considering the appointment, the Audit Committee or the Board, as the case may be, shall have regard to any order or pending proceeding relating to professional matters of conduct against the proposed auditor before the Institute of Chartered Accountants of India or any competent authority or any Court.
- The Audit Committee or the Board, as the case may be, may call for such other information from the proposed auditor as it may deem fit.
- Where a company is required to constitute the Audit Committee, the committee shall recommend the name of an individual or a firm as auditor to the Board for consideration and in other cases; the Board shall consider and recommend an individual or a firm as auditor to the members in the annual general meeting for appointment.
- If the Board agrees with the recommendation of the Audit Committee, it shall further recommend the appointment of an individual or a firm as auditor to the members in the annual general meeting.
- If the Board disagrees with the recommendation of the Audit Committee, it shall refer back the recommendation to the committee for reconsideration citing reasons for such disagreement.
- If the Audit Committee, after considering the reasons given by the Board, decides not to reconsider its original recommendation, the Board shall record reasons for its disagreement with the committee and send its own recommendation for consideration of the members in the annual general meeting; and if the Board agrees with the recommendations of the Audit Committee, it shall place the matter for consideration by members in the annual general meeting.
- The auditor so appointment shall be subject to ratification in every annual general meeting till the sixth such meeting by way of passing of an ordinary resolution. If the appointment is not ratified by the members of the company, the Board of Directors shall appoint another individual or firm as its auditor or auditors after following the procedure laid down in this behalf under the Act.
- The auditor appointed in the annual general meeting shall hold office from the conclusion of that meeting till the conclusion of the sixth annual general meeting, with the meeting wherein such appointment has been made being counted as the first meeting:

Conditions for appointment and notice to Registrar

The auditor appointed under Rule 3 the Companies (Audit and Auditors) Rules shall submit a certificate that -

- the individual or the firm, as the case may be, is eligible for appointment and is not disqualified for appointment under the Act, the Chartered Accountants Act, 1949 and the rules or regulations made thereunder;
- the proposed appointment is as per the term provided under the Act;
- the proposed appointment is within the limits laid down by or under the authority of the Act;
- the list of proceedings against the auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct.
- The notice to Registrar about appointment of auditor under fourth proviso to sub-section (1) of section 139 shall be in Form ADT-1.

Mandatory Rotation of Auditors

Under the Section 139(2), the system of rotation of auditors has been introduced for the auditors of listed companies and other class of companies.

The other class of companies (specified companies) shall mean the following classes of companies excluding one person companies and small companies as prescribed under Rule 5 of the Companies (Audit and Auditors) Rules.

(a) all unlisted public companies having paid up share capital of rupees ten crore or more;

(b) all private limited companies having paid up share capital of rupees twenty crore or more;

(c) all companies having paid up share capital of below threshold limit mentioned in (a) and (b) above, but having public borrowings from financial institutions, banks or public deposits of rupees fifty crores or more

The provisions for rotation of auditors under sub sections 2, 3 and 4 of section 139 are given below:

- If the auditor is an individual, he cannot be auditor of such a company for more than 5 consecutive years.
- If an audit firm/LLP is auditor of the company, it cannot be auditor of such a company for more than two terms of 5 consecutive years (i.e. 10 years)
- If an individual auditor who has completed his one term of 5 years, shall not be eligible for reappointment as auditor in the same company for 5 years from the completion of his term.
- In an audit firm/LLP which has completed its one term of 10 years, shall not be eligible for reappointment as auditor in the same company for 5 years from the completion of its term.
- It may be noted that any firm/LLP which has one or more partners who are also partners in the outgoing audit firm/LLP cannot be appointed as auditors during this 5 year period.
- There is a transition period of three years, from date of enactment of the 2013 Act, to comply with this requirement. All listed companies or specified companies will have to comply with the above provisions relating to rotation of auditors within 3 years from the date of commencement of this Act i.e. within 31st March 2017.
- However there will be no effect on the right of the company to remove an auditor or the right of the auditor to resign from such office of the company because of the provisions mentioned above.
- The members of a company may also provide for the rotation of auditing partner and his team at specified intervals in the audit firm appointed by the company.
- The members of a company may also provide that the audit shall be conducted by more than one auditor.

Manner of rotation of auditors by the companies on expiry of their term

A company shall follow the procedure prescribed under the Rule 6 of the Companies (Audit and Auditors) Rules, 2014 for the rotation of auditors under section 139(2).

- The Audit Committee shall recommend to the Board, the name of an individual auditor or of an audit firm who may replace the incumbent auditor on expiry of the term of such incumbent.
- Where a company is required to constitute an Audit Committee, the Board shall consider the recommendation of such committee, and in other cases, the Board shall itself consider the matter of rotation of auditors and make its recommendation for appointment of the next auditor by the members in annual general meeting.
- For the purpose of the rotation of auditors-

  (i) in case of an auditor (whether an individual or audit firm), the period for which the individual or the firm has held office as auditor prior to the commencement of the Act shall be taken into account for calculating the period of five consecutive years or ten consecutive years, as the case may be;

(ii) the incoming auditor or audit firm shall not be eligible if such auditor or audit firm is associated with the outgoing auditor or audit firm under the same network of audit firms which includes the firms operating or functioning, hitherto or in future, under the same brand name, trade name or common control.

- For the purpose of rotation of auditors,-

(i) a break in the term for a continuous period of five years shall be considered as fulfilling the requirement of rotation;

(ii) if a partner, who is in charge of an audit firm and also certifies the financial statements of the company, retires from the said firm and joins another firm of chartered accountants, such other firm shall also be ineligible to be appointed for a period of five years.

Appointment of first auditor:

- According to section 139(6), the first auditor of a company, other than a Government company, shall be appointed by the Board of Director within thirty days from the date of registration of the company.
- In the case of failure of the Board to appoint such auditor, it shall inform the members of the company, who shall within ninety days at an extraordinary general meeting appoint such auditor and such auditor shall hold office till the conclusion of the first annual general meeting.

Filling of casual vacancy

Removal of Auditors

- New Section 140 provides for Removal, Resignation etc. of Auditors. The procedure given in this section is more or less similar to the existing procedure in section 225 with the following difference.
- (i) Under new section 140 an auditor can be removed from his office before the expiry of his term only after obtaining the previous approval of the Central Government and after passing a Special Resolution by the Members. For this purpose the company will have to comply with the prescribed rules.
- (ii) If an auditor resigns from his office, he is required to file, within 30 days, a statement in the prescribed form with the company and ROC. In the case of a Government company, this form is also required to be filed with C& AG. In this statement the auditor has give reasons and other facts relevant for his resignation. For failure to comply with this requirement, the auditor is punishable with a minimum fine of Rs. 50,000/ - which may extend upto Rs. 5 lakh.
- (iii) If the auditor is found to have, directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by the company or any of its officers, the Tribunal can, on its own or on an application by the company, Central Government or any concerned person, direct the company to change the auditors. In the case of such an application by the Central Government for change of Auditors, the Tribunal can, within 15 days, pass an order that the auditor shall not function as such and the Central Government will be able to appoint another auditor. The auditor who is removed by the Tribunal cannot be appointed as an auditor of that company for 5 years. Further, under the new section 447 the auditor who is guilty of fraud will be punishable with imprisonment for a minimum term of six months which may extend to 10 years and shall also be liable to pay a minimum fine of an amount involved in the fraud which may extend to 3 times the said amount. If the fraud involves public interest the minimum period of imprisonment will be 3 years.
- Rules 7 and 8 provide for procedure for removal and resignation of an Auditor.

Qualifications and Disqualifications of Auditors: The section 141 of the Companies Act 2013 deals with the eligibility, qualifications and disqualifications of auditors. This section is similar to the existing section 226 of the

Companies Act 1956. Under the 1956 Act, a Chartered Accountant holding a certificate of practice or a firm of Chartered Accountants (only) can be appointed as auditor(s) of a company. The section 141 (1) and (2) of the 2013 Act, in addition, provides-

- A firm of Chartered Accountants or Limited Liability Partnership (LLP) can be appointed as an auditor of a company only if majority partners practising in India are qualified for appointment as an auditor of a company.
- Where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

The Companies Act 2013 has also made addition in the list of disqualifications of auditors. According to the section 141 (3) of the Companies Act 2013, the following persons shall not be eligible for appointment as an auditor of a company:–

(a) a body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008;

(b) an officer or employee of the company;

(c) a person who is a partner, or who is in the employment, of an officer or employee of the company;

(d) a person who, or his relative or partner—

- is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company: Provided that the relative may hold security or interest in the company of face value not exceeding rupees one lakh;
- is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company in excess of rupees five lakh or
- has given a guarantee or provided any security in connection with the indebtedness of any third person to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company in excess of one lakh rupees.

(e) a person or a firm who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company. The term “business relationship” shall be construed as any transaction entered into for a commercial purpose, except –

- commercial transactions which are in the nature of professional services permitted to be rendered by an auditor or audit firm under the Act and the Chartered Accountants Act, 1949 and the rules or the regulations made under those Acts;
- commercial transactions which are in the ordinary course of business of the company at arm’s length price - like sale of products or services to the auditor, as customer, in the ordinary course of business, by companies engaged in the business of telecommunications, airlines, hospitals, hotels and such other similar businesses.

(f) a person whose relative is a director or is in the employment of the company as a director or key managerial personnel;

(g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies;

(h) a person who has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction;

(i) any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialised services as provided in section 144.

A person who is appointed as an auditor of a company incurs any of the disqualifications mentioned above after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor according to section 141(4) of the Companies Act 2013.

Remuneration of Auditors: According to section 142 of the Companies Act 2013, the remuneration of the auditor of a company shall be fixed in its general meeting or in the manner as determined in the general meeting.

- The remuneration of the first auditor appointed by the board may be fixed by the Board.
- The remuneration shall be in addition to the fee payable to an auditor, include the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility extended to him but does not include any remuneration paid to him for any other service rendered by him at the request of the company.

Powers or Rights of Auditors: Section 143(1) provides for powers or rights of auditors. Every Auditor of a company shall have a right of access at all times to the books of account and vouchers of the company, whether kept at the registered office of the company or at any other place and shall be entitled to require from the officers of the company such information and explanation as he may consider necessary for the performance of his duties as auditor and amongst other matters inquire into the following matters, namely:—

(a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;

(b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

(c) where the company not being an investment company or a banking company,

whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;

(d) whether loans and advances made by the company have been shown as deposits;

(e) whether personal expenses have been charged to revenue account;

(f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading:

The auditor of a company which is a holding company shall also have the right of access to the records of all its subsidiaries in so far as it relates to the consolidation of its financial statements with that of its subsidiaries.

Duties of Auditors: Section 143(2), 143(3) and 143(4) provides for the duties of auditors. The auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made thereunder or under any order made under sub-section (*11*) and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year.

The auditor's report shall also state –

(a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;

(b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;

(c) whether the report on the accounts of any branch office of the company audited under sub-section (*8*) by a person other than the company's auditor has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;

(d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;

(e) whether, in his opinion, the financial statements comply with the accounting standards;

(f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;

(g) whether any director is disqualified from being appointed as a director under sub-section (*2*) of section 164;

(h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;

(i) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;

Other matters to be included in auditor's report: The auditor's report shall also include their views and comments on the following matters, namely:-

(a) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;

(b) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;

(c) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

Where any of the matters required to be included in the audit report under this section is answered in the negative or with a qualification, the report shall state the reasons therefor.

Branch Audit: Section 143(8) provides the provisions for branch audit of companies. These provisions are-

- If any company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (the company's auditor) or by any other person qualified for appointment as an auditor of the company under this Act.
- The branch auditor shall be appointed under section 139.
- If the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country.
- The branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

Duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor:

- **T**he duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor shall be same as the duties and powers of the auditors for the audit of the company under sub section 1 to 4 of section 143.
- The branch auditor shall submit his report to the company's auditor.
- The provisions of sub-section (12) of section 143 read with rule 12 hereunder regarding reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

Auditing Standards and National Financial Reporting Authority (NFRA): The Companies Act, 2013 provides that every auditor shall comply with the auditing standards. The auditing standards will be prescribed by the Central Government 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. Until any auditing standards are notified, any standard or standards of auditing specified by the Institute of Chartered Accountants of India shall be deemed to be the auditing standards.

Under the 2013 Act, National Financial Reporting Authority (NFRA) which replaces existing National Advisory Committee on Accounting Standards will make recommendations to the Central Government on laying down auditing and accounting standards applicable to companies. NFRA will monitor and enforce compliance with auditing standards.

Fraud reporting by auditors: Under section 143(12), if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government immediately but not later than sixty days of his knowledge and after following the procedure indicated herein below:

- auditor shall forward his report to the Board or the Audit Committee, as the case may be, immediately after he comes to knowledge of the fraud, seeking their reply or observations within forty-five days;
- on receipt of such reply or observations the auditor shall forward his report and the reply or observations of the Board or the Audit Committee alongwith his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within fifteen days of receipt of such reply or observations;
- in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of forty-five days, he shall forward his report to the Central Government alongwith a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he failed to receive any reply or observations within the stipulated time.
- The report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed post followed by an e-mail in confirmation of the same.
- The report shall be on the letter-head of the auditor containing postal address, e-mail address and contact number and be signed by the auditor with his seal and shall indicate his Membership Number.
- The report shall be in the form of a statement as specified in Form ADT-4.

No duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter referred to in sub-section (12) if it is done in good faith.

The provisions of this section shall mutatis mutandis apply to –

(a) the cost accountant in practice conducting cost audit under section 148; or

(b) the company secretary in practice conducting secretarial audit under section 204.

If any auditor, cost accountant or company secretary in practice do not comply with the provisions of sub-section (12), he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.

The term "Fraud" as defined under the 2013 Act is very wide and encompasses every act of omission or commission. "Fraud" in relation to affairs of a company or anybody corporate, includes any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss.

Prohibition on the services to be rendered by the auditors:

Section 144 provides that an auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which shall not include any of the following services rendered directly or indirectly to the company or its holding company or subsidiary company, namely:–

(a) accounting and book keeping services;

(b) internal audit;

(c) design and implementation of any financial information system;

(d) actuarial services;

(e) investment advisory services;

(f) investment banking services;

(g) rendering of outsourced financial services;

(h) management services; and

(i) any other kind of services as may be prescribed:

This is a new provision and there was no restriction of this type in the Companies Act 1956. Therefore, an auditor or audit firm who or which has been performing any non-audit services on or before the commencement of this Act shall comply with the provisions of this section before the closure of the first financial year after the date of commencement of the Act i.e within 31st March 2015.

It is also provided in this section that the prohibited non-audit services cannot be rendered by the following associates of the auditor.

(i) If the auditor is an Individual :- The Individual himself, his relative any person connected or associated with him, or any entity in which the Individual has significant influence or control or whose name or trade mark/brand is used by the Individual.

(ii) If the auditor is a firm or LLP:- Such firm/LLP either itself or through its partner or through its parent, subsidiary or associate or through any entity in which the firm/LLP or its partner has significant influence or control or whose name, trade mark or brand is used by the firm/LLP or any of its partners.

Signing of Audit Reports:

Section 145 of the Companies Act 2013, provides that the person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document of the company.

It also provides that the qualifications, observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company mentioned in the auditor's report shall be read before the company in general meeting and shall be open to inspection by any member of the company.

Auditors to attend general meeting:

Section 146 of the Companies Act 2013, provides that all notices of, and other communications relating to, any general meeting shall be forwarded to the auditor of the company, and the auditor shall, unless otherwise exempted by the company, attend either by himself or through his authorised representative, who shall also be qualified to be an auditor, any general meeting and shall have right to be heard at such meeting on any part of the business which concerns him as the auditor.

Penal Provisions: Section 147 provides for punishment for contravention of the provisions of sections 139 to 146. These penalty provisions are as under.

- If a company contravenes any of the provisions of sections 139 to 146 it shall be liable to pay minimum fine of Rs. 25,000/- which may extend to Rs. five lakh. Further, every officer who is in default shall be punishable with imprisonment upto one year and minimum fine of Rs. 10,000/- which may extend to Rs. one lakh or with both.
- If an auditor of a company contravenes any of the provisions of sections 139, 143 144 or 145, the auditor shall be punishable with minimum fine of Rs. 25,000/- which may extend to Rs. five lakh.
- If it is found that the auditor has contravened the provisions of sections 139, 143 144 or 145, knowingly or willfully with the intention to deceive the company, its share holders, creditors or tax authorities, he shall be punishable with imprisonment for a term upto one year and with a minimum fine of Rs. one lakh which may extend upto Rs. 25 lakh.
- If any auditor contravened any of the provisions of sections 139, 143 144 or 145, he shall be liable to-

  (b) refund the remuneration received by him to the company and

  (c) pay for damages to the company, statutory bodies/authorities or to any other persons for loss arising out of incorrect or misleading statements of particulars made in his audit report.
- The Central Government shall, by notification, specify any statutory body or authority or an officer for ensuring prompt payment of damages to the company or the persons under clause (ii) of sub-section (3) and such body, authority or officer shall after payment of damages to such company or persons file a report with the Central Government in respect of making such damages in such manner as may be specified in the said notification.
- Where, in case of audit of a company being conducted by an audit firm, it is proved that the partner or partners of the audit firm has or have acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to or by, the company or its directors or officers, the liability, whether civil or criminal as provided in this Act or in any other law for the time being in force, for such act shall be of the partner or partners concerned of the audit firm and of the firm jointly and severally.

Other Penalties on Auditor under Companies Act 2013:

(a) Class action suit against the Auditors U/s 245: To protect investor interest, Section 245 of Companies Act 2013 has introduced the concept of class action suits, through which shareholders, depositors can initiate legal action against the company and auditors in the event of fraudulent activity. A class of shareholders or deposit holders can now claim damages or compensation or demand other suitable action against the auditor, including the audit firm, by filing an application with the NCLT.

(b) Prosecution by NFRA (National Financial Reporting Authority) U/s 132: NFRA may investigate either suo moto or on a reference made to it by the Central Government on matters of professional or other misconduct committed by any member or firm of chartered accountants, registered under the Chartered Accountants Act, 1949 chartered accountants. If professional or other misconduct is proved, NFRA has the power to make order for-

- imposing penalty of (I) not less than one lakh rupees, but which may extend to five times of the fees received, in case of individuals; and (II) not less than ten lakh rupees, but which may extend to ten times of the fee received, in case of firms;
- debarring the member or the firm from engaging himself or itself from practice as member of the Institute of Chartered Accountant of India referred to in clause (e) of sub-section (1) of section 2 of the Chartered Accountants Act, 1949 for a minimum period of six months or for such higher period not exceeding ten years as may be decided by the National Financial Reporting Authority.

(c) Punishment for fraud U/s 447: Any person who is found to be guilty of fraud, shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud. Provided that where the fraud in question involves public interest, the term of imprisonment shall not be less than three years.

(d) Punishment for false statement U/s 448: If any return, report, certificate, financial statement, prospectus, statement or other document required by, or for, the purposes of any of the provisions of this Act or the rules made thereunder, any person makes a statement-

- which is false in any material particulars, knowing it to be false; or
- which omits any material fact, knowing it to be material, he shall be liable under section 447.

INTERNAL AUDIT

Section 138 under Chapter IX of the Companies Act, 2013 contains provisions regarding internal audit. The provisions regarding internal audit of the company according to section **138** of the Companies Act, 2013 and the Companies (Accounts) Rules, 2014 are discussed below-

Qualifications for the internal auditor: The internal auditor shall either be a chartered accountant whether engaged in practice or not or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the company.

Report of the internal audit: The report of internal audit shall be submitted to the Board of the company.

Companies required to appoint internal auditor: The following class of companies shall be required to appoint an internal auditor or a firm of internal auditors, namely:-

(a) every listed company;

(b) every unlisted public company having-

- paid up share capital of fifty crore rupees or more during the preceding financial year; or
- turnover of two hundred crore rupees or more during the preceding financial year; or
- outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or
- outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(c) every private company having-

- turnover of two hundred crore rupees or more during the preceding financial year; or
- outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year:

Other Provisions:

- All the companies covered under any of the above criteria will have to comply with the requirements of section 138 and this rule within six months of commencement of such section.
- The internal auditor may or may not be an employee of the company.
- The Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.

SECRETARIAL AUDIT

The Companies Act 2013 has introduced a new requirement of Secretarial Audit for bigger companies, which has been prescribed under Section 204 of the Act. The provisions regarding secretarial audit of the company according to section 204 of the Companies Act, 2013 and the Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014 are discussed below-

Companies required conducting secretarial audit:

(1) Every listed company and

(2) Company belonging to other class of companies: The other class of companies are

- every public company having a paid-up share capital of fifty crore rupees or more; or
- every public company having a turnover of two hundred fifty crore rupees or more.

Qualifications for the secretarial auditor: A Secretarial Audit has to be conducted by a Practising Company Secretary in respect of the secretarial and other records of the company.

Report of the secretarial audit: A secretarial audit report shall be annexed with the Board's report of the company. The Board of Directors, in their report made in terms of sub-section (3) of section 134, shall explain in full any qualification or observation or other remarks made by the company secretary in practice in his report under sub-section (1). The format of the Secretarial Audit Report shall be in Form No.MR.3.

Other Provisions:

- It shall be the duty of the company to give all assistance and facilities to the company secretary in practice, for auditing the secretarial and related records of the company.
- If a company or any officer of the company or the company secretary in practise, contravenes the provisions of this section, the company, every officer of the company or the company secretary in practice, who is in default, shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees. As per Section 143(14), all provisions regarding rights, duties and obligations of statutory auditors shall also apply to Company Secretary in Practice conducting secretarial audit.

COST AUDIT

Section 148 of the Companies Act provides that the Central Government may, by order, in respect of such class of companies engaged in the production of such goods or providing such services as may be prescribed, direct that particulars relating to the utilisation of material or labour or to other items of cost as may be prescribed shall also be included in the books of account kept by that class of companies:

Provided that the Central Government shall, before issuing such order in respect of any class of companies regulated under a special Act, consult the regulatory body constituted or established under such special Act.

- If the Central Government is of the opinion, that it is necessary to do so, it may, by order, direct that the audit of cost records of class of companies, which are covered under sub-section (1) and which have a

net worth of such amount as may be prescribed or a turnover of such amount as may be prescribed, shall be conducted in the manner specified in the order.

- The audit under sub-section (2) shall be conducted by a Cost Accountant in practice who shall be appointed by the Board on such remuneration as may be determined by the members in such manner as may be prescribed: Provided that no person appointed under section 139 as an auditor of the company shall be appointed for conducting the audit of cost records:

  Provided further that the auditor conducting the cost audit shall comply with the cost auditing standards.

  "cost auditing standards" mean such standards as are issued by the Institute of Cost and Works Accountants of India, constituted under the Cost and Works Accountants Act, 1959, with the approval of the Central Government.

- An audit conducted under this section shall be in addition to the audit conducted under section 143.
- The qualifications, disqualifications, rights, duties and obligations applicable to auditors under this Chapter shall, so far as may be applicable, apply to a cost auditor appointed under this section and it shall be the duty of the company to give all assistance and facilities to the cost auditor appointed under this section for auditing the cost records of the company: Provided that the report on the audit of cost records shall be submitted by the cost accountant in practice to the Board of Directors of the company.
- A company shall within thirty days from the date of receipt of a copy of the cost audit report prepared in pursuance of a direction under sub-section (*2*) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein.
- If, after considering the cost audit report referred to under this section and the information and explanation furnished by the company under sub-section (*6*), the Central Government is of the opinion that any further information or explanation is necessary, it may call for such further information and explanation and the company shall furnish the same within such time as may be specified by that Government.
- If any default is made in complying with the provisions of this section,—

  (a) the company and every officer of the company who is in default shall be punishable in the manner as provided in sub-section (*1*) of section 147;

  (b) the cost auditor of the company who is in default shall be punishable in the manner as provided in sub-sections (*2*) to (*4*) of section 147.

JOINT AUDIT

Meaning of Joint Audit: when two or more auditors are appointed for the execution of same audit assignment, it is termed as joint audit. Joint auditors are mainly appointed for audit assignment of public enterprises and big companies.

Institute of Chartered Accountants of India (ICAI) has issued SA 299 on "Responsibility of Joint Auditors" w.e.f. April, 1996. Basic principles governing a joint audit are discussed herein given below

Division of Work - Where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves in terms of audit of identifiable units or specified areas. If due to the nature of the business of the entity under audit, such a division of work may not be possible the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. The division of work among joint auditors as well as the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity.

Coordination - Where, in the course of his work, a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or

require discussion with, or application of judgement by, other joint auditors, he should communicate the same to all the other joint auditors in writing. Thus should be done by the submission of a report or note prior to the finalisation of the audit.

Relationship among joint auditors - In respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared as separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible:

(a) In respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

(b) In respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors. It may, however, be clarified that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing or extent of the audit procedures agreed upon among them; proper execution of these audit procedures is the separate and specific responsibility of the joint auditor concerned;

(c) In respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;

(d) For examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and

(e) For ensuring that the audit report complies with the requirements of the relevant statute.

If any matters of the nature referred above are brought to the attention of the entity or other joint auditors by an auditor after the audit report has been submitted, the other joint auditors would not be responsible for those matters. Subject to paragraph (b) above, it is the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the area of work allocated to him; The issues such as appropriateness of using test checks or sampling should be decided by each joint auditor in relation to his own area of work. This responsibility is not shared by the other joint auditors.

Thus, it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him. Similarly, the nature, timing and extent of the enquiries to be made in the course of audit as well as the other audit procedures to be applied are solely the responsibility of each joint auditor. In the case of audit of a large entity with several branches, including those required to be audited by branch auditors, the branch audit reports/returns may be required to be scrutinised by different joint auditors in accordance with the allocation of work. In such cases, it is the specific and separate responsibility of each joint auditor to review the audit reports/returns of the divisions/branches allocated to him and to ensure that they are properly incorporated into the accounts of the entity. In respect of the branches which do not fall within any divisions or zones which are separately assigned to the various joint auditors, they may agree among themselves as regards the division of work relating to the review of such branch returns. It is also the separate and specific responsibility of each joint auditor to exercise his judgement with regard to the necessity of visiting such divisions/branches in respect of which the work is allocated to him. A significant part of the audit work involves obtaining and evaluating information and explanations from the management. This responsibility is shared by all the joint auditors unless they agree upon a specific pattern of distribution of this responsibility. In cases where specific responsibility of each joint auditor to obtain appropriate information and explanations from the management in respect of such divisions/zones/units and to evaluate the information and explanations so obtained by him.

Each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work in accordance with the generally accepted audit procedures. It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner. Each joint auditor is entitled to rely upon the other joint auditors for bringing

to his notice accounting principles or any material error noticed in the course of the audit. Where separate financial statements of a division/branch are audited by one of the joint auditors, the other joint auditors are entitled to proceed on the basis that such financial statements comply with all the legal and professional requirements regarding the disclosures to be made and present a true and fair view of the state of affairs and of the working results of the division/branch concerned, subject to such observations as may be communicated by the joint auditor concerned.

Reporting Responsibilities - Normally, the joint auditors are able to arrive at an agreed report. However, where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express his own opinion through a separate report. A joint auditor is not bound by the view of the majority of the joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement. For the purpose of computation of the number of company audits held by an auditor pursuant to the ceiling rule introduced in the Companies Act, 1956 each joint auditor ship in a company will be counted as one unit

CAG AUDIT

CAG Audit is known as audit of public enterprises done by Comptroller and Auditor General of India and here we will be discussing about Government Audit as CAG audit.

In India, government audit is performed by an independent constitutional authority, i.e. Comptroller and Audit General of India (C&AG), through the Indian Audit and Accounts Department. The Constitution of India gives a special status to the C&AG and contains provisions to safeguard his independence. Article 148 of the constitution provides that the C&AG shall be appointed by the President and can be removed from the office only in a like manner and on the like grounds as a judge of the Supreme Court. Article 151 of the Constitution requires that the audit reports of the C&AG relating to the accounts of the Central/State Government should be submitted to the President/Governor of the State who shall cause them to be laid before Parliament/State Legislative.

The Comptroller and Audit General's (Duties, Power and Conditions of Services) Act, 1971, prescribes that the C&AG shall hold office for a term of six years or upto the age of 65 years, which is earlier. He can resign at any time through a resignation letter addressed to the President. The Act also assigns the duties regarding the audit to be followed by C&AG.

Organizations subject to the audit of the Comptroller and Auditor General of India

The organisations subject to the audit of the Comptroller and Auditor General of India are:-

- All the Union and State Government departments and offices including the Indian Railways and Posts and Telecommunications.
- About 1500 public commercial enterprises controlled by the Union and State governments, i.e. government companies and corporations.
- Around 400 non-commercial autonomous bodies and authorities owned or controlled by the Union or the States.
- Over 4400 authorities and bodies substantially financed from Union or State revenues

Audit of Government Companies (Commercial Audit)

There is a special arrangement for the audit of companies where the equity participation by Government is 51 percent or more. The primary auditors of these companies are Chartered Accountants, appointed by the Comptroller and Auditor General of India, who gives the directions to the auditors on the manner in which the audit should be conducted by them. The Comptroller and Auditor General of India is also empowered to comment upon the audit reports of the primary auditors. In addition, the Comptroller and Auditor General of India conducts a test audit of the accounts of such companies and reports the results of his audit to Parliament and State Legislatures.

Nature of Audit

While fulfilling his Constitutional obligations, the Comptroller & Auditor General examines various aspects of Government expenditure. The audit done by C&A G is broadly classified into Regularity Audit and Performance Audit.

Regularity Audit (Compliance)

- Audit against provision of funds to ascertain whether the moneys shown as expenditure in the Accounts were authorized for the purpose for which they were spent.
- Audit against rules and regulation to see that the expenditure incurred was in conformity with the laws, rules and regulations framed to regulate the procedure for expending public money.
- Audit of sanctions to expenditure to see that every item of expenditure was done with the approval of the competent authority in the Government for expending the public money.
- Propriety Audit which extends beyond scrutinizing the mere formality of expenditure to it wisdom and economy and to bring to light cases of improper expenditure or waste of public money.

While conducting the audit of receipts of the Central and State Governments, the Comptroller & Auditor General satisfies himself that the rules and procedures ensure that assessment, collection and allocation of revenue are done in accordance with the law and there is no leakage of revenue which legally should come to Government.

Regularity Audit (Financial)

In regularity (financial) audit and in other types of audit when applicable, auditors analyze the financial statements to establish whether acceptable accounting standards for financial reporting and disclosure are complied with. Analysis of financial statements is performed to such a degree that a rational basis is obtained to express an opinion on financial statements.

Performance Audit

Performance audit is done to see that Government programmes have achieved the desired objectives at lowest cost and given the intended benefits.

Action on Audit Reports

The Annual Accounts and the Audit Reports of public enterprises and government companies are scrutinized by the Parliament. Since parliament has limited time for discussion on the issue of national importance, therefore the Parliament and the State Legislatures have, constituted specialized Committees like the Public Accounts Committee (PAC) and the Committee on Public Undertakings (COPU) for review and scrutiny of audit Reports and Annual Accounts of public enterprises and government companies

Public Accounts Committee

The Committee on Public Accounts is constituted by Parliament each year for examination of accounts showing the appropriation of sums granted by Parliament for expenditure of Government of India, the annual Finance Accounts of Government of India, and such other Accounts laid before Parliament as the Committee may deem fit, such as accounts of autonomous and semi-autonomous bodies (except those of Public Undertakings and Government Companies which come under the purview of the Committee on Public Undertakings).

Constitution of the Committee

The Committee consists of not more than 22 members comprising 15 members elected by Lok Sabha every year from amongst its members according to the principle of proportional representation by means of single transferable vote and not more than 7 members of Rajya Sabha elected by that House in like manner are associated with the Committee. The Chairman is appointed by the Speaker from amongst its members of Lok Sabha. The Speaker, for the first time, appointed a member of the Opposition as the Chairman of the Committee

for 1967-68. This practice has been continued since then. A Minister is not eligible to be elected as a member of the Committee. If a member, after his election to the Committee is appointed a Minister, he ceases to be a member of the Committee from the date of such appointment.

The Public Accounts Committee satisfies itself:-

(a) that the money shown in the accounts as having been disbursed were legally available for, and applicable to the service or purpose to which they have been applied or charged;

(b) that the expenditure conforms to the authority which governs it; and

(c) That every re-appropriation has been made in accordance with the provisions made in this behalf under rules framed by the competent authority.

It is also the duty of the PAC to examine the statement of accounts of autonomous and semi-autonomous bodies, the audit of which is conducted by the Comptroller & Auditor General either under the directions of the President or by a Statute of Parliament.

Committee on Public Undertakings

The Committee on Public Undertakings exercises the same financial control on the public sector undertakings as the Public Accounts Committee exercises over the functioning of the Government Departments. The functions of the Committee are:-

(a) To examine the reports and accounts of public undertakings.

(b) To examine the reports of the Comptroller & Auditor General on public undertakings.

(c) To examine the efficiency of public undertakings and to see whether they are being managed in accordance with sound business principles and prudent commercial practices.

The examination of public enterprises by the Committee takes the form of comprehensive appraisal or evaluation of performance of the undertaking. It involves a thorough examination, including evaluation of the policies, programmes and financial working of the undertaking.

The objective of the Financial Committees, in doing so, is not to focus only on the individual irregularity, but on the defects in the system which led to such irregularity, and the need for correction of such systems and procedures.

CAG's Role in functioning of financial committees of Parliament

The Comptroller & Auditor General of India plays a key role in the functioning of the financial committees of Parliament and the State Legislatures. He has come to be recognised as a 'friend, philosopher and guide' of the Committee. His Reports generally form the basis of the Committees' working, although they are not precluded from examining issues not brought out in his Reports. He scrutinizes the notes which the Ministries submit to the Committees and helps the Committees to check the correctness submit to the Committees and helps the Committees to check the correctness of facts and figures in their draft reports.

The Financial Committees present their Report to the Parliament/ State Legislature with their observations and recommendations. The various Ministries / Department of the Government are required to inform the Committees of the action taken by them on the recommendations of the Committees (which are generally accepted) and the Committees present Action Taken Reports to Parliament / Legislature.

In respect of those cases in Audit Reports, which could not be discussed in detail by the Committees, written answers are obtained from the Department / Ministry concerned and are sometimes incorporated in the Reports presented to the Parliament / State Legislature. This ensures that the audit Reports are not taken lightly by the Government, even if the entire report is not deliberated upon by the Committee.

Where, in any financial year, the accounts of the branch office of a company have not been audited by an auditor mentioned in sub-section (1) of section 228, the auditor of the company shall expressly state in the audit report that the branch office is exempt from the requirements of section 228 by virtue of rule 3 or that an exemption has been granted under rule 4.

8. Revocation of exemption.-

The Central Government may, after giving the company reasonable opportunity to make its objections, revoke an exemption granted under these rules, if-

(a) there has been a contravention of any of the terms and conditions subject to which the exemption was granted;

(b) there has been a material alteration in the circumstances relating to the scrutiny, check or audit of the accounts of the branch office on the basis of which the exemption was granted ; and

(c) for any other reason, the Central Government is satisfied that the exemption is no longer necessary or justified.

LESSON ROUND UP

1. Section 139 to 147 under Chapter X of Companies Act, 2013 contains provision regarding audit and auditors
2. An auditor under section 139 shall hold office from first AGM till conclusion of Sixth AGM.
3. An auditor can be removed, or can resign from his office by procedure given under section 140.
4. Section 141 provides for qualifications and disqualifications of Auditors.
5. Remuneration of Auditors is prescribed under section 142.
6. Powers and duties of an auditors are defined under section 143.
7. Some services which are prohibited to be rendered by an auditor prescribed under section 144.
8. Section 145 contains the provisions for signing of Audit Reports.
9. Section 147 provides for punishment for contravention of the provisions of section 139 to 146.
10. Section 138 under Chapter IX of Companies Act, 2013 contains provisions regarding internal audit.
11. The Companies Act, 2013 has introduced a new requirement of Secretarial Audit under section 204, for bigger companies.
12. Section 148 of Act provides that Central Government in respect of such class of Companies engaged in the production of such goods or providing such services as may be prescribed, direct that particulars relating to the utilization of material or labour or to other terms of cost shall also be included in the books of account kept by that class of companies.
13. When 2 or more auditor are appointed for the execution of same audit assignment is termed as Joint Audit.
14. CAG Audit is audit of public enterprises done by Comptroller and Auditor General of India.
15. There is a special arrangement for the audit of Companies where the equity participation by Government is 51% or more named as ‘Audit of Government Companies’.

SELF TEST QUESTIONS

(These are meant for re-capitulation only. Answers to these questions are not to be submitted for evaluation)

1. What is the meaning of term cost auditing, explain its reference to statutory audit.
2. Explain Statutory Audit under Companies Act, 2013
3. Explain the manner and procedure of selection and appointment of auditors.
4. States the requirement of cost audit in brief.

Lesson 12

Internal Audit

LESSON OUTLINE

– Introduction
– Propriety Audit
– Compliance Audit
– Objectives and benefits of compliance audit
– Compliance audit process
– Efficiency Audit
– Objectives of Efficiency Audit
– Advantages of Efficiency Audit
– What is Internal Audit
– Nature of Internal Audit
– Scope of Internal Audit
– Techniques of Internal Audit
– Internal Audit Process-Step wise approach
– Advantages of Internal Audit
– Functions and Responsibilities of internal audit
– Distinction between internal audit and statutory audit
– Role of Internal auditor in different areas
– Lesson Round Up
– Self Test Question

LEARNING OBJECTIVES

Internal Audit is a tool of control to measure and evaluate the effectiveness of the working of an organization primarily with accounting, financial and operational matters. The job of internal audit is to ensure that the work of the company is going on smoothly, efficiently and economically and that all the laws, rules and regulations governing the operations of the organization are adhered to, besides ensuring that an effective internal control system exists to prevent errors, frauds and misappropriations. The objective of this lesson is to create an understanding of Internal audit, its different forms, its uses and its role in different areas.

After reading this lesson, the student should be able to understand:

– The meaning of propriety and propriety audit, objectives of propriety audit.
– The meaning of compliance audit and its objective and advantages.
– The meaning of efficiency audit, its objectives and its advantages.
– Nature and scope of internal audit.
– Different techniques used in internal audit and their application.
– Advantages of Internal Audit.
– Limitations of Internal Audit
– Distinction between an internal audit and statutory audit.
– Role of internal audit in different areas, function, responsibilities attached with internal auditor.

Kohler has defined propriety as that which meets the test of public interest, commonly accepted customs and standard of conduct and particularly as applied to professional performance, requirements of Government regulations and professional codes.

INTRODUCTION

There are various forms of auditing exercise. In many cases, audit is prescribed by relevant statutes i.e. Companies Act, 2013, Income Tax Act, 1961, otherwise, audit can be carried out at the discretion of management. Here we would be discussing mainly Internal Audit, its features, its role. Other than this first let us discuss Propriety Audit, Compliance Audit and Efficiency Audit.

PROPRIETY AUDIT

Kohler has defined propriety as that which meets the test of public interest, commonly accepted customs and standard of conduct and particularly as applied to professional performance, requirements of Government regulations and professional codes. Propriety Audit carry out to check, mean whether the transactions have been done in conformity with established rules, principles and established standard.

The Propriety Audit means the verification of following main aspects to find out whether:

(i) Proper recording has been done in appropriate books of accounts.

(ii) The assets have not been misused and have been properly safeguarded.

(iii) The business funds have been utilized properly.

(iv) The concern is yielding the expected results.

The system of Propriety Audit is applied in respect to Government companies, Government Department because public money and public interest are involved therein. It is an essential function of audit to bring to light not only cases of clear irregularity but also every matter which in its judgement appears to involve improper expenditure or waste of public money or stores, even though the accounts themselves may be insufficient to see that sundry rules or orders of competent authority have been observed. It is of equal importance to ensure that the broad principles of orthodox finance are borne in mind not only by disbursing officers but also by sanctioning authorities.

COMPLIANCE AUDIT

A compliance audit is a comprehensive review of an organization's adherence to regulatory guidelines.

What, precisely, is examined in a compliance audit will vary depending upon whether an organization is a public or private company, what kind of data it handles and if it transmits or stores sensitive financial data.

It is common to us that the business undertakings require some certified statement on various matters and the auditors certify such statements after carrying out audit which might be necessary under the particular cases. All such audits are called Compliance Audit. Suppose when a company applies to a bank for some loan, a certified statement showing the turnover of the company for the past two or three years along with the current year might be necessary, and for this purpose the certified statements are to be attached with the application, otherwise the application will be rejected. So these certified statements showing the turnover of the company fall under the category of compliance audit. Internal audit for compliance could be more broad base to include compliance with documented procedures/policies, compliance with statutory requirements in the relevant areas etc.

Objectives of Compliance Audit

The objective of a compliance audit is to determine whether the auditee is following prescribed laws, regulations, policies, or procedures. These audits can be performed within a business organization for internal purposes or in response to requirements by outside groups, particularly government.

Benefits of Compliance Audit

1. Adherence to the established standards.
2. Improvement of internal processes and technologies.
3. Maintenance of Certifications.
4. Adherence to governmental regulations.
5. Cost recovery.
6. Elevate fraud awareness and deter fraudulent activity.
7. Manage contract areas of risk.

THE COMPLIANCE AUDIT PROCESS

Doing a Compliance Audit, a stepwise approach is required. First the compliance auditor needs to have a clear knowledge of audit's objective and scope. Accordingly he decides the time to be devoted in the compliance audit. Before beginning a particular compliance audit, the auditor must gain thorough understanding of applicable rules, guidelines and procedures to be evaluated. He should decide how to recognize when a deviation has occurred, and how to evaluate evidence obtained through audit tests.

The auditor must figure out, for each event to be tested, just what evidence signifies compliance and what evidence signifies noncompliance. The auditor may also prepare a detailed questionnaire about key compliance issues.

Assessing compliance may be simple, requiring a brief inspection to find out whether rules were followed or not however in some cases making a judgment may require extensive research of regulatory requirements, interpretations, and technical materials. If the auditor is not sufficiently experienced in very specialized compliance topics then the opinions of an expert should be sought.

The auditor may choose a sample of events or transactions for testing when it is not practical to examine every one that falls within the scope of the audit.

Compliance audit reports must be made in the format that is relevant to the auditee or sponsoring entity i.e. government. Reports usually describe the objectives of the compliance audit, the number of conditions examined during the time period considered, the frequency of events conforming to conditions, and the number of exceptions. When a statistical sample of events has been tested and required assumptions are appropriate, results from the sample may be used to predict the level of compliance for all events or transactions within the scope of the audit. Compliance audit reports often indicate reasons for deviations from standards, describe implications of those deviations, and recommend actions that strengthen control procedures for assuring compliance.

EFFICIENCY AUDIT

In essence, efficiency indicates how well an organization uses its resources to produce goods and services. It focuses on resources (inputs), goods and services (outputs), and the rate (productivity) at which inputs are used to produce or deliver the outputs. To understand the meaning of "efficiency", it is necessary to understand the following terms: inputs, outputs (including quantity and quality), productivity, and level of service.

Inputs are resources (e.g., human, financial, equipment, material, facilities, information, energy and land) used to produce outputs.

Outputs are goods and services produced to meet client needs. Outputs are defined in terms of quantity and quality and are delivered within parameters relating to level of service.

Quantity refers to the amount, volume, or number of outputs produced.

Quality refers to various attributes and characteristics of outputs such as reliability, accuracy, timeliness, service courtesy, safety, and comfort.

Productivity is the ratio of the amount of acceptable goods and services produced (outputs) to the amount of resources (inputs) used to produce them. Productivity is expressed in the form of a ratio such as cost or time per unit of output.

Efficiency is a relative concept. It is measured by comparing achieved productivity with a desired norm, target, or standard. Output quantity and quality achieved and the level of service provided are also compared to targets or standards to determine to what extent they may have caused changes in efficiency. Efficiency is improved when more outputs of a given quality are produced with the same or fewer resource inputs, or when the same amount of output is produced with fewer resources.

Efficiency audit refers to comparing the actual results with the desired/projected results. It is directed towards the measurement of whether plans have been effectively executed. It is concerned with the utilisation of the resources in economic and most remunerative manner to achieve the objectives of the concern. It comprises of studying the plans of organisation, comparing actual performance with plans and investigating the reasons for variances to take remedial action

OBJECTIVES OF EFFICIENCY AUDIT

The objectives of auditing efficiency can include assessing one or more of the following:

- the level of efficiency achieved by an organization or operation in relation to reasonable standards;
- the adequacy and reliability of systems or procedures used to measure and report efficiency;
- an organization's efforts to explore and exploit opportunities to improve efficiency; and
- whether the management processes and information systems, operational systems, and practices of an organization help to achieve efficiency.

Advantages of Efficiency Audit

Auditing efficiency enables the management/owner to know whether the departments and agencies manage resources with due regard to efficiency. It can also directly or indirectly help departments and agencies to identify opportunities to provide more or better services at the same or lower cost. More specifically, such audits can:

- help managers and staff to be more sensitive to their obligation of due regard to efficiency;
- underline the importance of measuring efficiency and of using that information for managing operations and providing accountability;
- identify means for improving efficiency, even in operations where efficiency is difficult to measure;
- demonstrate the scope for lowering the cost of delivering programs without reducing the quantity or quality of outputs or the level of service;
- increase the quantity or improve the quality of outputs and level of service without increasing spending; and
- identify needed improvements in existing controls, operational systems, and work processes for better use of resources.

INTERNAL AUDIT

Internal Audit is performed by professionals with an in-depth understanding of the business culture, systems,

and processes. Internal audit activity provides assurance that internal controls in place are adequate to mitigate the risks, governance processes are effective and efficient, and organizational goals and objectives are met

As per The Institute of Internal Auditors (IIA):

Internal Auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

Independence is established by the organizational and reporting structure. Objectivity is achieved by an appropriate mind-set. The internal audit activity evaluates risk exposures relating to the organization's governance, operations and information systems, in relation to:

1. Effectiveness and efficiency of operations.
2. Reliability and integrity of financial and operational information.
3. Safeguarding of assets.
4. Compliance with laws, regulations, and contracts.

Based on the results of the risk assessment, the internal auditors evaluate the adequacy and effectiveness of how risks are identified and managed in the above areas. They also assess other aspects such as ethics and values within the organization, performance management, communication of risk and control information within the organization in order to facilitate a good governance process.

An effective internal audit activity is a valuable resource for management and the board or its equivalent, and the audit committee due to its understanding of the organization and its culture, operations, and risk profile. The objectivity, skills, and knowledge of competent internal auditors can significantly add value to an organization's internal control, risk management, and governance processes. Similarly an effective internal audit activity can provide assurance to other stakeholders such as regulators, employees, providers of finance, and shareholders.

NATURE OF INTERNAL AUDIT

1. **A Management tool:** Internal Audit is management tool performed by the employees of the organisation or the engaged professional firm to check the appropriateness of internal checks and control in the organisation. The reporting authority is generally board of directors and audit committee.
2. **A continuous Exercise:** Internal Audit is a continuous and systematic process of examining and reporting the operations and records of a concern by its employees or external agencies specially assigned for this purpose. It is, in essence, auditing for the management and its scope may vary depending upon the nature and size of the concern.
3. **A Control System**: It is a control system concerned with examination and appraisal of other control mechanisms.
4. **A Risk Management Tool**: The internal audit work encompasses fostering the creation of a risk management process and ensuring it addresses key objectives, and the subsequent evaluation of the process. The internal audit work also encompasses an identical role in the creation and subsequent evaluation of, the business continuity planning process, and the information security and privacy system.

SCOPE OF INTERNAL AUDIT

The Institute of Internal Auditors defines scope of internal auditing as 'The examination and evaluation of the adequacy and effectiveness of organization's system of internal control and the quality of actual performance'.

On the analysis of above, it can be argued that internal auditing is concerned with an evaluation of both internal control as well as the quality of actual performance. According to The Institute of Internal Auditors, internal audit involves five areas of operations, which can be discussed as follows:

1. **Reliability and Integrity of Financial and Operating Information:** - Internal Auditors should review the reliability and integrity of financial and operating information and the means used to identify, measure, classify and report such information.
2. **Economical and Efficient Use of Resources:** - Internal Auditor should ensure the economic and efficient use of resources available.
3. **Compliance with Laws, Policies, Plans, Procedures, and Regulations:** - Internal Auditor should review the systems established to ensure compliance with those policies, plans and procedures, law and regulations which could have a significant impact on operations and should determine whether the organization is in compliance thereof.
4. **Accomplishment of Established Goals for Operations: -** Internal Auditor should review operations, programmes to ascertain whether results are consistent with established objectives and goals and whether the operations or programmes are being carried out as planned.
5. **Safeguarding of Assets: -** Internal Auditor should verify the existence of assets and should review means of safeguarding assets.

Techniques of Internal Audit

An Internal auditor uses Internal Audit tools/techniques to ensure that controls, processes and policies are adequate and effective, and that they adhere to industry practices and regulatory mandates. An internal auditor also checks a corporation's financial statements to ensure that such reports are prepared in accordance with generally accepted accounting principles. The techniques which are often used by an internal auditor are discussed herein.

Review of Operating Environment

For carrying out the audit effectively, it is necessary for an internal auditor to understand how the company operates. He determines it by referring to departmental employees, external auditors report, and risk specialists. A firm's operating environment describes management's ethical qualities, leadership style and business practices. An internal auditor also could determine how a corporation operates by evaluating industry trends and regulations.

Review Controls

An internal auditor determines how a company's segment or departmental controls operate by reading prior audit reports or working papers and by inquiring from segment employees who perform such controls on a regular basis. An auditor applies generally accepted auditing standards (GAAS) to detect mechanisms, procedures, tools and methodologies that build controls.

Test Controls

An internal auditor tests a business organization's controls, policies and guidelines to ensure that such controls are adequately designed and are operating effectively. Controls are mechanisms and methodologies a corporation's management puts into place to prevent losses due to error, fraud, theft or breaks in technology systems. Effective controls remedy deficiencies and problems properly. Controls are adequate if they provide detailed step-by-step procedures and guidelines for task performance, decision-making processes and lines of hierarchy.

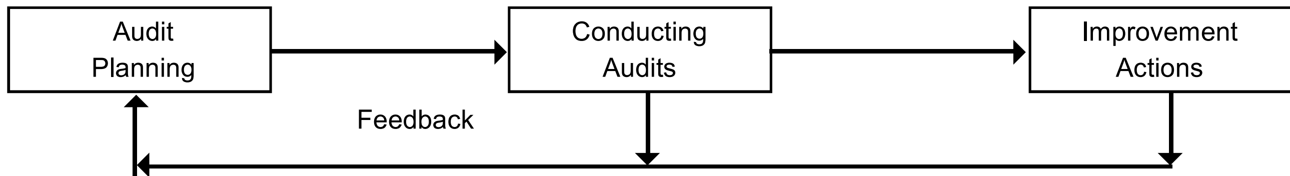
Account Details

An internal auditor performs tests of account details to ensure that financial statements of a business entity are

not "materially misstated." Tests of account details and account balances are referred to as substantive tests. An auditor conducts such tests if a firm's controls and processes are not adequate or not functioning properly. "Material" means significant or substantial in accounting and audit parlance; a misstatement could result from human errors, intentional fraud or technology system weaknesses.

The above list is not exhaustive and other techniques may also be used by an Internal Auditor in the internal audit exercise.

Internal Audit Process



INTERNAL AUDIT PROCESS: STEP WISE APPROACH

1. Establish and communicate the scope and objectives for the audit to appropriate management.

2. Develop an understanding of the business area under review. This includes objectives, measurements and key transaction types. This involves review of documents and interviews. Flow charts and narratives may be created if necessary.

3. Describe the key risks facing the business activities within the scope of the audit.

4. Identify control procedures used to ensure each key risk and transaction type is properly controlled and monitored.

5. Develop and execute a risk-based sampling and testing approach to determine whether the most important controls are operating as intended.

6. Report problems identified and negotiate action plans with management to address the problems.

7. Follow-up on reported findings at appropriate intervals. Internal audit departments maintain a follow-up database for this purpose.

WHY INTERNAL AUDIT IS REQUIRED/ADVANTAGES OF INTERNAL AUDIT

Management is responsible for establishing and maintaining a system of internal controls within an organization. Internal controls are those structures, activities, processes, and systems which help management effectively mitigate the risks to an organization's achievement of objectives. Management is charged with this responsibility on behalf of the organization's stakeholders and is held accountable for this responsibility by an oversight body (e.g. board of directors, audit committee, elected representatives).

A dedicated, independent and effective internal audit activity assists both management and the oversight body (e.g. the board, audit committee) in fulfilling their responsibilities by bringing a systematic disciplined approach to assessing the effectiveness of the design and execution of the system of internal controls and risk management processes. The objective assessment of internal controls and risk management processes by the internal audit activity provides management, the oversight body, and external stakeholders with independent assurance that the organization's risks have been appropriately mitigated. Because internal auditors are experts in understanding organizational risks and internal controls available to mitigate these risks, they assist management in understanding these topics and provide recommendations for improvements.

Beside above, Internal Audit has become an important management tool for the following reasons

1. Internal Auditing is a specialized service to look into the standards of efficiency of business operation.

2. Internal Auditing can evaluate various problems independently in terms of overall management control and suggest improvement.

3. Internal Audit's independent appraisal and review can ensure the reliability and promptness of MIS and the management reporting on the basis of which the top management can take firm decisions.

4. Internal Audit system makes sure the internal control system including accounting control system in an organization is effective.

5. Internal Audit ensures the adequacy, reliability and accuracy of financial and operational data by conducting appraisal and review from an independent angle.

6. Internal Audit is an integral part of "Management by System".

7. Internal Audit can break through the power ego and personality factors and possible conflicts of interest within the organization.

8. It ensures compliance of accounting procedures and accounting policies.

9. Internal Auditor can be of valuable assistance to management in acquiring new business, in promoting new products and in launching new projects for expansion or diversification of business

LIMITATION OF INTERNAL AUDIT

Despite numerous benefits, internal audit has got some limitations.

1. The installation and operation of internal audit involve extra expenditure which cannot be met by many small concerns. As a matter of fact, internal audit is confined to larger business.
2. The limitation of internal audit starts when there is time lag between recording and checking of entries. The accounting and internal audit must go side by side with minimum time gap
3. Internal audit becomes as better as it is used by managers. There are occasions when managers cannot accept the finding of internal audit and take consequent actions. This defect arises mainly from the deficiencies of the internal auditing staff, because of their advisory staff position, unfamiliarity with operating aspects of work and accounting bias, internal auditors fail to be of any real help to the manager in many cases.
4. Internal audits are employed by the organization and this can be impair their independence and objectivity and ability to report fraud/error to senior management because of perceived threats to their continued employment within the company to ensure the transparency. Best practice indicates that the internal audit should report both to management and those charged with governance (audit committee).
5. Internal auditors are not required to be professionally qualified and so there may be limitations in their knowledge and technical expertise.

FUNCTIONS AND RESPONSIBILITIES OF INTERNAL AUDITORS

"Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation in accomplishing its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."

Major roles and responsibilities of internal auditor are summarized below

1. To work with board and management to ensure that a system is in place which ensures that all major risks are identified and analyzed. Evaluate and provide reasonable assurance that risk management, control, and governance systems are functioning as intended and will enable the organisation's objectives and goals to be met.
2. To plan, organize and carry out the internal audit function including the preparation of an audit plan which fulfils the responsibility of the department, scheduling and assigning work and estimating resource needs.
3. Report risk management issues and internal controls deficiencies identified directly to the audit committee and provide recommendations for improving the organisation's operations, in terms of both efficient and effective performance.
4. Evaluation of information security and associated risk exposures. Evaluation of the organisation's readiness in case of business interruption.
5. Evaluation of regulatory compliance program with consultation from legal counsel.
6. Maintain open communication with management and the audit committee. Team with other internal and external resources as appropriate. Engage in continuous education and staff development. To report to both the audit committee and management on the policies, programmed and activities of the department.
7. Provide support to the company's anti-fraud programs.
8. To coordinate coverage with the external auditors and ensure that each party is not only aware of the other's work but also well briefed on areas of concern.
9. To make recommendations on the systems and procedures being reviewed, report on the findings and recommendations and monitor management's response and implementation.
10. To review and report on the accuracy, timeliness and relevance of the financial and other information that is provided for management.

Organisational Status of Internal Auditing Function

Where there is an internal audit function, its status is derived from the needs of the organisation and should be set at the top of the organisation, i.e. by the board and the audit committee. There is no single model for internal audit and each organisation will determine what is appropriate to suit its requirements. In general, internal audit could, if agreed by the audit committee, seek assurance that:

– The organisation has a formal governance process which is operating as intended: values and goals are established and communicated, the accomplishment of goals is monitored, accountability is ensured and values are preserved.

– Significant risks within the organisation are being managed and controlled to an acceptable level as determined by the board.

In addition, internal audit can be used to facilitate the strengthening of the governance and risk framework within the organisation.

The audit committee should consider the role that has been set for internal audit within the organisation's overall assurance framework. The evaluation of internal audit role should be on an ongoing basis (at least annually). The audit committee should challenge the organisation's decisions (if required) in relation to the role that has been set for internal audit and question whether its scope, authority and resources are adequate and consistent with the risks that the organisation faces and the effectiveness of the internal controls that are in place to address those risks.

Terms of reference

The overall status and remit of internal audit should be formalized in terms of reference it is often referred to as an audit charter, and approved by the board, normally through the audit committee. These should then be communicated to relevant people within the organisation. Internal audit's terms of reference or charter should provide clarity about its:

– Strategy and objectives;

– Role and responsibilities within the organisation;

– Scope of work;

– Accountability to the audit committee;

– Reporting lines for line management purposes;

– Accessibility to the board and the audit committee; and

– Unfettered access to all information, people and records across the organisation.

The terms of reference should make it clear that internal audit should not be put in a position where it has to review its own work.

INTERNAL AUDIT STATUS VIS-A-VIS STATUTORY AUDIT

Relationship between internal auditor and statutory auditor.

Statutory Auditor and Internal Auditor both are independent entity. A statutory Auditor of a company cannot be the internal auditor of the same company. In certain cases, statutory auditor refers the report of internal auditor and he expresses his opinion based on the report of internal auditor. Similarly in certain cases, internal auditor also refers the report of statutory auditors. The relationship between statutory auditor and internal auditor may be summed up as given below:

1. **Comment on the Internal Audit System in place:** the statutory auditor has to comment upon the effectiveness and suitability of internal audit system laid down by the management. To discharge this responsibility statutory auditor should evaluate the internal audit system. He should evaluate the strength of the internal audit staff, their qualification and experience.

2. **Evaluation of the actual work of internal auditor:** After studying the internal audit system and structure actual work of the internal auditor should also be evaluated. Statutory auditor has to make use of the work of internal auditor. This he can do only when he himself puts faith in the work of internal auditor.

3. **Relying on the work of internal auditor**: Statutory auditor has to decide that up to what extant he can rely upon the work of the internal auditor. This will decide the extent of checking by statutory auditor. If he feels that internal auditor has properly done his work he can reduce the extent of his checking.

4. **No reduction in responsibility:** Relying on work of internal auditor in no way reduces the responsible for the discharge of his duties as statutory auditor. Relying on the internal auditor can only reduce the burden of the statutory auditor. For all his works statutory auditor would remain responsible.

Difference between Internal Audit and Statutory Audit

There are some differences between statutory audit and internal audit. The details are as given below:

1. Appointment: Internal Auditor is appointed by the management of the organization while the statutory auditor is appointed by owners i.e. shareholder for a company. First statutory auditors of a company are appointed by the board of directors.

2. Qualification: Qualifications of the statutory auditor are prescribed in the Companies Act, 1956. In case of a company, a practicing chartered Accountants or a firm of practicing chartered Accountants can only be appointed as a statutory auditor. There are no fixed qualifications for the position of an internal auditor.

3. Objects: The main object of the statutory audit is to form an opinion on the financial statement of the organization. Auditor has to state that whether the financial statements are showing the true and fair view of the affairs of the organization or not. The main object of the internal audit is to detect and prevent the errors and frauds.

4. Scope: The scope of the statutory audit is fixed by the Companies Act, 1956. It cannot be changed by mutual consent between the auditor and the management of the audited business unit. The scope of the internal audit is fixed by the mutual consent of the auditor and the management of the unit under audit.

5. Report: The statutory auditor submits his report to the shareholder of the company in its general meeting. The internal auditor submits his report to the management of the company who is also his appointing authority.

6**. Removal**: The procedure of removal of the statutory auditor is very complex. Only the company in the general meeting can remove the auditor. It also has to take the permission of the central government. The management of the entity can early remove internal auditor. No permission of Central Government is require.

ROLE OF INTERNAL AUDIT IN DIFFERENT AREAS

Role of Internal Audit in Internal Control

The Internal auditor should examine and contribute to the ongoing effectiveness of the internal control system through evaluation and recommendations. However, the internal auditor is not vested with management's primary responsibility for designing, implementing, maintaining and documenting internal control. Internal audit functions add value to an organization's internal control system by bringing a systematic, disciplined approach to the evaluation of risk and by making recommendations to strengthen the effectiveness of risk management efforts. The internal auditor should focus towards improving the internal control structure and promoting better corporate governance**.** The role of the internal auditor encompasses:

- Evaluation of the efficiency and effectiveness of controls
- Recommending new controls where needed or discontinuing unnecessary controls
- Using control frameworks
- Developing Control self-assessment

Role of Internal Audit in risk management

Internal auditing professional standards require the function to monitor and evaluate the effectiveness of the organization's Risk management processes. Risk management relates to how an organization sets objectives, then identifies, analyzes, and responds to those risks that could potentially impact its ability to realize its objectives.

Under the COSO Enterprise Risk Management (ERM) Framework, risks fall under strategic, operational, financial reporting, and legal/regulatory categories. Management performs risk assessment activities as part of the ordinary course of business in each of these categories. Examples include: strategic planning, marketing planning, capital planning, budgeting, hedging, incentive payout structure, and credit/lending practices. Sarbanes-Oxley regulations also require extensive risk assessment of financial reporting processes. Corporate legal counsel often prepares comprehensive assessments of the current and potential litigation a company faces. Internal auditors may evaluate each of these activities, or focus on the processes used by management to report and monitor the risks identified. For example, internal auditors can advise management regarding the reporting of forward-looking operating measures to the Board, to help identify emerging risks.

In larger organizations, major strategic initiatives are implemented to achieve objectives and drive changes. As a member of senior management, the Chief Audit Executive (CAE) may participate in status updates on these major initiatives. This places the CAE in the position to report on many of the major risks the organization faces to the Audit Committee, or ensure management's reporting is effective for that purpose.

Role of Internal Audit in corporate governance

Internal auditing activity as it relates to corporate governance is generally informal, accomplished primarily through participation in meetings and discussions with members of the Board of Directors. Corporate governance is a combination of processes and organizational structures implemented by the Board of Directors to inform, direct, manage, and monitor the organization's resources, strategies and policies towards the achievement of the organizations objectives. The internal auditor is often considered one of the "four pillars" of corporate governance, the other pillars being the Board of Directors, management, and the external auditor.

A primary focus area of internal auditing as it relates to corporate governance is helping the Audit Committee of the Board of Directors (or equivalent) perform its responsibilities effectively. This may include reporting critical internal control problems, informing the Committee privately on the capabilities of key managers, suggesting questions or topics for the Audit Committee's meeting agendas, and coordinating carefully with the external auditor and management to ensure the Committee receives effective information.

LESSON ROUND-UP

- Propriety audit is a concept widely used in government audit. Propriety Audit means whether the transactions have been done in conformity with established rules, principles and some established standard.
- A compliance audit is a comprehensive review of an organization's adherence to regulatory guidelines, procedures, laws. The objective of a compliance audit is to determine whether the auditee is following prescribed laws, regulations, policies, or procedures
- Efficiency indicates how well an organization uses its resources to produce goods and services. Efficiency audit refers to comparing the actual results with the desired/projected results. It is directed towards the measurement of whether plans have been effectively executed.
- Internal Audit is performed by professionals with an in-depth understanding of the business culture, systems, and processes. Internal audit activity provides assurance that internal controls in place are adequate to mitigate the risks, governance processes are effective and efficient, and organizational goals and objectives are met.
- There are various techniques of internal audit including Review of Operating Environment, review of controls, test controls, accounts details.
- The work of internal auditor and statutory auditor is interlinked. In his report, statutory auditor needs to comment on the adequacy of internal control system and internal audit. In many case, internal auditor is also required to refer the statutory auditor report.
- Internal audit and statutory audit differs with each other in terms of the scope, responsibilities, terms of reference etc.
- Internal audit play a very important role in risk management, corporate governance and internal control. He is who examine and contribute to the ongoing effectiveness of the internal control system through evaluation and recommendations.

SELF-TEST QUESTIONS

(These are meant for re-capitulation only. Answers to these questions are not to be submitted for evaluation)

1. What is propriety Audit? What are the objective and scope of propriety audit?
2. What is the meaning of Compliance audit? State the objective of compliance audit.
3. Explain efficiency audit and its objectives. Differentiate between compliance audit and efficiency audit.
4. Explain internal audit and its, objectives and scope.
5. What are the different techniques of internal audit? Explain in brief.
6. How does the internal audit carry out? Explain stepwise approach.
7. What are the advantages and limitations of Internal Audit?
8. Difference between statutory audit and internal audit.
9. Explain the role of internal audit in corporate governance , risk management and internal control

Lesson 13

Internal Control

LESSON OUTLINE

- Introduction
- Definitions of internal control
- Nature of internal control
- Scope of Internal control system
- Internal control objectives
- Elements of internal control system
- Limitation of internal control
- Internal check
- Difference between internal control system and internal check system
- Difference between internal audit and internal check
- Difference between internal control and internal audit
- Techniques of internal control system
  - Preventive control techniques
  - Detective control techniques
- Review of Internal control
  - Narrative records
  - Check list
  - Internal control questionnaire
  - Flow chart
- Audit testing
- Sampling in Audit testing
- Approaches to statistical sampling
- Inter firm and intra firm comparison
- Ratio /trend analysis as a tool of inter-firm and intra- firm comparison
- Audit in depth
- Lesson Round Up
- Self Test Question

LEARNING OBJECTIVES

Internal control is a process effected by plan management and other personnel, and those charged with governance, and designed to provide reasonable assurance regarding the achievement of objectives in the reliability of financial reporting. Internal Control is not only important in ensuring the reliability of financial reporting but is also necessary for survival of an organisation's success. In lack of an effective internal control system, it is quite for an organisation to survive in continuous changing environment. The objective of this lesson is to create an understanding of Internal Control , its Scope, its objective, its techniques and its review.

After reading this lesson, the student will be able to understand:

- The meaning of internal control system, its nature, objectives, scope and elements
- The meaning of internal check system and difference between internal control system, internal check system and internal audit system
- Difference techniques used in internal control
- How the review of internal control is done. Techniques used in internal control review.
- Meaning of audit testing, use of sampling in audit testing, different approaches used in audit sampling
- Meaning of inter firm comparison and intra firm comparison
- Meaning of audit in depth and its characteristics.

Internal controls as a system comprising of controls environment and procedures. It includes polices and ways adapted by management of an enterprise to assist it in achieving its objectives.

The International Standards of Auditors

INTERNAL CONTROL

Introduction

Internal control means different things to different people. This causes confusion among businessman, legislators, regulators and others.

Internal control is broadly defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

1. Effectiveness and efficiency of operations.
2. Reliability of financial reporting.
3. Compliance with applicable laws and regulations.

The first category addresses an entity's basic business objectives, including performance and profitability goals and safeguarding of resources. The second relates to the preparation of reliable published financial statements, including interim and condensed financial statements and selected financial data derived from such statements, such as earnings releases, reported publicly. The third deals with complying with those laws and regulations to which the entity is subject. These distinct but overlapping categories address different needs and allow a directed focus to meet the separate needs.

Definitions of Internal Control

De Paula [1989] defined internal controls as a system of controls, financial and otherwise established by management in order to carry on the business of the company in an orderly and efficient manner to ensure the adherence to management policies, safeguard the assets, and secure as much as possible the completeness of an internal control system.

Gibbins, [1990]; argues that the safeguarding of assess , prevention and detection of frauds and errors , the accuracy and completeness of accounting records and timely preparation of reliable information, he argues that internal controls may be incorporated with in computerized accounting system, which extends beyond those matters which are related directly to the accounting system.

Lucy argues that internal controls comprise the control environment and control procedures. It includes all the policies and procedures adopted by the directors and management of an entity to assist in achieving their objective of ensuring are efficient and orderly conduct of its business and adherence to internal policies.

Thomas Evans, in his book "International Accounting and reporting "defines internal controls as policies and procedures that an organization develops to safe guard its resources and provide for the reliability of financial records.

The international standards of auditors define internal controls as a system comprising of controls environment and procedures. It includes polices and ways adapted by management of an enterprise to assist it in achieving its objectives.

Nature of Internal control

Internal controls can be detective, corrective, or preventive by nature.

1. Detective controls are designed to detect errors or irregularities that may have occurred.
2. Corrective controls are designed to correct errors or irregularities that have been detected.

3. Preventive controls, on the other hand, are designed to keep errors or irregularities from occurring in the first place.

SCOPE OF INTERNAL CONTROL SYSTEM

It is very important to have an internal control system for an organisation. There is no universal model of internal control, system. It is up to every company to design an internal control system which is suitably adapted to its situation. Internal control is neither limited to a set of procedures nor to financial controls. Operational control such as quality control, work standards, budgetary control, periodic reporting, policy appraisal, quantitative controls etc are all parts of internal control system.

INTERNAL CONTROL OBJECTIVES

Internal control objectives are desired goals or conditions for a specific event cycle which, if achieved, minimize the potential that waste, loss, unauthorized use or misappropriation will occur. They are the conditions which we want the system of internal control to satisfy. For a control objective to be effective, compliance with it must be measurable and observable.

Internal audit evaluates the organisation's system of internal control by accessing the ability of individual process controls to achieve seven pre-defined control objectives. The control objectives include:

Authorization - the objective is to ensure that all transactions are approved by responsible personnel in accordance with their specific or general authority before the transaction is recorded.

Completeness - the objective is to ensure that no valid transactions have been omitted from the accounting records.

Accuracy - the objective is to ensure that all valid transactions are accurate, consistent with the originating transaction data, and information is recorded in a timely manner.

Validity - the objective is to ensure that all recorded transactions fairly represent the economic events that actually occurred, are lawful in nature, and have been executed in accordance with management's general authorization.

Physical Safeguards and Security - the objective is to ensure that access to physical assets and information systems are controlled and properly restricted to authorized personnel.

Error Handling - the objective is to ensure that errors detected at any stage of processing receive prompts corrective action and are reported to the appropriate level of management.

Segregation of Duties - the objective is to ensure that duties are assigned to individuals in a manner that ensures that no one individual can control both the recording function and the procedures relative to processing a transaction.

Elements of Internal control

INTERNAL CONTROL ELEMENTS

Internal control consists of five interrelated components. These are derived from the way management runs a business, and are integrated with the management process. Although the components apply to all entities, small and mid-size companies may implement them differently than large ones. Its controls may be less formal and less structured, yet a small company can still have effective internal control. The components are:

Control Environment

The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organizes and develops its people; and the attention and direction provided by the board of directors.

Risk Assessment

Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent. Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed. Because economic, industry, regulatory and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with change.

Control Activities

Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.

Information and Communication

Pertinent information must be identified, captured and communicated in a form and timeframe that enable people to carry out their responsibilities. Information systems produce reports, containing operational, financial and compliance-related information, that make it possible to run and control the business. They deal not only with internally generated data, but also information about external events, activities and conditions necessary to informed business decision-making and external reporting. Effective communication also must occur in a broader sense, flowing down, across and up the organization. All personnel must receive a clear message from top management that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties, such as customers, suppliers, regulators and shareholders.

Monitoring

Internal control systems need to be monitored—a process that assesses the quality of the system's performance over time. This is accomplished through ongoing monitoring activities, separate evaluations or a combination of the two. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported to top management and the board.

There is synergy and linkage among these components, forming an integrated system that reacts dynamically to changing conditions. The internal control system is intertwined with the entity's operating activities and exists for fundamental business reasons. Internal control is most effective when controls are built into the entity's infrastructure and are a part of the essence of the enterprise. "Built in" controls support quality and empowerment initiatives, avoid unnecessary costs and enable quick response to changing conditions

ADVANTAGES OF INTERNAL CONTROL SYSTEM

Increase in operational efficiency

One advantage of internal controls involves the efficiency they create. Technological advances to improve the accuracy of each transaction also streamline manual processes.

Accurate Recording

Another advantage of internal controls revolves around the accuracy in recording each transaction. Internal controls help prevent errors and irregularities from occurring. If errors or irregularities do occur, internal controls will help ensure they are detected in a timely manner. It creates confidence that only authorized transactions have taken place

Safeguarding Assets

It minimizes of the risk of fraud and misappropriation of assets. It involves fraud monitoring and prevention techniques. For example in case of a banking internal control system, mmonitoring activities include security cameras and security guards and prevention activities include cash counting by two employees at a time and cash reconciliation by non-tellers..

Compliance

Another advantage of using internal controls includes increasing compliance with regulatory agencies. Internal controls encourage adherence to prescribed policies and procedures. It assures that adequate documentation supporting transactions is created and retained.

Protection of Employees

Internal controls protect employees: 1) by clearly outlining tasks and responsibilities, 2) by providing checks and balances, and, 3) from being accused of misappropriations, errors or irregularities

Benefits of Internal Control to the Auditor

I f the audit client benefits from a sound system of internal control, it is likely that the auditor will also be benefited. All of the above stated benefits help to promote a situation where the financial statements present a true and fair view. A good system of internal control will make life easier for the auditor

LIMITATIONS OF INTERNAL CONTROLS

No matter how well the internal controls are designed, they can only provide a reasonable assurance that objectives will be achieved. Some limitations are inherent in all internal control systems. These limitations include:

Judgment - the effectiveness of controls will be limited by decisions made with human judgment under pressures to conduct business based on the information available at hand.

Breakdowns - even well designed internal controls can break down. Employees sometimes misunderstand instructions or simply make mistakes. Errors may also result from new technology and the complexity of computerized information systems.

Management Override - high level personnel may be able to override prescribed policies or procedures for personal gains or advantages. This should not be confused with management intervention, which represents management actions to depart from prescribed policies and procedures for legitimate purposes.

Collusion - control system can be circumvented by employee collusion. Individuals acting collectively can alter financial data or other management information in a manner that cannot be identified by control systems.

A well designed process with appropriate internal controls should meet most if not all of these control objectives.

INTERNAL CHECK

Internal check is best regarded as indicating checks on the day-to-day transactions which operate continuously as a part of the routine systems whereby work of one person is proved independently or is complementary to the work of another, the object being the prevention of or early detection of errors and frauds".

The main objective of internal check is prevention of errors and frauds and/or detection of errors and frauds at the earliest. Internal check is a continuous process and is part of the day-to-day routine. It relates to all the transactions that take place every day. Internal check is achieved by complementary allocation of duties and by independent verification of the work of one person by another.

Internal check is a part of internal control system. It ensures that all financial transactions are properly recorded. It also ensures efficiency of the accounting system followed by the organization and enables easy preparation of financial statements. It achieves its main object of minimizing errors and frauds. A sound system of internal check increases the reliability of financial statements. Internal check discourages fraud and collusion among employees by instilling a fear of detection in their minds. Internal check assigns responsibilities to persons and enables maintenance of records and documents properly and thereby ensures smooth flow of work.

DIFFERENCE BETWEEN INTERNAL CONTROL SYSTEM AND INTERNAL CHECK SYSTEM

Internal control is the system of control established by the management in order to carry on business in an orderly and efficient manner, ensure adherence to management policies, safeguard assets and completeness of records whereas Internal check is a system of allocation of responsibility, division of work and methods of recording transactions, whereby the work of one employee is checked continuously by another.

Internal check system is one part of internal control system. Internal control is broader concept as compare to internal check system; it contains many more types of controls other than the internal check system.

In internal control system, controls other than the internal check system are internal audit system and other non-financial control systems like quality control, purchasing controls, marketing controls etc.

The essence of internal check system is that the check should be automatic, continuous and objective while the essence of internal control system is in implementation of Internal check and Internal audit.

DIFFERENCE BETWEEN INTERNAL CHECK AND INTERNAL AUDIT

Way of checking: In internal check system work is automatically checked whereas in internal audit system work is checked specially.

Cost involvement: in internal check system checking is done when the work is being done. Mistake can be checked at an early stage in internal check system.

Thrust of system: Thrust of internal check system is to prevent the errors and whereas the thrust of internal audit system is to detect the errors and frauds.

Time of checking: In internal check system checking is done when the work is being done whereas in internal audit system work is checked after it is done. Mistakes can be checked at an early stage in internal check system.

DIFFERENCE BETWEEN INTERNAL CONTROL AND INTERNAL AUDIT

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes, on the other hand Internal control is the system of control established by the management in order to carry on business in an orderly and efficient manner, ensure adherence to management policies, safeguard assets and completeness of records

Internal control system is a broad concept and in includes internal audit system as we.. Internal audit system is comparatively a narrow concept.

Internal control system is necessary for every organisation while internal audit system is to be implemented as per the suitability of the organisation.

The primary objective of internal control system is to prevent the occurrence of fraud while the internal audit is primarily a backward looking activity.

TECHNIQUES OF INTERNAL CONTROL SYSTEM

There are two types of techniques used in internal control system **Preventive internal control techniques** and **Detective internal control techniques** controls. Both types of internal control techniques are essential to an effective internal control system. From a quality standpoint, preventive controls techniques are essential because they are proactive and emphasize quality. However, detective controls techniques play a critical role by providing evidence that the preventive controls techniques are functioning as intended

Preventive Controls techniques are designed to discourage errors or irregularities from occurring. They are proactive in nature that helps to ensure departmental objectives are being met. Examples of preventive controls techniques are:

1. **Segregation of Duties:** Duties are segregated among different people to reduce the risk of error or inappropriate action. Normally, responsibilities for authorizing transactions (approval), recording transactions (accounting) and handling the related asset (custody) are divided.
2. **Approvals, Authorizations, and Verifications**: Management authorizes employees to perform certain activities and to execute certain transactions within limited parameters. In addition, management specifies those activities or transactions that need supervisory approval before they are performed or executed by employees. A supervisor's approval (manual or electronic) implies that he or she has verified and validated that the activity or transaction conforms to established policies and procedures.
3. **Security of Assets (Preventive and Detective):** Access to equipment, inventories, securities, cash and other assets is restricted; assets are periodically counted and compared to amounts shown on control records.

Detective Controls techniques are designed to find errors or irregularities after they have occurred. Examples of detective controls techniques are:

1. **Reviews of Performance:** Management compares information about current performance to budgets, forecasts, prior periods, or other benchmarks to measure the extent to which goals and objectives are being achieved and to identify unexpected results or unusual conditions that require follow-up.
2. **Reconciliations:** An employee relates different sets of data to one another, identifies and investigates differences, and takes corrective action, when necessary.
3. Physical Inventories
4. Internal Audits

REVIEW OF INTERNAL CONTROL

Internal Controls are to be an integral part of any organization's financial and business policies and procedures. Internal controls consists of all the measures taken by the organization for the purpose of; (1) protecting its resources against waste, fraud, and inefficiency; (2) ensuring accuracy and reliability in accounting and operating data; (3) securing compliance with the policies of the organization; and (4) evaluating the level of performance in all organizational units of the organization. Internal controls are simply good business practices.

Review of internal control system is a very important task for an auditor. It is required to ensure that any inefficiency or ineffectiveness in system is captured. A statutory auditor us also required to evaluate the effectiveness of internal control system and to state in his report to shareholders.

Steps for Internal Control and Audit Evaluation

A review of internal control can be done by a process of study, examination and evaluation of the control system installed by the management. The first step involves determination of the control and procedures laid down by the management. By reading company manuals, studying organization charts and flow charts and by making suitable enquiries from the officers and employees, the auditor may ascertain the character, scope and efficacy of the control system. To acquaint him-self about how all the accounting information is collected and processed and to learn the nature of controls that makes the information reliable and protect the company's assets, calls for considerable skill and knowledge. In many cases, very little of this information is available in writing; the auditor must ask the right people the right questions if he is to get the information he wants. It would be better if he makes written notes of the relevant information and procedures contained in the manual or ascertained on enquiry. To facilitate the accumulative of the information necessary for the proper review and evaluation of internal controls, the auditor can use one of the following to help him to know and assimilate the system and evaluate the same:

(1) Narrative record;

(2) Check list;

(3) Questionnaire; and

(4) Flow chart;

(1) **The narrative record** is a complete and exhaustive description of the system as found in operation by the auditor. Actual testing and observation are necessary before such a system is in operation and would be more suited to small business. The basic disadvantages of narrative records are:

1. To comprehend the system is operation is quite difficult.
2. To identify weaknesses or gaps in the system
3. To incorporate charges arising on account of reshuffling of manpower, etc.

(2) **A check list** is a series of instruction and/or answer. When he completes instruction, he initials the space against the instruction. Answers to the check list instruction are usually Yes, No or Not applicable. This is again an on the job requirement and instructions are framed having regard to the desirable element of control. A few examples of check list instruction are given hereunder:

1. Are tenders called before placing orders?
2. Are the purchases made on the basis of a written order?
3. Is the purchase order form standardized?
4. Are purchase order forms are pre-numbered?

5. Are the stock control accounts maintained by persons who have nothing to do with:
   (1) Custody of work;
   (2) Receipt of stock;
   (3) Inspection of stock; and
   (4) Purchase of stock.

The complete check list is studied by the principle/manager/senior to ascertain existence of internal control and evaluate its implementation and efficiency.

(3) **Internal control questionnaire** is a comprehensive series of questions concerning internal control. This is the most widely used from for collecting information about the existence, operation and efficiency of internal control in an organization. An important advantage of the questionnaire approach is that oversight or omission of significant internal control review procedures is less likely to occur with this method. With a proper questionnaire, all internal control evaluation can be completed at one time or in sections. The review can more easily be made on an interim basis. The questionnaire form also provides an orderly means of disclosing control defects. It is the general practice to review the internal control system annually and record the review the detail. In the questionnaire, generally questions are so framed that a 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness. Provision is made for an explanation or further details of 'No' answers. In respect of questions not relevant to the business, 'Not applicable' reply is given.

The questionnaire is annually issued to the client and the client is requested to get it filled by the concerned executives and employees. If on a perusal of the answers, inconsistencies or apparent incongruities are noticed, the matter is further discussed by auditor's staff with the client employees for a clear picture. The concerned auditor then prepares a report of deficiencies and recommendation for improvement.

(4) **A flow chart** is a graphical presentation of each part of the company's system of internal control. A flow chart is considered to be the most concise way of recording the auditor's review of the system. It minimizes the amount of narrative explanation and thereby achieves and consideration or presentation not possible in any other form. It gives bird's eye view of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested. It is also necessary for the auditor to study the significant features of the business carried on by the concern: the nature of its activities and various channels of goods and materials as well as cash, both inward and outward, : and also a comprehensive study of the entire process of manufacturing, trading and administration. This will help him to understand and evaluate the internal controls in the correct perspective.

AUDIT TESTING

An audit test is a procedure performed by either an external or internal auditor in order to assess the accuracy of various financial statement assertions. The two common categorizations of audit tests are substantive tests and tests of internal controls. Both types of tests are used in external and internal audits in order to reach established audit objectives, as can be outlined in audit checklists or determined based on the results of audit questionnaires. Audit tests typically are performed on a sample basis over an existing group of similar transactions. Sampling approaches can either be statistical or non-statistical, with the ultimate goal being to obtain the most representative sample of the population before testing begins.

A substantive audit test is a direct test that validates a financial statement balance, while internal control tests are focused on key controls, such as management reviews or standardized templates that are designed to prevent and detect material misstatements. Substantive testing often requires a large deal of recalculating, confirming, and vouching. For example, when an auditor substantively tests an inventory balance, the auditor will go to the on-site location of the inventory, run reports that list the amount of inventory stored on the premises, and physically count each inventory item on a sample basis. Using the same example under an internal control

testing approach, an auditor would assess the systems generating the reports, consider the experience level of the personnel on the premises that manage the inventory, and review shipping and receiving documents for the appropriate sign-offs instead of counting the actual inventory on the premises.

SAMPLING IN AUDIT TESTING

Sampling is a process of selecting a subset of a population of items for the purpose of making inferences to the whole population. Accounting populations usually consist of a large number of items (debtors, creditors), often totalling millions of rupees, and a detailed examination of all accounts is not possible. Audit sampling is defined as

> "The application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the auditor to obtain and evaluate evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population which makes up the account balance or class of transactions"

A fundamental element of any audit programme will be the selection of transactions to be tested as a sample of all available transactions. Sampling is used in both compliance and substantive testing and is described in numerous textbooks in auditing

Need for Audit Sampling

Formalized audit sampling procedures offer innumerable benefits to all auditors. These include:

1. Developing a consistent approach to audit areas;
2. Providing a framework within which sufficient audit evidence is obtained;
3. Forcing clarification of audit thinking in determining how the audit objectives will be met;
4. Minimising the risk of over-auditing; and
5. Facilitating more expeditious review of working papers

STATISTICAL SAMPLING IN AUDIT

Statistical sampling involves the random selection of a number of items for inspection and is endorsed by the accountancy bodies. In statistical sampling, each item has a calculable chance of being selected.

A commonly held misconception about statistical sampling is that it removes the need for the use of the professional judgement. While it is true that statistical sampling uses statistical methods to determine the sample size and to select and evaluate audit samples, it is the responsibility of the auditor to consider and specify in advance factors such as, materiality, the expected error rate or amount, the risk of over-reliance or the risk of incorrect acceptance, audit risk, inherent risk, control risk, standard deviation and population size, before the sample size can be determined.

Statistical sampling allows an auditor's judgement to be concentrated on those areas of the audit where it is most needed. It allows the quantification of key factors and the risk of errors. This is not to suggest that statistical sampling methods remove the need for professional judgement, but rather that they allow elements of the evaluation process to be quantified, measured and controlled.

The advantages of statistical sampling are numerous:

1. The sample result is objective and defensible. Nearly all phases of the statistical process are based on demonstrable statistical principles.
2. The method provides a means of advance estimation of sample size on an objective basis. The sample size is no longer determined by traditional methods of guesswork; it is determined by a statistical method.

3. The method provides an estimate of error. When probability sampling is used, the results may be validated in terms of how far the sample projection might deviate from the value that could be obtained by a 100% check.
4. Statistical samples may be combined and evaluated, even though accomplished by different auditors. That the entire test operation has an objective and scientific basis makes it possible for different auditors to participate independently in the same test and for the results to be combined as though accomplished by one auditor.
5. Objective evaluation of test results is possible. Thus, all auditors performing this audit would be able to reach the same conclusion about the numerical extent of error in the population. While the impact of these errors might be interpreted differently, there can be no question as to the facts obtained, since the method of determining their frequency in the population is objective.

APPROACHES TO STATISTICAL SAMPLING

In statistical sampling, samples during an audit are normally selected through one of the probability sampling methods — random, systematic or stratified. Probability sampling provides an objective method of determining sample size and selecting the items to be examined. Unlike non-statistical sampling, it also provides a means of quantitatively assessing precision (how closely the sample represents the population) and reliability (confidence level, the percentage of times the sample will reflect the population).

Simple Random Sampling

In auditing, this method uses sampling without replacement; that is, once an item has been selected for testing it is removed from the population and is not subject to re-selection. An auditor can implement simple random sampling in one of two ways: computer programs or random number tables.

Systematic (Interval) Sampling

This method provides for the selection of sample items in such a way that there is a uniform interval between each sample item. Under this method of sampling, every "Nth" item is selected with a random start.

Stratified (Cluster) Sampling

This method provides for the selection of sample items by breaking the population down into stratas, or clusters. Each strata is then treated separately. For this plan to be effective, dispersion within clusters should be greater than dispersion among clusters. An example of cluster sampling is the inclusion in the sample of all remittances or cash disbursements for a particular month. If blocks of homogeneous samples are selected, the sample will be biased.

Remember, an essential feature of probability sampling methods is that each element of the population being sampled has an equal chance of being included in the sample and, moreover, that the chance of probability is known. Only in this way, is a probability sample representative of a population

INTER-FIRM COMPARISON

It is technique of evaluating the performance, efficiency, costs and profits of firms in an industry. It consists of voluntary exchange of information/data concerning costs, prices, profits, productivity and overall efficiency among firms engaged in similar type of operations for the purpose of bringing improvement in efficiency and indicating the weaknesses. Such a comparison will be possible where uniform costing is in operation.

An inter-firm comparison indicates the efficiency of production and selling, adequacy of profits, weak spots in the organisation, etc. and thus demands from the firm's management an immediate suitable action. Inter-firm comparison may enable the management to challenge the standards which it has set for itself and to improve

upon them in the light of the current information gathered from more efficient units. Such a comparison may be carried out in electrical industry, printing firms, cotton spinning firms, pharmaceuticals, cycle manufacturing, etc

Advantages of Inter-firm comparison: The main advantages of inter-firm comparison are:–

1. Such a comparison gives an overall view of the industry as a whole to its members– the present position of the industry, progress made during the past and the future of the industry.
2. It helps a concern in knowing its strengths or weaknesses in relation to others so that remedial measures may be taken.
3. It ensures an unbiased specialized reporting on particular problems of the concern.
4. It develops cost consciousness among members of the industry.
5. It helps Government in effecting price regulation.
6. It helps to improve the quality of products manufactured and to reduce the cost of production. It is thus advantageous to the industry as well as to the society.

Limitations of inter-firm comparison

The following are the limitations in the implementation of a scheme of inter-firm comparison :

1. Top management feels that secrecy will be lost.
2. Middle management is usually not convinced with the utility of such a comparison.
3. In the absence of a suitable Cost Accounting System, the figures supplied may not be reliable for the purpose of comparison.

INTRA-FIRM COMPARISON

Intra-firm comparison means comparison among different units/products/strategic business unit (SBU) of a firm. This comparison is possible only when uniform costing methods and practices are being adopted by all units and SBUs.

Intra firm comparison helps the management in identifying the units/Strategic SBUs which have not been performing as per the internal benchmark or standards achieved by other units SBUs. This comparison is difficult sometime when the firm is dealing in different product/sectors and their working conditions are significantly different.

Advantages of Intra-firm comparison: The main advantages of intra-firm comparison are:–

1. Such a comparison gives an overall view of the firm as a whole to the owner or stakeholders and gives a comparative view of different product/different business of the firm.
2. It helps a SBU in knowing its strengths or weaknesses in relation to others SBUs.
3. It develops cost consciousness among units of the firm.

RATIO /TREND ANALYSIS AS A TOOL OF INTER-FIRM AND INTRA- FIRM COMPARISON

Ratio analysis is a process of determining and interpreting relationships between the items of financial statements to provide a meaningful understanding of the performance and financial position of an enterprise. Ratio analysis is an accounting tool to present accounting variables in a simple, concise, intelligible and understandable form.

A firm would like to compare its performance with that of other firms and of industry in general. The comparison is called inter-firm comparison. If the performance of different units belonging to the same firm is to be compared, it is called intra-firm comparison. Such comparison is almost impossible without accounting ratios. Even the progress of a firm from year to year cannot be measured without the help of financial ratios. The accounting language simplified through ratios is the best tool to compare the firms and divisions of the firm.

AUDIT IN DEPTH

Audit in depth as the name implies means checking a transaction extensively from origin to end. It is an audit technique which is used to evaluate the effectiveness of internal control system in an organisation. It is used in investigation exercises whereby the objective is to thorough examination of transactions or records. In this technique all aspects relating to the transaction are checked such as sanctity of transaction, validity of transaction, adherences of prescribed procedures, arithmetical accuracy of transaction, accounting treatment of transaction etc. It is also called vertical vouching as against horizontal vouching.

For example, a purchase of goods may commence when a predetermined re-order level has been reached. The ensuing stages may be summarized as given below:-

1. **Authorization of Purchase requisition**: Check whether the requisitions are pre-printed, pre-numbered and authorized. See whether the purchase requisition have been authorized by competent official.
2. **Issue of Request for quotation**: Check whether request for quotatio0n have been issued or not. If not find the reasons of not issuing request for quotation. Check whether the requests for quotation have been issued to approved vendors.
3. **Issue of Purchase order: C**heck whether purchase order have been issued or not. If purchase order have been issued check whether it has been issued from the competent authority. Check whether the purchase order have been issued to the approved vendor who has given lowest quote. If not check the reasons. Check whether the reasons of issuing the purchase order to a vendor other than the lowest bidder have been approved by the competent authority.
4. **Receipt of goods and entry of goods in store ledger**: check whether the goods receipt is as per specification given in the purchase order. If not check whether the deviations have been recorded and the communication has been made to the supplier or not. Check whether the goods receipt have been properly recorded in store ledger or not.
5. **Approval of payment of Supplier Invoice:** Check whether the amount has been approved by the competent authority.
6. **Payment of supplier invoice:** Check whether the supplier bill have ben paid correctly. Check whether all deduction for short receipt of goods, late delivery of goods, inferior quality of goods, advance payment for the goods have been done or not.
7. **Accounting of Transaction:** Check whether accounting made is correct or not. Check whether correct expenses code have been debited or not. Check whether the applicable accounting standard have been complied with or not.

It should be noted that the above list is not necessarily comprehensive, nor does its constituent stages inevitably take place in the sequence suggested.

LESSON ROUND-UP

1. Internal control is broadly defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding effectiveness and efficiency of operations, reliability of financial reporting, compliance with applicable laws and regulations
2. Internal controls can be detective, corrective, or preventive by nature.
3. Internal control is neither limited to a set of procedures nor to financial controls. Operational control such as quality control, work standards, budgetary control, periodic reporting, policy appraisal, quantitative controls etc are all parts of internal control system.
4. Internal control objectives are desired goals or conditions for a specific event cycle which, if achieved,

minimize the potential that waste, loss, unauthorized use or misappropriation will occur.

5. Internal control system elements include control environment, risk assessment, control activities, information and communication and monitoring.

6. Internal control system provides benefits both to the auditors and auditee. It provides assurance about correctness of recording of data, safety from misappropriation of assets, adherence of rules and procedures.

7. Besides having many benefits, there are some limitation of internal control which fails the very purpose of internal control system. These limitations include Judgement, breakdown, management override, collusion etc.

8. Internal check is best regarded as indicating checks on the day-to-day transactions which operate continuously as a part of the routine systems whereby work of one person is proved independently or is complementary to the work of another, the object being the prevention of or early detection of errors and frauds.

9. Some people confused internal check with internal control system. Internal check system is one part of internal control system. Internal control is broader concept as compare to internal check system; it contains many more types of controls other than the internal check system.

10. There are two types of techniques used in internal control system. They arePreventive internal control techniques and Detective internal control techniques. Both types of internal control techniques are essential to an effective internal control system. Preventive internal control techniques include segregation of duties, approval authorization and verification and securities of assets. Detective control techniques include review of performance, reconciliation, physical inventories and internal audit.

11. Review of internal control system is a very important task for an auditor. It is required to ensure that any inefficiency or ineffectiveness in system is captured. Techniques used in review of internal control system include narrative records, checklist, internal control questionnaire and flow chart.

12. An audit test is a procedure performed by either an external or internal auditor in order to assess the accuracy of various financial statement assertions. Audit tests typically are performed on a sample basis over an existing group of similar transactions. Sampling approaches can either be statistical or non-statistical, with the ultimate goal being to obtain the most representative sample of the population before testing begins.

13. Sampling is a process of selecting a subset of a population of items for the purpose of making inferences to the whole population.

14. Statistical sampling involves the random selection of a number of items for inspection and is endorsed by the accountancy bodies.

15. In statistical sampling, samples during an audit are normally selected through one of the probability sampling methods — random, systematic or stratified. Probability sampling provides an objective method of determining sample size and selecting the items to be examined.

16. Inter-Firm Comparison is a technique of evaluating the performance, efficiency, costs and profits of firms in an industry. It consists of voluntary exchange of information/data concerning costs, prices, profits, productivity and overall efficiency among firms engaged in similar type of operations for the purpose of bringing improvement in efficiency and indicating the weaknesses.

17. Intra-firm comparison means comparison among different units/products/SBUs of a firm. This comparison is possible only when uniform costing methods and practices are being adopted by all units and SBUs.

18. Ratio analysis is a process of determining and interpreting relationships between the items of financial statements to provide a meaningful understanding of the performance and financial position of an enterprise.
19. Audit in depth as the name implies means checking a transaction extensively from origin to end. It is an audit technique which is used to evaluate the effectiveness of internal control system in an organisation. It is used in investigation exercises whereby the objective is to thorough examination of transactions or records.

SELF-TEST QUESTIONS

(These are meant for re-capitulation only. Answers to these questions are not to be submitted for evaluation)

1. Explain the meaning of internal control system and define internal control system.
2. Define internal control system, its objectives scope and advantages.
3. State the advantages of internal control system along with its limitations.
4. Are internal control and internal check system same? Explain
5. What is the meaning of internal check system? Distinguish between internal control system and internal audit system.
6. Explain the different techniques used in review of internal control system.
7. Write a short note on internal control questionnaire as a toll for review of internal control system.
8. State the usefulness of flow chart in review of internal control system of an organisation
9. State the different approaches used in statistical sampling.
10. Write a short note on audit in depth.
11. What is the difference between intra firm comparison and intra firm comparison? Explain the usefulness of ration analysis in inter firm comparison.

Lesson 14

Review of Internal Control

LESSON OUTLINE

- Introduction
- Review of purchase operations
- Objectives of review of internal control over purchases
- Different procedural aspects relating to review of purchase operations
- Review of management information system
- Objectives of review of management information system
- Management information system review procedure
- Review of selling and distribution policies and programs
- Review of manufacturing process
- Review of HR process
- Review of management decision making
- Questionnaire for review of purchase operations
- Questionnaire for review of HR operations
- Questionnaire for review of Management information system.
- Lesson Round Up
- Self Test Question

LEARNING OBJECTIVES

The internal control system provides for safeguarding of assets, proper recording of transactions, and the efficient and effective accomplishment of the entity's goals and objectives including compliance with Government rules and regulations. Review of internal control is very important for an organisation as it gives an insight about the appropriateness and strength of internal controls in an organisation. Review of internal control system makes management aware whether any system in place is able to meet organization requirement or there is a need of its overhauling/improvement. The objective of this lesson is to make the student aware about the importance of internal control review and to enable them to review the internal control of different function in an organisation.

After reading this lesson, the student will be able to understand how to carry out internal control review of –

- Purchase operations
- Management information system
- Sales and distribution program and policies
- Manufacturing operations
- HR policies and programs
- Management decision making.

"Review of Internal Control plays a very important role in ensuring that the system remain progressive, effective & efficient."

INTRODUCTION

The Assessment of internal control has gained much priority now days for its numerous advantages both to the auditor and auditee. After review of internal control system in an organisation, the auditor ascertains the depth of audit required while the auditee gets aware about the weakness in present system. This provides an opportunity to the auditee to improve upon the existing system and implement better system for ensuring accuracy in recording and reporting, safeguarding of assets, compliance of laws etc.

Here in this section we will cover review of purchase operation, management information system, selling and distribution policies and programs, manufacturing operations, HR system and management decisions.

REVIEW OF PURCHASING OPERATIONS

Purchase is one of the most important functions in a manufacturing organisation. In most of the manufacturing and trading organisation, purchases constitutes about 50-70% of the cost. So it becomes very important to have an efficient internal control over the purchasing activities of an organisation.

OBJECTIVES OF REVIEW OF INTERNAL CONTROL OVER PURCHASING OPERATIONS

The objectives of review of internal control system includes to ascertain

1. Whether controls are in place in the process to ensure that accountability is established as early as possible at all points along with the accountability chain.
2. Whether segregation of duties, risk mitigating controls, exists within transaction processing authorization. Whether separation of duties exists between various types of transaction processing (e.g., procurement, accounts payable, disbursements).
3. Whether the quantity and quality of goods and services received is documented and agrees with the requisition and performance expectations such as service level agreements, contract terms, and vendor performance.
4. Whether transactions are properly verified before disbursement, transactions and activities are properly authorized, transactions and events are properly recorded.
5. Whether accountability for refunds and credits are maintained. Whether staff understands their duties, responsibilities, and accountabilities.
6. Whether procurement practices and procedures are documented, and in compliance with central and state laws and other requirements such as contract terms and conditions. Procurement records for authorizations and transactions are maintained in accordance with established requirements.
7. Whether accounting records are protected from theft, obsolescence, or destruction. Whether assets are safeguarded from loss through watchful and responsible care and reconciliation functions

DIFFERENT PROCEDURAL ASPECTS RELATING TO REVIEW OF PURCHASE OPERATIONS

Segregation of duties in purchase operations

To ensure proper separation of duties, assign related buying functions to different people. Ensure proper segregation, no single person has complete control over all buying activities.

It is always preferable to have different people who –

I. Approve purchases

II. Receive ordered materials

III. Approve invoices for payment

IV. Review and reconcile financial records

V. Perform inventory counts

If segregation of duties does not exist in purchases operations, this may result into unauthorized or unnecessary purchases, improper charges to department budgets, purchase of goods at excessive costs, use of goods for personal purposes

Accountability, authorization, and approval mechanism

In an efficient purchase system, the mechanism of authorization, review, and approval should exist. All purchases should be made on the basis of signed agreements, contract terms, and purchase orders.

It will always be advisable to –

(i) Comply with ethical buying practices and policy.

(ii) Review and update signature authorizations periodically.

(iii) Obtain pre-approval of consultant agreements by Purchasing.

(iv) Verify receipt of goods and services against contract/ purchase order and invoice information.

(v) Reconcile ledgers for accuracy of recorded transactions.

(vi) Monitor to ensure that invoices are paid in a timely manner.

In case the mechanism of ascertaining accountability does not exist. it may result into unauthorized or unnecessary purchases, purchases at higher rate, misappropriation of funds.

Physical control over of assets

Once the purchases are done, it is necessary to secure the materials in a safe location. To ensure that the resources are accounted for, it is necessary to periodically verify the inventory and compare the results with the books.

To ensure security of assets, it is advisable to –

(i) Secure goods received in a restricted area.

(ii) Restrict inventory access to appropriate staff.

(iii) Lock goods and materials, and provide key or combination to as few people as possible.

(iv) Keep inventory records and periodically calculate beginning and ending inventory amounts.

If physical control over assets does not exists, it may result into theft of goods, inventory shortages, additional costs incurred for replacement of goods

Review and reconciliation

Review and reconciliation is a very important part of purchase internal control system. Timely review of supplier's invoice, packing slips, and purchase orders is very necessary to ensure accuracy of the information for prior payment, correct quantity ordered, and price charged. Monthly ledger reconciliation enables to find improper charges and validate appropriate financial transactions.

It is advisable to –

(i) Review supplier invoices for accuracy by comparing charges to purchase orders.

(ii) Verify that the goods and services purchased have been received.

(iii) Perform monthly reconciliations of operating ledgers to ensure accuracy and timeliness of expenses.

In case review and reconciliation process is missing, it may result into improper charges to the department budgets, Disallowances resulting from costs charged to incorrect accounts/funds, payments made for items or services not provided

REVIEW OF MANAGEMENT INFORMATION SYSTEM

A management information system (MIS) provides information that organizations need to manage themselves efficiently and effectively. MIS is an information system which provides information to the management so that management may take timely decisions. MIS is basically concerned with processing data into information which is then communicated to the various Departments in an organisation for appropriate decision-making. MIS provides several benefits to the business organisation: the means of effective and efficient coordination between Departments; quick and reliable referencing; access to relevant data and documents; improvement in organisational and departmental techniques. Management information system helps companies keep track of its resources and stay organised. MIS allows managers to make different types of reports about the company activities.

The clear starting point in reviewing the Management Information System (MIS) is to understand what it collects, how it works, and how teams can call (or contribute) information using it. There are some basic questions to consider:

– What are the components of the information system?

– Who uses each component?

– What information is available?

– What information is not available?

– How reliable is the information?

– How readily, and how quickly, is it available?

– How hard is it to modify data?

Management Information Systems Review Objectives

1. To determine whether review procedures are necessary to achieve stated objectives.
2. To determine whether MIS policies or practices, processes, objectives, and internal controls are adequate.
3. To evaluate whether MIS applications provide users with timely, accurate, consistent, complete, and relevant information.
4. To assess the types and level of risk associated with MIS and the quality of controls over those risks.
5. To determine whether MIS applications and enhancements to existing systems adequately support corporate goals.
6. To determine whether MIS is being developed in compliance with an approved corporate MIS policy or practice statement.
7. To determine whether management is committed to providing the resources needed to develop the required MIS.
8. To determine if officers are operating according to established guidelines.
9. To evaluate the scope and adequacy of audit activities.
10. To initiate corrective action when policies or practices, processes, objectives, or internal controls are deficient.
11. To determine if any additional work is needed to fulfill the examination strategy of the institution.

MANAGEMENT INFORMATION SYSTEMS REVIEW PROCEDURES

Review of management information system requires a systematic approach. Following steps are require to be taken for review of MIS system of an organisation

1. Obtain following documents
   a. MIS-related audit/compliance reviews?
   b. Institution's formal MIS policies and practices framework/guidelines
   c. Board/MIS Committee-related minutes
   d. Organization charts detailing MIS responsibility.
2. Study previous MIS review's findings and management's response to those findings. Study the deficiencies or strengths pointed out in the reports. On the basis of deficiencies reported, set priorities for review. Study the recommendations provided for resolving MIS deficiencies and management's responses. Check whether corrective actions have been initiated and/or completed and see follow-up audit activities.
3. Determine any material changes in regard to the five MIS elements i.e. Timeliness, Accuracy, Consistency, Completeness, and Relevance. Review MIS-related policies, practices and processes. See if any changes have been made since the previous review.
4. Review the Internal Control Questionnaire (ICQ) and determine the scope and objectives of the MIS review.
5. Identify each of the functional or product related areas to be reviewed. Provide copies of the MIS review objectives, review procedures and highlight the areas of MIS review that need to be addressed during the review. Aggregate these observations, conclusions, and recommendations for each of the functional areas addressed and incorporate them (as appropriate) into the final MIS review conclusions.
6. For the selected sample of MIS system(s) and as appropriate to support the defined scope, obtain user manual, user training manual/instructions, project plan and related work papers, Sample of MIS output Reports, MIS project development/enhancement work papers.
7. Test for compliance with established policies or practices and processes, and the existence of appropriate internal control measures. Refer to the Internal Control Questionnaire as needed.
8. Identify any area with inadequate supervision and/or undue risk. As required, perform appropriate verification procedures.
9. Select and review samples of ongoing executive reports for the targeted MIS area(s). Determine whether
   a. The source of the information collected originates from the expected business area.
   b. Users of the information are the appropriate employees or managers within that area of activity.
   c. The reports are ultimately distributed to the appropriate users.
   d. The flow of these MIS information/reports is consistent with the responsibilities reflected on the area's official organization chart.
10. Determine the degree to which management and the staff in an area under review use MIS adequately and can support that the MIS being used is appropriate and effective. Discuss the five MIS elements with a senior manager(s) of the respective business unit. Repeat this work step with an employee of the business unit who has experience with the MIS system. Based on management's self-assessment of the usability of its MIS, identify any planned activities to enhance, modify, or expand these systems.
11. Review minutes of the board of directors or committee(s) representing the MIS target area(s) for a

relevant time period. Determine any areas where MIS does not seem to meet the five required elements of MIS. Identify MIS issues for follow up.

12. Request a copy of the development plan for significant MIS-related projects. Review MIS project objectives and determine if they address reported MIS weaknesses and meet business unit plans. Review the project management technique used by management and determine the status of important MIS projects. Sample a significant MIS project(s) and determine whether it follows an approved and implemented development methodology.

13. Select a system and request copies of relevant user instructions. Determine whether the guidelines are meaningful, easy to understand, and current.

14. Determine whether user manuals provide adequate guidelines about complete description of the system, Input instructions, including collection points and times to send updated information, Balancing/ reconciliation instructions, full listing of output reports, including sample formats.

15. To review how information is identified, gathered, merged, manipulated, and presented, obtain a work flow showing data from the point-of-entry, through user processes, to final product. Discuss the area's MIS process with a representative sample of users and determine if they know where the data is coming from, where it is going, and how it gets there. Identify and note the points where adjustments to data occur. Identify the department staffs who are responsible for the MIS related input data and reports. Determine if preparation and reconciliation processes are sufficient to reasonably ensure integrity of information. Check whether data adjustments are adequately documented.

16. Review the effectiveness of MIS in communication linking executives, appropriate users, and information systems employees. Review the effectiveness of the flow of communication throughout the organization and the documentation of which underlying MIS process supports the area's management.

17. Determine the adequacy of MIS training including whether training needs are properly identified and prioritized. Check whether training is organized in a formal classroom setting, or on-the-job, or is a combination of both approaches. Check whether training material is provided or not. Check whether any training manual exist or not. Check whether training material adequately covers relevant and current issues.

18. Determine whether established procedures are sufficient to ensure the proper testing of system developments or enhancements. Determine if authorized processes are followed as data is acquired, merged, manipulated, and up-loaded from subsystems.

19. Check if the organization has had recent merger and/or acquisition activity, determine how management at the senior and departmental levels ensure that the resulting MIS supports and includes the five MIS elements. If mergers and acquisitions are frequent, determine whether appropriate policies or practices and procedures have been developed to support such activity from an integrated MIS perspective and the consolidation of MIS systems in a merger still meets the requirements of a quality MIS system.

20. Review the results of your work, summarize your findings and initial conclusions, and discuss issues with an appropriate officer(s):

    a. How well risks are controlled.

    b. Identify significant control deficiencies.

    c. Recommend action to remove deficiencies.

    d. Obtain management's corrective commitments and firm time frames.

21. Prepare a memorandum of your conclusions and supporting findings. Identify suggested follow-up actions, prepare a memorandum and document work programs to facilitate future examinations.

REVIEW OF SELLING AND DISTRIBUTION POLICIES AND PROGRAMS

Selling and distribution function are one of the most important function for an organisation. The survival of an organisation largely depends on the effectiveness of selling and distribution function. Management of distribution channels involves efficient channel design, conflict management and implementation of sophisticated channel information systems which will enhance the process of making the products available to the end consumer in a timely manner.

Review of sales and distribution function is very important from internal control point of view and it requires a detailed understanding of company business.

Objectives of review of sales and distribution policies and programs

1. To determine whether sales and distribution policies and programs are adequately documented
2. To determine whether sales and distribution policies and programs are approved by the appropriate authority.
3. To determine that sales and distribution policies are matching with the overall corporate objective.
4. To determine whether maker checker and approver concept exist in the framing, approval and implementation of policies.
5. To check whether the distribution program is able enough to serve customers of all regions.
6. Whether controls are in place in the process to ensure accountability is established as early as possible at all points along the accountability chain.
7. Whether segregation of duties, or mitigating controls, exists within transaction processing authorization, custody, and recording functions. Separation of duties exists between the various types of transaction processing (e.g., Discount approval, selection of mode of transportation. Accounts receivable etc).

Review Procedure

A: SALES (Final product, Rejected Products, Scrap, Stores sales)

1. Check whether all the Sales of sold stock according to schedules. If not, prepare the list of the delay dispatches along with reason of the delay in dispatches.
2. Quantify the losses, for the material which are not dispatched with in time i.e. the company has paid the Airfreight/sea freight.
3. Check whether all the bills are made according to the purchase contracts with the customer. If not list out the discrepancy. Check the billing system and see whether the billing has been done through the authorized channel. Check for any informal billing system. If such system exists, analyze with management and report. List out the cases of delays in dispatches for sold & unsold stock after production. Also find out the average no of days taken to clear the stock after production. Review the system of stock records maintenance.
4. Check whether there is variance in actual and target sales prices. If so ascertain the reasons after discussions with marketing executives. Check whether the discount given is approved by the appropriate authority.

B: Review of system of awarding the transport contracts

1. Check the system of sending enquiry and receiving quotations.
2. Check the control over sending enquiry and receiving, how followed up, record keeping, etc.

3. Check whether basis of taking decision is documented properly or not.
4. Check whether date of approval, name of approving authority is mentioned on the approval document or not.
5. Check whether the contract is entered into with thee selected transporter. Check the terms and conditions of transporter agreement and report lapses if any.

C: Review of process of taking insurance during transit

1. Check whether the process of taking insurance for transit vehicle exists or not.
2. Check the coverage of insurance policy i.e. it covers full inventory value or just material price.
3. Check who takes the insurance transporter or the client
4. Check whether proper insurance value is declared for insurance coverage.
5. Check whether the insurance policy is made available to all concerned.
6. Check whether any cost benefit analysis has been done for the insurance premium paid and claim launched.

D: Review of Sales Return

1. Is the mechanism of schedule of schedule of authority exist for the sales return i.e. system relating to sale returns prescribe limits on the authority of managers at various levels to accept return of goods?
2. Are sale return analyzed with reference to the reason & necessary actions taken *viz- a- viz* reasons identified
3. Are the returned goods inspected before acceptance? Are returned goods duly accounted in inventory records?
4. Is an inward return note prepared promptly against each sale return, indicating the quantity and specifications of the goods received back?
5. Whether credit note are issued on the basis of inward returned note. Whether a proper control over the issue of credit notes especially with regard to the authority for issuing the same. Whether credit notes are properly checked with reference to the relevant inward return note before it is approved and sent to the customer? Are appropriate entries made in the books of account promptly? Check whether the excise paid is reversed for the returned goods or not
6. Is the sale commission paid in respect of goods returned recovered through an appropriate debit note?

E: Review of Claims by customer

1. Are all claims (for poor quality or for delay in delivery and similar other reason) approved by an authorized manager? Is the approval granted only after a proper examination of the matter?
2. Is a credit note sent to the customer in respect of each approved claim? Are appropriate entries made in the books of account promptly?

F: Review of Debit/Credit notes

1. Check whether the corresponding impact of credit note/debit note on Sales Tax, Excise etc. have been considered or not
2. Check whether credit note/debit note are issued in accordance with the Sales Policy and term of the Sales Order.
3. Check whether credit note/debit note properly authorized.

G: Review of Sales Commission

1. Check all the sales commission are given as per contracts made with the party
2. Make the reconciliation of sales with sales commission.

H: Review of Export Sales

1. Reasons wise analysis of the overdue bills.
2. Loss of overdue interest due to delay in realization of the export bills.
3. Norms of Export trade, imports, process of order booking to production planning, realization, settlement benefits, claims, etc.

I: Review of Marketing – International & Domestic:

1. Are standard price lists maintained? Is a special sanction from a senior manager required in the case of sales at prices lower than the standard price?
2. Does the system of allowing rebates and discount provide for adequate controls? In particular is there a clear cut policy for allowing such rebates and discounts? Are the authorities for various managers in this regard clearly laid down and are they reasonable?
3. Are special sanctions required in case of sales to those companies/ other enterprises in which the managerial personnel or senior employees are interested?
4. Is there a well defined policy for making sales to employees at concessional prices? Does it laid down any limits in this regard?
5. Is there a timely preparation of a written sale order on receipt of an order from a customer?
6. Are sale orders pre numbered? Is a lack of continuity in sale order number duly enquired into?
7. Is there a proper authorization of credit, price, quantity and other important terms of the sale order?
8. Is there a system of fixing credit limit for regular customer? Are these limits approved by a senior manager as per the sales policy determined by the top management? Are these limits reviewed periodically in the light of the experienced in dealing with the customer?
9. Is credit limit of the customer concerned checked before sanctioning the credit on the sale order? Is up to date information on the extent of the credit already extended to the customer readily available for this purpose?
10. Is a copy of each sale order sent to the dispatch department and the accounts department?
11. Is a dispatch document, e.g. a good outward challan, prepared at the time the goods are dispatch to the customer? Is it matched with the bill of lading or railway receipt/transporter receipt?
12. Are dispatch documents pre numbered and missing document numbered duly enquired into?
13. Is there a system of checking each consignment of good leaving the premises with the related dispatch document?
14. Is a copy of dispatch document, i.e. goods outward challan/gate pass sent to the customer and to the accounts department?
15. Is an acknowledgement of receipt of goods obtained from the customer or from his agent on the copy of the dispatch document?

REVIEW OF MANUFACTURING OPERATIONS

In general parlance, Manufacturing means converting an input (Raw material) into output (finished product) with the use of man, machines, material, power etc. Such finished goods may be used for manufacturing other, more complex products, such as aircraft, household appliances or automobiles, or sold to wholesalers, who in turn sell them to retailers, who then sell them to end users – the “consumers”.

Manufacturing operations is a prime source of money outflow i.e. a large amount of money is spent on manufacturing process e.g. in buying machinery, raw material, consumables, paying salary to workers etc. It is very important to review the manufacturing operations in timely manner so that the identified in-efficiency may be eliminated controlled on immediate basis.

Objectives of Review of Manufacturing Operations

1. Whether the organization have any manufacturing process management system.
2. Whether the policies and procedures for production planning well defined & well documented.
3. Whether the organisation have a quality management system in place. If so, whether the organisation have a written quality policy and whether it is adhered or not.
4. Whether the organization is following six sigma. Whether the organisation have a written maintenance policy.
5. Whether the organization have a written scrap policy.
6. Whether security policies are documented or not.

Review of Production/Modification Planning

1. Whether a standard documentation is used to communicate sales orders and production/modification requirements to production personnel.
2. Whether production/modification schedules are compared to sales orders to ensure that production timing and quantities are appropriate.
3. Whether Production/modification schedules is reviewed and approved by an appropriate officer.
4. Whether standard documentation is used to communicate material requirement plans (including quantities and dates) to the purchasing department.
5. Whether Material requirement plans (MRPs) is compared to production/modification schedules weekly to ensure that quantities and timing (including the effect of lead times) are appropriate.
6. Whether instances of insufficient or excessive raw material inventory are monitored weekly/monthly.
7. Whether MRP is based on accurate and up-to-date bill of materials (BOM). Whether production/ Modification Process Employees are trained in the use of the equipment.
8. Whether employees are trained to perform a number of tasks to provide cover for other skilled employees.
9. Whether continuous improvement initiatives such as Kaizen, Poke-yoke are pursued.
10. Whether management reviews and follow-up following on daily/weekly basis
    - Order book status and order intake trends
    - Production volumes and variances by product and location
    - Machine utilisation rates

- Production efficiency data (e.g. usage, scrap, rework etc.)
- Scheduled and unscheduled downtime
- Inspection and testing results
- Product quality data (defects, failures, customer complaints, warranty costs etc.)
- Output per employee and per productive hour

11. Whether production performance measures are benchmarked internally and against other organizations, including:
    - Machine utilisation rates
    - Materials usage costs as a percentage of total production costs
    - Scrap and rework levels
    - Scheduled and unscheduled downtime as a percentage of total production time
    - Inspection and testing costs as a percentage of total production costs defect and failure rates
    - Warranty and product liability costs as a percentage of total production costs
    - Customer complaint and return rates
    - Material stock levels divided by average daily usage employee productivity levels
12. The costing of the modification job should be approved by an appropriate officer.

Review of Quality Management system

1. Whether formal documented instructions / procedures are available on:
    I. Quality tests to be performed at each stage of the production process
    II. Steps to be taken in the case of negative results
    III. Documentation required to evidence completion and results of quality checks
2. Whether sufficient quantities of each production run are tested to enable compliance with quality control standards
3. Whether Quality assurance procedures are integrated into the production process.
4. Whether defect rates, customer returns and complaints due to poor quality are monitored.
5. Whether measuring equipment and devices are calibrated on a periodic basis i.e. quarterly, half yearly.

Review of Maintenance Management System

1. Whether responsibility for all aspects of equipment maintenance and management are clearly defined.
2. Whether a planned program for scheduled preventative maintenance is prepared or not.
3. whether production equipment are maintained in accordance with-
    a. Manufacturers specifications
    b. Contractual agreements
    c. Legal requirements or not

Review of working environment, safety and security

1. Whether separate areas are identified for inventory storage and handling, high value part storage, shipping and receiving, vaults, toxic materials
2. Whether entry and exit points for sensitive areas have appropriate security controls such as security personnel, gate passes, restricted access mechanisms, card keys, cameras and lighting, perimeter fencing
3. Whether smoke detection and fire-fighting equipment are functional and provide adequate protection.
4. Whether the workers use self protective devices at the work place.
5. Whether equipment and evacuation procedures are tested on a regular basis and documented.
6. Whether security incidents i.e. accidents/theft etc are formally reported and tracked.

REVIEW OF PERSONNEL POLICIES

In review of personal polices, several functions of Human resources department are reviewed. This review is more than just looking at personnel files to make sure they're complete and consistent with applicable laws and legislation pertaining to employment practices. In personal policies review it is ascertained whether human resources function is supporting the company philosophy, mission and values.

A. Review of Employee Relations

The employee relations area of human resources is typically responsible for addressing employee concerns, designing and analyzing employee opinion surveys, assisting HR leadership with monitoring the performance management system, and representing the company in matters involving claims pertaining to unemployment compensation and unfair employment practices. An review of these functions includes reviewing the level of employee satisfaction. Employee satisfaction can be measured by turnover rate; number of employee complaints filed and resolved, the status of action plans from recent employee opinion surveys, and the effectiveness of performance management system.

B. Review of Safety and Risk Management

The goal of HR department's safety and risk management program is to create and maintain a safe work environment. Auditing safety and risk management function goes beyond merely assessing adherence to company occupational health safety policy, however it includes assessing employee participation in maintaining a safe work environment, measuring the effectiveness of safety training to reduce the number of workplace injuries, and providing training related to workplace violence, actions of disgruntled employees and civil unrest.

C. Review of Compensation and Benefits

Reviewing compensation and benefits begins with an analysis of compensation practices — review the employee survey to get sure that organisation's pay practices are appropriate for each job group, as competitive as possible for geographic area and the industry, and, importantly, the pay practices must be fair. Reviewing compensation plans takes time to complete; based on the size of the workforce. This part of your person policy review may be more effectively outsourced than conducting the analyses in-house.

D. Recruitment and Selection

Organization's recruitment and selection process shapes part of company's reputation. Reviewing human resources employment function involves a review of the way applicants are received. An review should reveal how knowledgeable the engaged employment specialists are concerning organizational structure, positions within each department, and fair employment practices in recruiting and hiring candidates.

E. HR Departmental Practices

In addition to auditing specific areas of human resources department, review of HR function in its totality and in relationship to other departments is also required. An ineffective HR programs can undermine an organization's ability to achieve its mission by stunting its competitiveness in the labor market, increasing unjustified financial costs, and putting the organization at risk for lawsuits or regulatory inquiries due to non-compliance or misconduct.

APPRAISAL OF MANAGEMENT DECISIONS

Management decision making

Decision-making is an essential aspect of modern management. It is a primary function of management. A manager takes hundreds of decisions consciously and subconsciously. A decision may be defined as "a course of action which is consciously chosen from among a set of alternatives to achieve a desired result." It represents a well-balanced judgment and a commitment to action. Decision-making pervades all managerial actions and a continuous process. Decision-making is an indispensable component of the management process itself.

Management decision-making process steps:

1. Define the problem.
2. Identify limiting factors.
3. Develop potential alternatives.
4. Analyze the alternatives.
5. Select the best alternative.
6. Implement the decision.
7. Establish a control and evaluation system.

Objectives of appraisal of management decisions

The main objective of appraisal of management decision is to see how decisions are taken, whether decisions taken are meeting the organisation objectives. Whether documentation is made to substantiate the decision making process.

Management decision making appraisal process

1. In appraisal of management decision, one of the most important things is to see whether the objectives are well defined**.** Objectives and outputs should be set out clearly and relate explicitly to policy or strategy. They should be defined so that it can be established by evaluation after the event whether and to what extent objectives have been met. It is important that objectives are not described in such a way as to exclude options. Ideally objectives should be SMART i.e. specific, measurable, agreed, realistic and time-dependent
2. Check while taking the decision how many options have been considered. These must include a "do nothing" or "do minimum" option which provide a benchmark against which other options can be judged. Factors below could influence the choice of alternatives:
   - Risk;
   - Timing;
   - Scale and location;
   - Scope for shared service arrangements with other public bodies;

- Degree of private sector involvement;
- Capacity of the market to deliver the required output;
- Alternative asset uses;
- Use of new or established technology; and
- Environmental equality.

3. For Major Investment Projects as wide a range of options as possible should be considered before preparing a short list for full appraisal. Time pressures frequently cause a manager to move forward after considering only the first or most obvious answers. However, successful problem solving requires thorough examination of the challenge, and a quick answer may not result in a permanent solution. Thus, a manager should think through and investigate several alternative solutions to a single problem before making a quick decision. Techniques like brainstorming, Delphi technique, nominal group technique may be used to develop alternative solution. Where some options are dismissed before a full appraisal the reasons should be explained.

4. **Whether potential options are analyzed reviewed in terms of value costs, benefits, risk and uncertainties of options**

While evaluating various options, it is necessary to decide the relative merits of each idea. Managers must identify the advantages and disadvantages of each alternative solution before making a final decision.

Evaluating the alternatives can be done in numerous ways.

- Determine the pros and cons of each alternative.
- Perform a cost-benefit analysis for each alternative.
- Weight each factor important in the decision, ranking each alternative relative to its ability to meet each factor, and then multiply by a probability factor to provide a final value for each alternative.

Regardless of the method used, a manager needs to evaluate each alternative in terms of its

- **Feasibility** — can it be done?
- **Effectiveness** — How well does it resolve the problem situation?
- **Consequences** — what will be its costs (financial and nonfinancial) to the organization?

5. **Whether the options are selected after due analysis and a consensus decision is taken**

After a manager has analyzed all the alternatives, it is necessary that the best one should be selected. While reviewing the management decision making, it is necessary to see which option have been selected. If an option other than the best option have been selected, it is necessary that justification need to be given. While reviewing whether the selected decision is best of not, justification given may be evaluated. The basic elements of internal control should prevail in decision making process

Sometimes, though, the best alternative may not be obvious. That's when a manager must decide which alternative is the most feasible and effective, coupled with which carries the lowest costs to the organization. Probability estimates, where analysis of each alternative's chances of success takes place, often come into play at this point in the decision-making process. In those cases, a manager simply selects the alternative with the highest probability of success. All such cases should be reviewed with utmost care

6. **Whether the selected alternative implemented efficiently**

   Managers are paid to make decisions, but they are also paid to get results from these decisions. Positive results must follow decisions. Everyone involved with the decision must know his or her role in ensuring a successful outcome. To make certain that employees understand their roles, managers must thoughtfully devise programs, procedures, rules, or policies to help them in the problem-solving process. While reviewing the implementation phase, it should be seen whether the proper policies and program have been designed to implement the selected proposition. Whether the selected alternative has been implemented as decided.

7. **Review of management decision control and evaluation system**

   Ongoing actions need to be monitored. An evaluation system should provide feedback on how well the decision is being implemented, what the results are, and what adjustments are necessary to get the results that were intended when the solution was chosen.

In order for a manager to evaluate his decision, he needs to gather information to determine its effectiveness. Was the original problem resolved? If not, is he closer to the desired situation than he was at the beginning of the decision-making process?

If a manager's plan hasn't resolved the problem, he needs to figure out what went wrong. A manager may accomplish this by asking the following questions:

- **Was the wrong alternative selected?** If so, one of the other alternatives generated in the decision-making process may be a wiser choice.
- **Was the correct alternative selected, but implemented improperly?** If so, a manager should focus attention solely on the implementation step to ensure that the chosen alternative is implemented successfully.

Annexure

INTERNAL CONTROL QUESTIONNAIRE FOR REVIEW OF PURCHASE OPERATIONS

Question	*Yes*	*No*	*N/A*	*Comments*
SEGREGATION OF DUTIES				
1. Are the individuals responsible for the requisitioning/receiving and purchasing functions different from the individuals responsible for the invoice processing/accounts payable, and budget monitoring/review?				
2. Are the individuals responsible for the purchasing function different from the individuals responsible for the requisitioning/receiving functions?				
3. Are the individuals responsible for the invoice processing/accounts payable functions different from the individuals responsible for the budget monitoring/review functions?				
4. Are the individuals responsible for the payment document creation and payment approval functions different from the individuals responsible for budget monitoring/review?				
5. Have individuals received training on the policy and procedures for the business functions they perform?				
6. Have individuals received ERP system training (If ERP Exists) for the transactions they have been given security to perform?				
REQUISITIONING PROCEDURES AND CONTROLS				
1. Is the initiation of purchases of goods and services done by properly authorized requisitions bearing the approval of officials designated to authorize requisitions?				
2. Does the person requesting the purchase indicate the budget to be charged on the purchase requisition?				
3. Are there procedures that monitor budgets to ensure that expenditures are in align year to date and do not exceed the budget for the fiscal year?				
4. Do technical specifications accompany requests for special purpose (non-stock items) materials or personal services?				
PURCHASING PROCEDURES AND CONTROLS:				
5. Are employees encouraged and supported to attend Procurement training courses.				
6. Is a procedure in place to determine availability of item/service from another branch/ associated entity?				
7. Are procedures in place to determine if item/service is currently available on agency contract within your department?				
8. For purchases under a definite amount i.e. Rs. 25000/- are appropriate management authorizations in place?				
9. For purchases are agency competitive bidding procedures in place (obtain minimum three quotes)?				

10. When determining the budget for a purchase, are freight and/or delivery charges included in the total estimated purchase price?				
11. Does your agency promote the use of the P-card?				
12. Is the P-card monthly statement reconciled to approved supporting documentation and the entry to allocate the expenditures posted by the end of the following month?				
13. For purchases made within specific delegated authority, are procedures in place to obtain competition, select the appropriate supplier, and document the process?				
14. Are there procedures to prevent and detect splitting orders to avoid higher levels of approval?				
15. Does the agency maintain a record of suppliers who have not met quality or other performance standards				
16. Are open purchase orders reviewed on at least a quarterly basis to determine if correct and valid?				
17. Are changes to contracts or purchase orders subjected to the same controls and approvals as the original agreement?				
18. Are available offered discounts for purchases entered on the purchase order transaction?				
19. Are periodic checks made for compliance with your purchasing policy?				
RECEIVING PROCEDURES AND CONTROLS:				
20. Is the receipt of all goods documented with at least a signature and date?				
21. Are claims filed against carriers or vendors for all shortages or damaged materials?				
22. Are goods received accurately counted and examined to verify they meet quality standards?				
23. Are copies of receiving reports sent directly to accounting, purchasing, and (if applicable) inventory record keeping?				
INVOICE PROCESSING PROCEDURES AND CONTROLS				
24. Are payments made only on the basis of original invoices?				
25. Are copies of receiving reports and applicable purchase orders obtained directly from issuing departments?				
26. Are invoice quantities, prices, and terms compared with those on the purchase order?				
27. Are invoice quantities compared with those on the receiving report?				
28. Are differences in invoice and purchase order price, terms, shipping arrangements, or quantities referred to the purchasing department or appropriate manager for review and approval?				

29. Is the accuracy of all calculations checked?				
30. Are available offered discounts entered on the payment transaction (if they were not entered on a preceding purchasing transaction)?				
31. Are available offered discounts for purchases deducted when paying by P Card?				
32. Calculation of Sales tax, excise duty and other levies is checked before payment?				
33. Is a review of the distribution of charges in the accounting department done by an individual with the knowledge and experience to determine the correctness of the distribution?				
34. Are the program and expenditure accounts to be charged reviewed for propriety and budget conformity?				
35. Does a senior employee reviewing and approving invoices for payment physically check each for completeness of supporting documents and required clerical checking?				
36. Is the payment document number written on the invoice or kept as part of the batch documentation?				
37. Are the paid invoices and documentation filed with the transaction they were paid on?				
38. Are both the accounting and purchasing departments promptly notified of returned purchases?				
39. When a vendor credit advice or refund check is received, is it matched with the notification of returned purchases for quantities, prices, and restocking fees?				
40. (a) If returned purchases are refunded with a check before any other accounting transactions are recorded, or				
(b.) If a check is received for a duplicate payment, is a CR done for the amount received				
(Entering the Vendor Number, using the original coding block, and noting the original transaction number in the reference field)?				
DISBURSEMENTS PROCEDURES AND CONTROLS:				
41. Is the payment transaction approved timely to insure that the available discounts are taken?				
ACCOUNTS PAYABLE CONTROLS:				
42. Payments are not made from vendor statements?				
43. Are outstanding balances on vendor statements investigated to determine if not yet paid and the reason why?				

Annexure 2

HR REVIEW QUESTIONNAIRE

Question	*Yes*	*No*	*N/A*	*Comments*
Management				
1. Are HR goals in line with those of the organization?				
2. Are workweeks identified and defined?				
3. Are full-time and part-time hours defined?				
4. Are shifts defined?				
5. Is there open communication to and from the HR department?				
Hiring				
1. Do job descriptions exist?				
2. Are job descriptions up to date?				
3. Are forms and acceptable documentation reviewed annually?				
4. Are job openings offered to current employees?				
5. Are applicant references checked?				
6. Are turnover rates monitored?				
7. Are selection processes used with reference to the Uniform Guidelines?				
8. Are all applicants required to fill out and sign an application form?				
9. Are applicants asked to voluntarily identify their affirmative action information?				
10. If applicable, do application forms identify that the employment relationship at the organization "at-will"?				
11. Do employment applications refrain from requesting protected information?				
12. Are independent contractors accurately identified?				
13. If the organization has a qualifying federal contract, is there an affirmative action plan?				
14. Is medical information kept separately from personnel files?				
New employees				
1. Are workplace policies in place?				
2. Do policies focus on your workplace?				
3. Are policies communicated?				
4. Are policies enforced?				

5. Is there an employee handbook?				
6. Is the employee handbook specific to your workplace?				
7. Do employee orientations take place?				
8. Are employees trained on policies and work rules?				
9. Are employees trained on discrimination issues?				
Wages and hours				
1. Are compensation levels monitored and reviewed?				
2. Is there a formal pay structure?				
3. Is the compensation structured reviewed regularly?				
4. Is working time documented?				
5. Are paid time off (vacation, holidays, etc) structures developed?				
6. Are non-exempt employees compensated at least one and one-half times their hourly wage for any hours worked beyond 40?				
7. Is the compensation plan communicated to all employees?				
8. Are appropriate payroll withholdings performed?				
Benefits				
1. Are employees informed about their benefits?				
2. Are Summary Plan Descriptions provided to plan participants?				
3. Are supervisors and managers trained to report employee absences of more than three days to HR?				
4. If there is a health care plan, is protected health information kept private?				
Employee relations				
1. Is there a system for performance evaluation?				
2. Does the system check for effectiveness of the evaluation?				
3. Is quality and quantity of work evaluated?				
4. Is performance tied to compensation?				
5. Are workplace policies flexible?				
6. Are disciplinary actions for violating workplace policies flexible?				
7. Is there a process for employees to lodge complaints?				
8. Are there a variety of individuals to whom employees may lodge complaints (supervisor, HR representative)?				
Safety and security				
1. Are safety hazards reported to the appropriate personnel?				
2. Are workplace accidents, near-misses, injuries, and illnesses reported and investigated?				
3. Are measures in place to prevent intruders from entering the grounds or buildings?				

4. Is bright, effective lighting installed indoors and outdoors?				
5. Are measures in place (access badges, traffic control, etc.) to keep unauthorized persons from entering the facility through normal entrances?				
6. Is there a reliable response system in place in the event an alarm is triggered?				
7. Are employees encouraged to promptly report incidents, and suggest ways to reduce or eliminate risks?				
8. Are structures readily accessible to disabled employees?				
9. Are minors prohibited from performing hazardous work?				
Discrimination and employee rights				
1. Are employees trained on discrimination issues?				
2. Are supervisors and managers trained in anti-discriminatory practices?				
3. Are employment practices in line with the various anti-discrimination laws?				
4. Are effective policies in place that prohibit retaliation against employees who exercise their rights?				
Workers' compensation				
1. Are injuries/incidents investigated?				
2. Is follow-up remediation performed where appropriate?				
3. Is regular contact made with employees out on lost time?				
4. Are return-to-work programs checked for effectiveness?				
5. Is contact made with medical providers?				
6. Are insurance premiums and competitive quotes reviewed on a periodic basis?				
7. Is the workplace environment maintained with safety in mind?				
8. Are state (new and existing) requirements monitored?				
Employee separation				
1. Do exit interviews take place?				
2. Are final paychecks provided on time?				
3. Recordkeeping and other documentation				
4. Are personnel files current?				
5. Are all appropriate labor posters displayed in a conspicuous place?				
6. Are documents regarding employees kept for their required duration?				

Annexure 3

MANAGEMENT INFORMATION SYSTEMS INTERNAL CONTROL QUESTIONNAIRE*

Sl. No.	*Subject*	*Yes*	*No*	*Comments*
	MIS Policies or Practices			
1	Has management developed and maintained a current MIS policy or practice?			
2.	Does the policy or practice provide guidance in the following areas: – The definition, purpose, and fundamental components of MIS? – How to achieve effective two-way communication between management and Employees and specific avenues to maintain such communication? – Processes for initiating, developing, and completing MIS enhancements? – Guidelines for installing MIS enhancements in a controlled change environment? – Procedures for acquiring, merging, manipulating, and up-loading data to other systems? – Guidance for delineating the need for internal/external audit coverage and testing?			
3.	Is the policy or practice reviewed and updated regularly?			
4.	Is the policy or practice distributed to appropriate employees?			
5.	– Does the policy or practice incorporate or require: – User approval for each phase? – Installation of MIS enhancements in a controlled change environment? – Employees to follow policy or practice and processes as data is acquired, merged, manipulated, and up-loaded to other systems? – Employees to be sufficiently trained for new systems and subsequent enhancements?			
	MIS Development			
6.	Does the internal planning process consider and incorporate the importance of MIS at both the strategic and tactical level? Are longer term strategic goals (beyond 2 years) supported by the development of appropriate MIS? Are shorter term tactical goals over the immediate one-to-two year period regularly and appropriately reviewed and monitored by management?			
7	Do project objectives address reported MIS weaknesses and meet business unit requirements?			
8	Does management have a process for monitoring project schedules?			

9	Does management use a project management technique to monitor MIS development schedules?			
10	Does the organization use a consistent and standardized approach or a structured methodology for developing MIS projects			
11	Does the methodology encompass the following phases: – Analysis of the concept, organization of tasks, completions of phases, and approvals? – Development of the program and contracting for equipment and software? – Development of user manuals and testing of the system? – Post-review of the system and future maintenance of it?			
	User Training and Instructions			
12	Is the user manual for the MIS system(s) meaningful, easy to understand, and current?			
13	Do user manual requirements include the following information? – A brief description of the application or system? – Input instructions, including collection points and times to send updated information? – Balancing/reconciliation instructions? – A full listing of output reports, including samples?			
	Communication			
14	Does management encourage communication lines to meet the following objectives: – To effectively link executives, other appropriate users, and information systems employees? – To ensure effective two-way communication between management and employees? – To document the MIS process?			
	Audit			
15	Has the MIS target area(s) been internally or externally audited in the past two years? If it has, review the scope of the audit, the findings, and management's response(s) to that report. If it hasn't, interview audit management to determine what their plans regarding an audit review of the MIS system are.			
	Conclusion			
16	Can this information be considered adequate for evaluating internal control of MIS activities? This question presumes that there are no additional significant internal auditing procedures, accounting controls, administrative controls, or other circumstances that impair any controls or mitigate any			

	weaknesses noted above. *(Note: Explain negative answers briefly, and indicate conclusions as to their effect on specific examination or verification procedures.)*			
17	Based on a composite evaluation, evidenced by answers to the previous questions, internal control is considered to be _________ *(good*, *medium*, or *bad*).			

**Source :* Management Information Systems 22 Comptroller's Handbook

LESSON ROUND-UP

- Strong internal control system is very important for an organisation. The strength of internal control system only decides the need and depth of audit. Internal control review is a very important task both for internal auditor as well as for external auditor.
- Material purchase constitutes about 50-70% of the cost of a product and an efficient internal control over the purchasing activities of an organisation is very much required.
- While reviewing internal control system over the purchasing system it is ascertained whether controls are in place in the process to ensure accountability is established as early as possible at all points along the accountability chain. Whether segregation of duties, or mitigating controls, exists within transaction processing authorization, custody, and recording functions. Separation of duties exists between the various types of transaction processing (e.g., procurement, accounts payable, disbursements).
- While reviewing the management information system of an organisation first step is to determine if MIS policies or practices, processes, objectives, and internal controls are adequate and whether MIS applications provide users with timely, accurate, consistent, complete, and relevant information.
- The survival of an organisation largely depends on the effectiveness of selling and distribution function. Review of sales and distribution function is very important from internal control point of view and it requires a detailed understanding of company business. In review of sales and distribution policies and programs, it is sales and distribution policies are matching with the overall corporate objective and are able enough to serve customers of all regions.
- Manufacturing operations is a prime source of money outflow i.e. a large amount of money is spent on manufacturing process e.g. in buying machinery, consumables, paying salary to workers etc. It is very important to review the manufacturing operations in timely manner so that the identified in-efficiency may be eliminated controlled on immediate basis.
- In review of personal polices, several functions of Human resources department are reviewed. This review is more than just looking at personnel files to make sure they're complete and consistent with applicable laws and legislation pertaining to employment practices. In personal policies review it is ascertained whether human resources function is supporting the company philosophy, mission and values.
- Decision-making is an essential aspect of modern management. A manager takes hundreds of decisions consciously and subconsciously. Decision-making pervades all managerial actions and a continuous process. Decision-making is an indispensable component of the management process itself. The main objective of appraisal of management decision is to see how decisions are taken, whether decisions taken are meeting the organisation objectives. Whether documentation is made to substantiate the decision making process.

SELF-TEST QUESTIONS

(These are meant for re-capitulation only. Answers to these questions are not to be submitted for evaluation)

1. Explain the objectives of the review of purchase firm.
2. Explain the term ‘Segregation of duties’ in context of purchase control review.
3. Prepare a small questionnaire enlisting the important things to be reviewed in case of purchase control of an organisation.
4. What are the objectives of review of management information system of an organisation?
5. What are the main characteristics of information? List down the main points to be considered while evaluation the MIS.
6. How would you carry out the review of discount given by an organisation? Explain the main points to be considered.
7. Explain the points to be considered while carrying out the internal control review of an organisation over the selection of transporter.
8. Explain the internal control review points for reviewing the marketing function of an organisation?
9. What are the points to be considered while reviewing the quality management system of a manufacturing organisation?
10. What are the pints to be considered while carrying out the internal control review of recruitment function?
11. Explain the main points to be considered in reviewing the decision making process of management.

Lesson 15

Audit Engagement and Documentation

LESSON OUTLINE

- Introduction
- Audit Plan
- Points for consideration in audit planning
- Audit programme
- Sample audit program for cash audit
- Voucher
- Meaning of voucher, example of vouchers
- Verification, Objective of verification
- Points to be considered in verification
- Distinction between vouching and verification
- Meaning of documentation
- Form and contents of documentation
- Permanent and temporary audit file
- Contents of permanent audit file
- Contents of temporary audit file
- Guidance on documentation
- Sampling, factors in determining sampling size
- Test check and techniques of test checks
- Lesson Round Up
- Self Test Question

LEARNING OBJECTIVES

Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. The objective of auditor is to plan the audit so that it will be performed in an effective manner. During Audit planning only, the audit decides about the audit technique, extent of audit required, documentation technique etc. Audit planning and documentation has a very important role to play in an auditing exercise. A good auditing planning make it possible to get the auditing exercise completed in a timely and cost effective manner. The objective of this lesson is to create understanding about audit planning, audit program, audit working papers and other audit documentation techniques.

After reading this lesson, the student will be able to understand :

1. How audit planning is done
2. Difference between audit plan and audit programme
3. Preparing audit programme for different audit assignments
4. Meaning of vouching and verification, their benefits and limitation
5. Distinction between vouching and verification
6. Meaning of audit working paper, concept of permanent and temporary audit file
7. Meaning of sampling and how sampling is done
8. Meaning of test check and different techniques used in test check.

"The skill of an accountant can always be ascertained by an inspection of his working papers."

Robert H. Montgomery, Montgomery's Auditing, 1912

AUDIT ENGAGEMENT AND DOCUMENTATION

Introduction: Audit procedures refer to the methodology adopted by an auditor in carrying out an audit assignment. Audit procedures have a very important role in the successful execution of an audit assignment. The most successful audits are those involving sound planning and those in which the auditee and the auditors have a constructive working environment. In a conducive environment, auditee, should understand what auditor has been doing and why. Although every audit is unique, the audit process is similar for most engagements, and normally consists of three stages: planning, executing and reporting.

Audit Plan

An audit plan is a step-by-step, methodical approach that enables auditors to focus on important areas under review. Audit Planning steps run the gamut, from engagement preparation and staff appointment to testing financial accounts and internal processes.

In order to ensure a high standard of performance, it is important that the auditor should prepare adequately for his work. Planning for an audit, just like every human endeavour, is essential for the smooth performance of the audit work and its successful completion. Planning ahead for an audit work will not only guarantee a valid audit opinion but will also help the auditor to ensure that:

(a) The audit objective is established and achieved;

(b) The audit is properly controlled and adequately directed at all stages;

(c) High risk and critical areas of the engagement are not omitted but that adequate attention is focused on these areas; and

(d) The work is completed economically and expeditiously, hence, saving on audit resources.

It is important to distinguish between an audit plan and audit planning memorandum. Audit plan relates to preparations made by the auditor for one specific audit engagement while audit planning memorandum is a standing arrangement made by the auditor for the continuing engagement of a particular client. Hence, an audit plan is a plan for the audit of one client for one year while audit planning memorandum is a standing plan for the continuing audit of a client from year to year.

Points for Consideration in Audit Planning: Audit planning requires a high degree of discipline on the part of the auditor. In order to make the planning more meaningful, the auditor should take into consideration the following matters in relation to the audit engagement:

(a) Preliminary Work to be done in addition to the real audit work

This will include such matters as stocktaking, cash count, debtors' circularisation and review of previous year's working papers. This will remind the auditor of those matters brought forward from the previous year and any other points to be resolved in the current year or problems anticipated.

(b) Changes in legislation, accounting or any auditing standards or guidelines

The auditor should acquaint himself with all the changes that took place during the year in applicable legislation, accounting and auditing standard. This will help an auditor in carrying out the auditing assignment in away that meets the legislative requirement.

(c) Analytical review of available management accounts and other management information that relate to the accounts

This will assist in establishing valuable ratios and indicators that will guide the auditor. For instance, the computation

of the gross profit percentage compared with that of the previous year will provide a good indicator to the auditor of the accuracy and reliability of sales and cost of sales.

(d) Changes in the business or management

The appointment of a new finance controller and the establishment of a new business line or the creation of a new branch are significant changes in the circumstances of the company which will necessitate changes in the existing audit plans. There may be similary changes for which change may be required in audit plan.

(e) Changes in the accounting system

The introduction of computers such that when a company introduces significant changes in its operating procedures will require a review and evaluation of the system of internal control.

(f) Deadlines established for the submission of audit report

Where a client has set deadlines for its statutory activities such as the annual general meeting, it is important for the auditor to work in line with such programmes.

(g) Use of Rotational Testing and Verification

In practice, the auditor may not carry out a hundred percent testing or verification of the client's transactions or segments of the business. Where rotational testing or verification is adopted, it will be necessary for the auditor to determine ahead of the date of the engagement which aspects of the business should be selected for testing or verification. An example of rotational testing could be applied on the client's branches to be visited.

AUDIT PROGRAMME

Most of the time audit is conducted by a team instead of just an individual. If business is small or if there is not much to be done then it might be possible to conduct the whole engagement easily by an individual. But usually amount of work, time constraints and other factors require the audit engagement to be conducted by more than one person.

Depending on the audit, audit team can have different number of members. Usually the team is structured in a Partner, Manager and Assistants which may further be divided into senior assistants and juniors.

In order to properly assign work to each individual and what is required to be done by whom there must be some kind of instructions set, otherwise, more than one member might be auditing the same area or in other case some areas may be left completely unaudited.

To ensure efficient and effective conduct of audit assignment, audit programmes or audit programs are used.

Audit programme contains step by step instructions to be carried out by team members i.e. it is simply a list of audit procedures to be executed by team members.

Audit programme or audit program is not a name of any computer program. Also it has nothing to do with computer programming in any way. However, audit programmes can be made using computer software in computer assisted auditing environment

Even though audit programme sets out the whole agenda for every member of the team but the main users are juniors for whom it acts as a dictation to be followed. The main purpose of audit programme is that every material area has been audited appropriately and sufficient appropriate audit evidence has been obtained in respect of every important areas of audit.

Audit programmes are prepared on the basis of audit plan usually by the auditor – who in the audit team is either partner or manager. But sometimes, audit firms have a basic audit programme and the same is used by the auditor after making some modifications to it to make it according the audit engagement in hand.

Mostly it is in the form of a checklist which can be used by the juniors to make sure every required procedure has been implemented. This can also help in monitoring the work of juniors in specific or assistants in general.

Audit programmes may be laid down in advance for the whole year for some aspects of the audit which auditor expects to be audited after regular intervals of time or when needed. For understandability and convenience, audit programmes are written for each audit area separately and then assigned to specific team members.

What procedures shall be part of audit programme is to be decided by the auditor and depends on the auditor's judgement.

SAMPLE AUDIT PROGRAM FOR CASH AUDIT

1. Discuss and document with the cashier about the procedures for the receiving and disbursement of cash.
   A. sources of cash (funds)
   B. frequency of deposits
   C. who makes the deposits
   D. the level of "cash" received
   E. the nature of documentation of expenditures (invoices, check requests, agreements…)
   F. authorization procedures
2. Determine whether the level of cash held in the field and in the office is appropriate.
3. For petty cash funds
   – Is an accurate petty cash voucher maintained?
   – Are physical cash counts
     (a) Conducted routinely by a person or people who are not direct custodians of the petty cash funds?
     (b) Reconciled with the petty cash voucher? Can all variances be explained?
     (c) Documented by those people who performed the counts and reconcile these counts against the petty cash voucher?
   – Is access to petty cash funds restricted? Who has access to these funds?
4. For all field checking accounts
   (a) Determine the number of signatures required on each check.
   (b) Determine the process by which cash is received for mission operations.
   (c) Obtain bank statements for each bank account.
   (d) Determine the frequency and timing of the preparation of bank reconciliations. Who does the reconciliations?
   (e) Summarize a listing of deposits from the bank statements and reconcile the amounts with reported home office transfers and other sources of income reflected on the field's financial reports.
   (f) Obtain bank reconciliations and test for accuracy.
   (g) Verify whether a second party reviews bank reconciliations monthly. These examinations should be documented with a date of examination and a signature of the second party.

VOUCHING

Vouching means the examination of documentary evidence in support of entries to establish the arithmetic accuracy. When the auditor checks the entries with some documents it is called vouching.

Vouching is the acid test of audit. It tests the truth of the transaction recorded in the books of accounts. It is an act of examining documentary evidence in order to ascertain the accuracy and authenticity of the entries in the books of accounts.

According to **Dicksee,** "Vouching consists of comparing entries in the books of accounts with documentary evidence in support thereof."

According to **Joseph Lancaster,** "it is often thought that vouching consists of the mere examination of the vouchers or documentary evidence with the book entries. This is, however, quite wrong, for vouching comprises such an examination of the ledger entries as will satisfy the auditor, not only that the entry is supported by the documentary evidence but it has been properly made upon the books of accounts."

From the above it becomes clear that vouching means testing the truth of entries appearing in the primary books of accounts. In short, vouching means to examine the evidence in support of any transaction or entry recorded in the books of accounts. Vouching does not merely see that the entries and transactions are supported by proper documentary evidence. The auditor should be satisfied that they are properly maintained, they are supported by all evidence and they are correctly recorded in the books of accounts.

VOUCHER

Any documentary evidence supporting the entries in the records is termed as a voucher. Any document, which supports the entries in the books of accounts and establishes the arithmetical accuracy, is called a voucher.

EXAMPLES OF VOUCHERS

A bill, a receipt, an invoice, goods received note, salaries and wages sheets, goods inward and outward register, stores records, counterfoil of a cheque book, counterfoil of pay-in-slip book, bank statement, bank pass book, delivery challans, agreements, a material requisition slip, copy of purchase order, minute book, rnemorandum and articles of association, partnership deed, trust deed, prospectus etc. are the examples of vouchers.

OBJECTIVES OF VOUCHING

The basic objectives of vouching are as under:

1. To ensure that all the transactions are properly recorded in the books of accounts.
2. To see the proper evidence supports all the entries of the transactions.
3. To make sure that fraudulent transactions are not recorded in the books of accounts.
4. To see that all transactions relating to business are recorded in the books of accounts.
5. To see that all transactions are properly authenticated by a responsible person.

IMPORTANCE OF VOUCHING

- Ensures genuineness of the transactions
- Enables to know transactions
- Helps to know relevance of the transaction
- Facilitates proper allocation of capital & revenue, expenditure

- Detects frauds and errors
- Decides authenticity of transactions
- Ensures proper accounting
- Compliance with law
- Ensures proper disclosure

The special considerations to be borne in mind by the auditor in the course of vouching

- The date of the voucher falls within the accounting period;
- The name as recorded and as contained in voucher is same
- Voucher/transactions therein are duly and properly authorized by the relevant signatory;
- The transaction for which payment have been made or amount have been received relates to business.
- The transactions being examined belongs to the entity and took place during the relevant period;
- Whether any alteration has been done in the voucher, if so whether it has been duly recorded and authorized.
- Whether any control number maintained on voucher or not. Whether there is any missing number or voucher.
- The transaction is recorded in the proper account and revenue or expenses is properly allocated to the accounting period.
- All transactions which have actually occurred have been recorded.
- The posting from the voucher of the amount needs to be correctly taken in the final accounts, disclosed in accordance with recognized accounting policies and procedures.

VERIFICATION

Spicer and Pegler have defined verification as, “it implies an inquiry into the value, ownership and title, existence and possession and the presence of any charge on the assets”. Verification is a process by which an auditor satisfies himself about the accuracy of the assets and liabilities appearing in the Balance Sheet by inspection of the documentary evidence available. Verification means proving the truth, or confirmation of the assets and liabilities appearing in the Balance Sheet.

Thus, verification includes verifying:-

1. The existence of the assets
2. Legal ownership and possession of the assets
3. Ascertaining that the asset is free from any charge, and
4. Correct valuation

Of course it is not possible for the auditor to verify each and every asset. It was held in Kingston Cotton Mills case that “it is not part of an auditor’s duty to take stock. No one contend that it is. He must rely on other people for the details of stock in trade in hand”. However, as per the decision given in Mc Kesson and Robins case (1939) the auditor must physically inspect some of the assets. Now the auditor has to report whether the balance sheet shows true and fair view of the state of affairs of the company. Hence, he is required to verify all the assets and liabilities appearing in the balance sheet. In case of failure, the auditor can be held liable for damages.

According to the 'statement of auditing practices' issued by ICAI, "the auditor's object in regard to assets generally is to satisfy that:

1. They exist,
2. They belong to the client,
3. They are in the possession of the client or the persons authorized by him,
4. They are not subject to undisclosed encumbrances or lien,
5. They are stated in the balance sheet at proper amounts in accordance with sound accounting principles, and
6. They are recorded in the accounts.

POINTS TO BE CONSIDERED IN VERIFICATION

While conducting verification following points should be considered by the auditor:-

1. **Existence:** The auditor should confirm that all the assets of the company physically exist on the date of balance sheet.
2. **Possession:** The auditor has to verify that the assets are in the possession of the company on the date of balance sheet.
3. **Ownership:** The auditor should confirm that the asset is legally owned by the company.
4. **Charge or lien:** The auditor has to verify whether the asset is subject to any charge or lien.
5. **Record:** The auditor should confirm that all the assets and liabilities are recorded in the books of account and there is no omission of asset or liability.
6. **Audit report:** Under CARO the auditor has to report whether the management has conducted physical verification of fixed assets and stock and the difference, if any, between the physical inventory and the inventory as per the book.
7. **Event after balance sheet date:** The auditor should find out whether any event after the date of balance sheet has affected any items of assets and liabilities.

SCOPE OF VERIFICATION

Verification includes information on the following:-

1. That the assets were in existence on the date of the balance sheet.
2. That the assets had been acquired for the purpose of business only.
3. That the assets had been acquired under a proper authority.
4. That the right of ownership of the assets vested in the organization.
5. That the assets were free from any charge.
6. That the assets were properly valued and disclosed in the balance sheet.

OBJECTS OF VERIFICATION

Following are the objects of verification of assets and liabilities.

1. To show correct valuation of assets and liabilities.
2. To know whether the balance sheet exhibits a true and fair view of the state of affairs of the business.

3. To find out the ownership and title of the assets.
4. To find out whether assets were in existence.
5. To detect frauds and errors, if any.
6. To find out whether there is an adequate internal control regarding acquisition, utilisation and disposal of assets.
7. To verify the arithmetic accuracy of the accounts.
8. To ensure that the assets have been recorded properly.

ADVANTAGES OF VERIFICATION

Advantages of verification are as under:-

1. It avoids manipulation of accounts.
2. It guards against improper use of assets.
3. It ensures proper recording and valuation of assets.
4. It exhibits true and fair view of the state of affairs of the company.

TECHNIQUES OF VERIFICATION:

1. Inspection: It means physical inspection of the assets i.e. company cash in the cash box, physical inventory, inspection of shares certificates, documents etc.

2. Observation: The auditor may observe or witness the inspection of assets done by others.

3. Confirmation: It means obtaining written evidence from outside parties regarding existence of assets.

VERIFICATION OF ASSETS

The term 'verification' signifies the physical examination of certain class of assets and confirmation regarding certain transactions. Sometimes verification is confused with vouching but they differ from each other on the nature and depth of the examination involved. Vouching goes to prove the arithmetical accuracy and the genuineness of the transactions, whereas verification goes to enquire into the value, ownership, existence and possession of assets and also to confirm whether they are free from any mortgage or charge. The fact of the presence of any entry regarding the acquisition of asset does not prove that the particular asset actually exists on the Balance Sheet date, rather it purports to prove that the asset ought to exist; on the other hand, verification through physical examination and confirmation proves whether a particular asset actually exists without having any charge on the date of the Balance Sheet.

Verification of assets involves the following steps:

1. Enquiry into the value placed on assets;
2. Examination of the ownership and title deeds of assets;
3. Physical inspection of the tangible assets; and
4. Confirmations regarding the charge on assets;
5. Ensuring that the assets are disclosed, classified and presented in accordance with recognized accounting policies and legal requirements.

The scope of verification is wide and consequently verification is an important part of the auditor's duties. An auditor should put all his endeavour to satisfy himself whether a particular asset is shown in the Balance Sheet

at proper value, whether the concern holds the title to the asset and the asset is in the sole possession of the concern and lastly whether the asset is free from any charge. If the auditor fails to perform his duty, he will be held liable.

In case of London Oil Storage Co. Ltd. Vs. Sear Hasluck & Co. (1904) Chief Justice Alverstone remarked: 'It is the duty of the auditor to verify the existence of the assets stated in the Balance Sheet and he will be liable for any damage suffered by the client if he fails in his duty. Besides the legal importance, verification also plays an important role to guard against improper valuation of assets like stock-in-trade which may inflate or deflate the profit position of the concern. Improper valuation of assets may also conceal the actual position of the business as reflected in the Balance Sheet. However, it is not possible on the part of the auditor to physically verify each and every asset because time may not permit him to do so, or he may not have sufficient technical knowledge of the assets concerned.

It was decided in the case of "Kingston Cotton Mills: that it is not a part of an auditor's duty to take stock. No one contends that it is. He must rely on other people for the details of the stock-in-trade. Again, while going through the decision of Mc Kesson and Robins case in 1939, we find that the auditor should physically verify some of the assets. If possible, title documents like negotiable instruments, shares, debentures, securities, etc. are to be thoroughly examined on the last day of the accounting period. He should satisfy himself that the transactions, if any, having bearing on the Balance Sheet date and date of audit are bona fide and are supported with proper evidence. The auditor is also supposed to verify stock-in-trade with reference to the purchase book, the stock records, the gatekeeper's book, etc. though law does not specially compel him to take stock-in-trade.

DISTINCTION BETWEEN VOUCHING AND VERIFICATION

Verification is made on the basis of vouching. So, verification is a part of vouching. Even though they have some differences which are as follows:

1. Meaning

Verification is the act of checking title, possession and valuation of assets but vouching is the act of checking the records with the help of evidential documents.

2. Nature

Verification is specially related to the assets and liabilities but vouching is related to all the accounting documents.

3. Person

Generally, assistant staff or auditor performs the work of vouching but auditor himself performs the work of verification.

4. Time

Vouching is made at the beginning of auditing but verification is made at the end of auditing or at the time of checking balance sheet.

DOCUMENTATION

"The skill of an accountant can always be ascertained by an inspection of his working papers."— Robert H. Montgomery, Montgomery's Auditing, 1912

Meaning of Documentation

The word "document" is used to refer to a written or printed paper that bears the original, official, or legal form of something and can be used to furnish decisive evidence or information. "Documentation" refers to the act or an instance of the supplying of documents or supporting references or records.

"Documentation" refers to the working papers prepared or obtained by the auditor and retained by him, in connection with the performance of the audit.

Form and content of documentation

The form and content of audit documentation should be designed to meet the circumstances of the particular audit. The information contained in audit documentation constitutes the principal record of the work that the auditors have performed in accordance with standards and the conclusions that the auditors have reached. The quantity, type, and content of audit documentation are a matter of the auditors' professional judgment**.** The Audit documentation therefore is not restricted to being only on papers, but can also be on electronic media.

Generally the factors that determine the form and content of documentation for a particular engagement are:

(a) The nature of the engagement.

(b) The nature of the business activity of the client.

(c) The status of the client.

(d) Reporting format.

(e) Relevant legislations applicable to the client.

(f) Records maintained by the client.

(g) Internal controls in operation.

(h) Quality of audit assistants engaged in the particular assignment and the need to direct and supervise their work.

Permanent and Current Audit files

In the case of recurring audits, some working paper files may be classified as permanent audit files, which are updated currently with information of continuing importance to succeeding audits. In contrast current audit files contain information relating primarily to the audit of a single period.

Content of permanent audit file

(a) Copy of initial appointment letter if the engagement is of recurring nature.

(b) Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor.

(c) NOC from previous auditor.

(d) Information concerning the legal and organisational structure of the entity.

In the case of a company, this includes the Memorandum and Articles of Association.

In the case of a statutory corporation, this includes the Act and Regulations under which the corporation functions, i.e.

(i) In case of partnerships- Partnership deed.

(ii) In case of trusts- Trust deed.

(iii) In case of societies- Certificate of registration/ Rules and Bye-laws.

(e) Organisational structure of the client.

(f) List of governing body including Name, Address and contact details. For instance, the list of directors in case of a company, list of partners in a partnership and list of trustees in a trust.

(g) Extracts or copies of important legal documents, agreements and minutes relevant to the audit.

(h) A record of the study and evaluation of the internal controls related to the accounting system. This might be in the form of narrative descriptions, questionnaires or flow charts, or some combination thereof.

(i) Copies of audited financial statements for previous years

(j) Analysis of significant ratios and trends

(k) Copies of management letters issued by the auditor, if any.

(l) Notes regarding significant accounting policies.

(m) Significant audit observations of earlier years.

(n) Assessment of risks and risk management

(o) Major policies related to Purchases and Sales

(p) Details of sister concerns

(q) Details of Bankers, Registrars, Lawyers etc

(r) Systems and Data Security policies

(s) Business Continuity Plans

Content of current audit file

The current file normally includes:

(a) Correspondence relating to acceptance of annual reappointment.

(b) Extracts of important matters in the minutes of Board Meetings and General Meetings, as are relevant to the audit.

(c) Evidence of the planning process of the audit and audit programme.

(d) Analysis of transactions and balances.

(e) A record of the nature, timing and extent of auditing procedures performed, and the results of such procedures.

(f) Evidence that the work performed by assistants was supervised and reviewed.

(g) Copies of communications with other auditors, experts and other third parties.

(h) Copies of letters or notes concerning audit matters communicated to or discussed with the client, including the terms of the engagement and material weaknesses in relevant internal controls.

(i) Letters of representation or confirmation received from the client.

(j) Conclusions reached by the auditor concerning significant aspects of the audit, including the manner in which exceptions and unusual matters, if any, disclosed by the auditor's procedures were resolved or treated.

(k) Copies of the financial information being reported on and the related audit reports.

(l) Audit review points and highlight.

(m) Major weakness in Internal control.

Need for Audit documentation

The audit working papers (current and permanent) for a client audit engagement should be sufficiently detailed to enable another appropriately experienced and competent auditor who is not familiar with the client to obtain an overall understanding of the engagement.

The need for Working papers

The need for Working papers listed as follows:

(a) They aid in the planning and performance of the audit;

(b) They aid in the supervision and review of the audit work and to review the quality of work performed, in accordance with AAS 17 "Quality Control for Audit Work";

(c) They provide evidence of the audit work performed to support the auditor's opinion;

(d) They document clearly and logically the schedule, results of test, etc.;

(e) The working papers should evidence compliance with technical standards;

(f) They document that Internal control has been appropriately studied and evaluated; and

(g) They document that the evidence obtained and procedures performed afford a reasonable basis for an opinion;

(h) They retain a record of matters of continuing significance to future audits of the entity;

(i) They enable an experienced auditor to conduct quality control reviews in accordance with Statement on Peer Review issued by the Institute of Chartered Accountants of India;

(j) The process of preparing sufficient audit documentation contributes to the quality of an audit

(k) They fulfil the need to document oral discussions of significant matters and communicate to those charged with governance, as discussed in AAS 27, "Communication of Audit Matters with those Charged with Governance.

GUIDANCE TO STAFF ON AUDIT DOCUMENTATION

Proper guidance should be given to staff regarding the following:

(a) Filing/keeping of working papers.

(b) Checklist of documents to be obtained and maintained.

(c) Indexing of documents/ working papers.

(d) Proper numbering/ sequencing of working papers.

(e) Summarizing of overall findings.

(f) Writing of queries.

(g) Discussing with seniors on matters of importance.

(h) Disposing of Query -at staff level/ senior level/ partner level.

(i) Importance of the working papers to be signed, dated and approved by relevant level of audit staff with sufficient cross reference.

(j) Importance of depicting the client's name, file number, accounting period, subject of working paper and reference of working paper with current or permanent file.

RETENTION OF WORKING PAPERS/ DOCUMENTS

Period of retention

The auditor should retain the working papers for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements of record retention.

Ownership and custody

Working papers are the property of the auditor. The auditor may, at his discretion, make portions of or extracts from his working papers available to his client.

The auditor should adopt reasonable procedures for custody and confidentiality of his working papers

General guidelines for the preparation of working papers are:

1. **Clarity and Understanding** – As a preparer of audit documentation, step back and read your work objectively. Would it be clear to another auditor? Working papers should be clear and understandable without supplementary oral explanations. With the information the working papers reveal, a reviewer should be able to readily determine their purpose, the nature and scope of the work done and the preparer’s conclusions.
2. **Completeness and Accuracy** – As a reviewer of documentation, if you have to ask the audit staff basic questions about the audit, the documentation probably does not really serve the purpose. Work papers should be complete, accurate, and support observations, testing, conclusions, and recommendations. They should also show the nature and scope of the work performed.
3. **Pertinence** – Limit the information in working papers to matters that are important and necessary to support the objectives and scope established for the assignment.
4. **Logical Arrangement** – File the working papers in a logical order.
5. **Legibility and Neatness** – Be neat in your work. Working papers should be legible and as neat as practical. Sloppy work papers may lose their worth as evidence. Crowding and writing between lines should be avoided by anticipating space needs and arranging the work papers before writing.
6. **Safety** – Keep your work papers safe and retrievable.
7. **Initial and Date** – Put your initials and date on every working paper.
8. **Summary of conclusions –** Summarize the results of work performed and identify the overall significance of any weaknesses or exceptions found.

SAMPLING

Audit sampling is the testing of less than 100% of the items within a population to obtain and evaluate evidence about some characteristic of that population, in order to form a conclusion concerning the population.

“Audit sampling” means the application of audit procedures to less than 100% of the items within an account balance about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population. It is important to recognise that certain testing procedures do not come within the definition of sampling. Tests performed on 100% of the items within a population do not involve sampling. Likewise, applying audit procedures to all items within a population which have a particular characteristic (for example, all items over a certain amount) does not qualify as audit sampling with respect to the population examined, nor with regard to the population as a whole, since the items were not selected from the total population on a basis that was expected to be representative. Such items might imply some characteristic of the remaining portion of the population but would not necessarily be the basis for a valid conclusion about the remaining portion of the population.

In an audit, sampling procedures are used because it is not practical to examine every single item in a population. For example, the auditor may select an audit sample of non-current assets, and verify their existence, condition and value. It would not be practical for the auditor to track down every single asset on the books. But, if all the items in the audit sample are verified then it may be appropriate to draw the conclusion that all the assets are correctly recorded in the books (assuming the audit sample has been selected correctly and is of sufficient size).

FACTORS IN DETERMINING SAMPLE SIZE- SAMPLING RISK

(1) When determining the sample size, the auditor should consider sampling risk, the tolerable error, and the expected error.

(2) Sampling risk arises from the possibility that the auditor conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.

(3) The auditor is faced with sampling risk in both tests of control and substantive procedure as follow:

(a) Tests of control:

(I) Risk of under reliance: The risk that, although the sample result does not support the auditor's assessment of control risk, the actual compliance rate would support such an assessment.

(II) Risk of over reliance: The risk that, although the sample result supports the auditor's assessment of control risk, the actual compliance rate would not support such as an assessment.

(b) Substantive procedures:

(I) Risk of incorrect rejection: The risk that, although the sample results the supports the conclusion that a recorded account balance or class of transactions is materially misstated, in fact it is not materially misstated.

(II) Risk of incorrect acceptance: The risk that, although the sample result supports the conclusion that a recorded account balance or class or transactions is not materially misstated.

(4) The risk of under reliance and the risk of incorrect rejection affect audit efficiency as they would ordinarily lead to additional work being performed by the auditor, or the entity, which would establish that the initial conclusions were incorrect. The risk of over reliance and the risk of incorrect acceptance affect audit effectiveness and are more likely to lead to an erroneous opinion on the financial statements than either the risk of under reliance or the risk of incorrect rejection.

(5) Sample size is affected by the level of sampling risk the auditor is willing to accept from the results of the sample. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

TOLERABLE ERROR

Tolerable error is the maximum error in the population that the auditor would be willing to accept and still concludes that the result from the sample has achieved the audit objective. Tolerable error is considered during the planning stage and, for substantive procedures, is related to the auditor's judgement about materiality. The smaller the tolerable error, the greater the sample size will need to be. In tests of control, the tolerable error is the maximum rate of deviation from a prescribed control procedure that the auditor would be willing to accept, based on the preliminary assessment of control risk. In substantive procedures, the tolerable error is the maximum monetary error in an account balance or class of transactions that the auditor would be willing to accept so that when the results of all audit procedures are considered, the auditor is able to conclude, with reasonable assurance, that the financial statements are not materially misstated.

Expected Error

If the auditor expects error to be present in the population, a larger sample than when no error is expected ordinarily needs to be examined to conclude that the actual error in the population is not greater than the planned tolerable error. Smaller sample sizes are justified when the population is expected to be error free. In determining the expected error in a population, the auditor would consider such matters as error levels identified in previous audits, changes in the entity's procedures, and evidence available from other procedures

SELECTION OF THE SAMPLE

The auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected.

While there are a number of selection methods, three methods commonly used are:

Random selection, which ensures that all items in the population have an equal chance of selection, for example, by use of random number tables.

Systematic selection, which involves selecting items using *a* constant interval between selections, the first interval having a random start. The interval might be based on a certain number of items (for example, every 20th voucher number) or on monetary totals (for example, every ₹ 1,000 increase in the cumulative value of the population). When using systematic selection, the auditor would need to determine that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population. For example, if in a population of branch sales, a particular branch's sales occur only as every 100th item and the sampling interval selected is 50, the result would be that the auditor would have selected all, or none, of the sales of that particular branch.

Haphazard selection, which may be an acceptable alternative to random selection, provided the auditor attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units. When the auditor uses this method, care needs to be taken to guard against making a selection that is biased, for example, towards items which are easily located, as they may not be representative.

TEST CHECKS AND TECHNIQUES OF TEST CHECKING

Carrying out detailed check of each and every transaction of a large business shall be time consuming for the auditor. In auditing the accounts of a business, every single copy is not usually checked by the auditor; what is usually done in practice is that a representative number of entries of each class are selected and checked and if they are found correct, the remaining entries are taken to be correct. This is known as Test Checking. In those organizations, where satisfactory internal check system is in existence, the auditor need not carry out detailed checking. He may adopt Test checking. It is a system of sampling employed by the auditor for the purpose of reducing the volume of detail checking involved in the audit. If, in Test Checking, he finds that the records checked by him are correct then no further detail checking need be carried out.

TEST CHECKING V/S STATISTICAL SAMPLING

Selection of items for the purpose of checking can be done in two ways: (i) Judgment (ii) Statistical Sampling. When the judgment method is applied, the method of checking is called test checking. When sampling techniques are applied it is called statistical sampling.

Precautions To Be Taken - While adopting the test check, the auditor must take the following precautions:

1. Entries selected for test checking must be representative of all transactions.
2. The selection of the items should be at random.
3. It cannot be adopted in case of vouching the cash book.

4. Client's staff should not come to know of the entries selected for test checking.
5. Period selected for test checking should differ from book to book and year to year.
6. He should not adopt test checking where the law requires thorough audit.
7. A number of entries of the first and last month of the year must be checked thoroughly.
8. Test should be so devised that a sizeable portion of the work done by each employee is checked.
9. Control accounts or impersonal ledger should not be subject to test checking.
10. Auditor should select the test independently without regard to the suggestions of the member of the client's staff.
11. Bank statement and entries for cash withdrawal and cash deposits should be checked in full.

The extent of the test checking will depend upon the judgment and wishes of the auditor but it must be remembered that time unnecessarily spent in routine checking is a waste of resources. Caution must also be taken to see that the test checking may not become insignificant in extent or automatic and unrepresentative. Test checking will be of no use unless the representative items selected for checking are chosen with great intelligence and imagination.

Advantages of Test Check

1. Volume of work is considerably reduced.
2. There is a saving in terms of time, cost and energy.
3. The extra time available can be utilised for concentrating on areas of considerable importance.
4. If done carefully, test checking can be quite effective.

Disadvantages of Test Check

1. The auditor always is under fear whether he has missed out certain important items or that errors have remained undetected while test checking.
2. Where the client's staff is aware that the auditor resorts to test checking, the staff may become careless.

Auditor's Liability

If any errors are found in the accounts the auditor cannot take the shield against the fact that he conducted test check. The auditor should very carefully select the items for test check and ensure on the whole that the accounts show a true and fair view of the Profit/Loss in the case of the Profit & Loss Account and of the state of affairs of the organisation in the case of Balance Sheet.

LESSON ROUND-UP

– Audit procedures refer to methodology adopted by an auditor in carrying out an audit assignment. Audit procedures have a very important role in successful execution of an audit assignment.

– An audit plan is a step-by-step, methodical approach that enables auditors to focus on important areas under review. Audit Planning steps run the gamut, from engagement preparation and staff appointment to testing financial accounts and internal processes.

– Audit programme contains step by step instructions to be carried out by team members i.e. it is simply a list of audit procedures to be executed by team members.

– Vouching means the examination of documentary evidence in support of entries to establish the arithmetic accuracy.

- Voucher means any documentary evidence supporting the entries in the records. A bill, a receipt, an invoice, goods received note, salaries and wages sheets, goods inward and outward register, stores records, counterfoil of a cheque book, counterfoil of pay-in-slip book, etc. are the examples of vouchers.
- Verification is a process by which an auditor satisfies himself about the accuracy of the assets and liabilities appearing in the Balance Sheet by inspection of the documentary evidence available. Verification means proving the truth, or confirmation of the assets and liabilities appearing in the Balance Sheet.
- Verification and vouching are not the same. Verification is made on the basis of vouching. So, verification is a part of vouching.
- Documentation refers to the working papers prepared or obtained by the auditor and retained by him, in connection with the performance of the audit.
- In the case of recurring audits, some working paper files may be classified as permanent audit files, which are updated currently with information of continuing importance to succeeding audits. In contrast current audit files contain information relating primarily to the audit of a single period.
- The audit working paper should be clear, understandable, complete accurate, legible and safe.
- Audit sampling is the testing of less than 100% of the items within a population to obtain and evaluate evidence about some characteristic of that population, in order to form a conclusion concerning the population.
- In auditing the accounts of a business, every single copy is not usually checked by the auditor; what is usually done in practice is that a representative number of entries of each class are selected and checked and if they are found correct, the remaining entries are taken to be correct. This is known as Test Checking.

SELF-TEST QUESTIONS

(These are meant for re-capitulation only. Answers to these questions are not to be submitted for evaluation)

1. What is the meaning of audit plan? State the reasons why audit plan is prepared.
2. Explain the term audit programme. What are the factors to be considered in preparing an audit plan?
3. Explain the meaning of term vouching and its objectives, advantages and limitation.
4. What do you mean by the term verification? State the differences between verification and vouching.
5. What do you mean by audit working paper? State the general guidelines for preparing audit working paper.
6. Explain the concept of permanent and current audit working file. What are the contents of permanent audit working file?
7. What do you mean by test checking in auditing? What are the different techniques used in test checking?
8. What do you mean by sampling? What are the factors which need to be considered while selecting a sample?

GLOSSARY – AUDITING

1	***Accuracy assertion***	It refers to management assertion that amounts and other data relating to recorded transactions and events have been recorded appropriately.
2	***Adverse Opinion***	Adverse opinions means a professional opinion made by an auditor indicating that a company's financial statements are misrepresented, misstated and do not show a true and fair view of the company's affairs.
3	**Approve**	Approve means to authorize e.g. a manager authorizes a cash payment by signing a voucher providing approval for the disbursement.
4	**Arm's Length Transactions**	It refers to the transactions between people who have no relationship other than that of buyer and seller. The price is the true fair market value of the goods or services sold.
5	**Ascertain**	It is an audit procedure to determine or to discover with certainty. For example, to ascertain the date on which an investment was purchased by examining source documents.
6	**Assertion**	Management asserts that financial statements are correct with regard to existence or occurrence of assets, liabilities or transactions, completeness of information in the financial statements, rights and obligations at a point in time, appropriate valuation or allocation, presentation and disclosure.
7	**Adverse**	An audit opinion that financial statements as a whole are not in conformity with Accounting Standards.
8	**Adjusting Entries**	It refers to accounting entries made at the end of an accounting period to allocate items between accounting periods.
9	**Accounting Records**	These are the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers, invoices, contracts, the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries, and records such as work sheets and spreadsheets, supporting cost allocations, computations, reconciliations and disclosures.
10	**Accounts Receivable**	Debts due from customers from sales of products and services reported as a current asset.
11	**Accounting Principles**	The rules and guidelines that companies must follow when reporting financial data.

12	**Accounting Estimate**	An approximation of a financial statement element.
13	**Accounting Data**	It includes journals, ledgers and other records such as spreadsheets, that support financial statements. It may be in computer readable form or on paper.
14	**Acceptance Sampling**	Sampling to determine whether internal control compliance is greater than or less than the tolerable deviation rate
15	**Anticipated**	Expected.
16	**Analytical Procedure**	A comparison of financial statement amounts with an auditor's expectation. An example is to compare actual interest expense for the year (a financial statement amount) with an estimate of what that interest expense should be. The estimate can be found by multiplying a reasonable interest rate times the average balance of interest bearing debt outstanding during the year (the auditor's expectation). If actual interest expense differs significantly from the expectation, the auditor explains the difference in audit documentation.
17	**Allocation**	Distribution according to a plan. Depreciation, Amortization and Depletion are the methods to allocate costs to periods benefited.
18	**Aggregate (Aggregated)**	Constituting the whole. Aggregate expenses include expenses of all divisions combined for the entire year.
19	**Assurance**	The level of confidence one has.
20	**Assessed**	Determined.
21	**Attest (Attestation) Report**	In an attest engagement, a professional issues a written conclusion about the reliability of a written assertion that is the responsibility of another.
22	**Appropriate Audit Evidence**	Evidence which is relevant (pertains to the proposition supported) and reliable (trustworthy).
23	**Application Control**	Programmed procedure in application software designed to ensure completeness and accuracy of information.
24	**Assess**	To determine the value, significance or extent of.
25	**Attribute Sampling**	The characteristic tested is a property that has only two possible values (an error exists or it does not).
26	**Audit Committee**	A committee of the board of directors responsible for oversight of the financial reporting process, selection of the independent auditor and receipt of audit results.
27	**Audit Documentation (Working Papers)**	These are records kept by the auditor of procedures applied, tests performed, information obtained and pertinent conclusions reached in the engagement. The documentation provides the principal support for the auditor's report.

28	**Audit Evidence**	It is information used by the auditor in arriving at the conclusions on which the auditor's opinion is based.
29	**Audit Objective**	In obtaining evidence in support of financial statement assertions, the auditor develops specific audit objectives in light of those assertions. For example, an objective related to the completeness assertion for inventory balances is that inventory quantities include all products, materials and supplies on hand.
30	**Audit Planning**	It means developing an overall strategy for the audit. The nature, extent and timing of planning varies with size and complexity of the entity, experience with the entity, and knowledge of the entity's business.
31	**Audit Risk**	A combination of the risk that material errors will occur in the accounting process and the risk the errors will not be discovered by audit tests. Audit risk includes uncertainties due to sampling (sampling risk) and to other factors (non-sampling risk).
32	**Auditing Standards Board**	Statements on Auditing Standards are issued by Auditing and Assurance Standard Board India, the body of the Institute of Chartered Accountants of India.
33	**Business Risks**	These are risks that could adversely affect an entity's ability to achieve its objectives and execute its strategies or from the setting of inappropriate objectives and strategies.
34	**Bill of Lading**	A document issued by a carrier to a shipper, listing and acknowledging receipt of goods for transport and specifying terms of delivery.
35	**Batch**	A set of computer data or jobs to be processed in a single program run.
36	**Backup**	A copy of a computer program or data stored separately from the original.
37	**Balance Confirmation**	A methodology used by auditor to confirm the balance from the third party i.e. customer, supplier, banks etc.
38	**Compare (comparison)**	An audit procedure. The auditor observes similarities and differences between items such as an account from one year to the next.
39	**Comparability**	Comparability is one of the key qualities which accounting information must possess. Accounting information is comparable when accounting standards and policies are applied consistently from one period to another and from one region to another.
40	**Collusion**	A secret agreement between two or more parties for fraud or deceit.

41	**Classification**	Arrangement or grouping. Assets and liabilities are normally classified as current or noncurrent.
42	**Check Digit**	A redundant digit added to a code to check accuracy of other characters in the code.
43	**caveat**	A warning or caution.
44	**Capitalized**	It refers to recorded a particular expenses as an asset
45	**Consistency**	To achieve comparability of information over time, the same accounting methods must be followed. If accounting methods are changed from period to period, the effects must be disclosed.
46	**Confirm (confirmation)**	Communication with outside parties to authenticate internal evidence.
47	**Compliance**	Following applicable internal control procedures, rules or laws
48	**Completeness**	It refers to management assertions about completeness deal with whether all transactions and accounts that should be in the financial statements are included. For example, management asserts that all purchases of goods and services are included in the financial statements. Similarly, management asserts that notes payable in the balance sheet include all such obligations of the entity.
49	**Compile (compilation)**	A compilation is presenting in the form of financial statements information that is the representation of management without expressing assurance. Compilation of a financial projection is assembling prospective statements based on assumptions of a responsible party, considering appropriateness of presentation and issuing a compilation report.
50	**Cutoff**	Designating a point of termination. An auditor uses tests of cutoff to obtain evidence that transactions for each year are included in the financial statements of the appropriate year.
51	**Corroborate**	To strengthen with other evidence, to make more certain.
52	**Control Risk**	The risk that material error in a balance or transaction class will not be prevented or detected on a timely basis by internal controls.
53	**Control Policies and Procedures**	Control activities are the policies and procedures that help ensure management directives are carried out. Those pertinent to an audit include performance reviews, information processing, physical controls and segregation of duties.
54	**Control Environment**	Control environment is the attitude, awareness and actions of the board, management, owners and others about the

		importance of control. This includes integrity and ethical rules, commitment to competence, board or audit committee participation, organizational structure, assignment of authority and responsibility and human resource policies and practices.
55	**Control**	A policy or procedure that is part of internal control.
56	**Continuing Accounting Significance**	Means matters normally included in the permanent audit documentation such as the analysis of balance sheet accounts and those relating to contingencies. Such information from a prior year is used by the auditor in the current year's audit and is updated each year.
57	**Continuing Auditor**	He is the auditor of the current year who also audited the financial statements of the client for the previous year.
58	**Detective control**	A control designed to discover an unintended event or result.
59	**Detection risk**	The risk audit procedures will lead to a conclusion that material error does not exist when in fact such error does exist.
60	**Defalcation**	To misuse or embezzle funds.
61	**Disclaimer**	A statement that the auditor is unable to express an opinion as to the presentation of financial statements in conformity with Indian GAAP.
62	**Disclosure**	Revealing information. Financial statement footnotes are one way of providing necessary disclosures.
63	**Edit checks**	Reasonableness, validity, limit and completeness tests that are programmed routines designed to check input data and processing results for completeness, accuracy and reasonableness.
64	**Effectiveness**	Producing a desired outcome. An audit procedure is effective if the evidence supports a correct conclusion.
65	**Efficiency**	The ratio of the audit evidence produced to audit resources used.
66	**Error**	Unintentional misstatements or omissions in financial statements. Errors may involve mistakes in gathering or processing accounting data, incorrect estimates from oversight or misinterpretation of facts and mistakes in application of principles relating to amount, classification, presentation or disclosure.
67	**Estimation Sampling**	Sampling to estimate the actual value of a population characteristic within a range of tolerable misstatement.
68	**Enterprise Risk Management (ERM)**	It identifies risks and opportunities, assesses them for likelihood and magnitude, determines responses strategy and monitors progress. ERM integrates strategic planning, operations management and internal control. Monitoring ERM is part of internal control activities.

69	**Engagement Letter**	A letter that represents the understanding about the engagement between the auditor and auditee. The letter identifies the financial statements and describes the nature of procedures to be performed. It includes the objectives of the procedures, an explanation that the financial information is the responsibility of the company's management and a description of the form of report.
70	**Embezzlement**	To take assets in violation of trust.
71	**Extend**	Extend means to multiply one number by another (to test extensions is to test the accuracy.
72	**Explicitly**	Fully and clearly expressed, leaving nothing implied.
73	**Explanatory Statement**	A paragraph added to an audit report to explain something, such as the reason for a qualified or adverse opinion.
74	**Existence**	Assertions about existence deal with whether assets or liabilities exist at a given date. For example, management asserts that finished goods inventories in the balance sheet are available for sale.
75	**Examine**	As an audit procedure to examine something is to look at it critically.
76	**Fraud**	A deliberate deception to secure unfair or unlawful gain.
77	**Flowchart**	A schematic representation of a sequence of operations in an accounting system or computer program.
78	**General Ledger**	A record to which monetary transactions are posted (in the form of debits and credits) from a journal. It is the final record from which financial statements are prepared. General ledger accounts are often control accounts that report totals of details included in subsidiary ledgers.
79	**GAAS**	"Generally Accepted Auditing Standards."
80	**GAAP**	"Generally Accepted Accounting Principles."
81	**Going Concern Assumption**	Going Concern Assumption assumes the company will continue in operation long enough to realize its investment in assets through operations (as opposed to sale).
82	**Interim Financial Information**	Interim Financial Information is financial statements of a time period less than a full year.
83	**Integrity**	Consistent adherence to an ethical code. If client management lacks integrity the auditor must be more skeptical than usual.
84	**Inspect (Inspection)**	As an audit procedure, to scrutinize or critically examine a document.
85	**Inherent risk**	The susceptibility of a balance or transaction class to error that could be material, when aggregated with other errors, assuming no related internal controls.

86	**Inherent Limitation**	The potential effectiveness of an entity's internal control is subject to inherent limitations. Human fallibility, collusion, and management override are examples.
87	**Independence**	This means freedom from bias, which is possible even when auditing one's own business (independence in fact).
88	**Implicitly**	Implied or understood even though not directly expressed.
89	**Immaterial**	Of no importance. Something in financial statements that will not change decisions of investors.
90	**Internal Control Weakness**	A defect in the design or operation of internal controls. A material weakness is a reportable condition that does not reduce to a relatively low level the risk that material errors or fraud would not be detected in a timely manner by employees in the normal course of their duties.
91	**Internal Control Questionnaire**	A list of questions about the existing internal control system to be answered (with answers such as yes, no, or not applicable) during audit fieldwork. The questionnaire is a part of the documentation of the auditor's understanding of the client's internal controls.
92	**Internal Auditors**	Internal Auditors are employees or independent professionals responsible for providing analysis, evaluations, assurances, recommendations, and other information to the entity's management and board. An important responsibility of internal auditors is to monitor performance of controls.
93	**liquidity**	The availability of cash or ability to obtain it quickly. Debt paying ability.
94	**Just-in-time**	An inventory system that attempts to minimize inventory costs that do not add value for the customer. It arranges for suppliers to deliver small quantities of raw materials just before those units are needed in production. Storing, insuring and handling raw materials are costs that add no value to the product and are minimized in a just in time system.
95	**Journal**	A book of original entry in a double-entry system. The journal lists all transactions and the accounts to which they are posted.
96	**Material**	Information important enough to change an investor's decision. Insignificant information has no effect on decisions, so there is no need to report it. Materiality includes the absolute value and relationship of an amount to other information.
97	**Manual Controls**	Manual Controls are controls performed manually, not by computer.
98	**Management Representation Letter**	A letter addressed to the auditor, signed by the Board representative generally. During an audit, management makes many representations to the auditor. Written representations from management in the letter confirm oral representations given to the auditor, document the continuing appropriateness of such representations and reduce the possibility of misunderstanding

99	**Management Controls**	Management Controls are controls performed by one or more managers.
100	**Mitigating**	Mitigating reducing in force or intensity.
101	**Misstatement**	Misstatement is a difference between the amount, classification, presentation or disclosure of a reported financial statement item and the amount, classification, presentation or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.
102	**Misappropriate**	To embezzle or appropriate dishonestly for one's own use.
103	**Memos**	Memos written records supporting journal entries. Credit memos support credits, while debit memos support debit entries.
104	**Material Weakness**	Material Weakness is a deficiency in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.
105	**Negative Confirmation Request**	The negative form of accounts receivable confirmation asks the client's customer to respond only if the customer disagrees with the balance determined by the client. The positive form asks the customer to respond whether the customer agrees or disagrees with the client's receivable balance. The negative form is used when controls over receivables are strong and accounts receivable consists of many accounts with small balances. The positive form is used when controls are weak or there are fewer, but larger, accounts.
106	**Narrative**	A written description of an internal control system.
107	**Peer Review**	A practice monitoring program in which the audit documentation of one auditor firm is periodically reviewed by independent partners of other firms to determine that it conforms to the standards of the profession.
108	**Opinion Paragraph**	The paragraph in the audit report that expresses the auditor's conclusions.
109	**Opinion**	An auditor's conclusion held with confidence but not substantiated by positive knowledge or proof.
110	**Observe**	Watch and test a client action (such as taking inventory).
111	**Operating Effectiveness**	How an internal control was applied, the consistency with which it was applied, and by whom.
112	**Production Order**	A document that initiates the manufacturing process.
113	**Production cycle**	The portion of an entity that acquires resources and converts them to the product or service for customers.
114	**Procedure**	An action, such as a step performed as part of an audit program or as part of the client's internal controls.

115	**Probable**	A contingent loss is probable if it is uncertain but likely to happen.
116	**Preventative control**	A control designed to avoid an unintended event
117	**Positive Confirmation**	The positive form of receivables confirmation asks the customer to respond whether the customer agrees or disagrees with the client's reported receivable balance.
118	**Persuasive**	It means having the power to influence. Most audit evidence is persuasive, but not conclusive.
119	**Perpetual**	An inventory accounting system updated for each addition to inventory and each issuance from inventory, so the records indicate the exact quantity on hand at any moment.
120	**Permanent Audit Documentation**	Permanent Audit Documentation includes items of continuing accounting significance, such as the analysis of balance sheet accounts and contingencies. Such information from a prior year is used in the current audit and updated each year. Sometimes called the continuing file.
121	**Program**	An audit program is a listing of audit procedures to be performed in completing the audit. A computer program (software) is a listing of steps to be performed in processing the data.
122	**Purchase Order**	A document from a buyer to a seller placing an order and listing quantities and specifications.
123	**Quantitative (Quantitatively)**	Expressed as a number, as opposed to qualitative measurement
124	**Qualitative**	Relating to the quality of a trait, as opposed to quantitative, which means expressed as a number.
125	**Reasonable Assurance**	In auditing, an auditor works within economic limits. The audit opinion, to be economically useful, must be formed in a reasonable time and at reasonable cost. The auditor must decide, exercising professional judgment, whether evidence available within limits of time and cost is sufficient to justify an opinion.
126	**Reliable (Reliability)**	Different audit evidence provides different degrees of assurance to the auditor. When evidence can be obtained from independent sources outside an entity it provides greater assurance of reliability for an independent audit than that secured solely in the entity. More effective internal controls provide assurance about reliability of the accounting data and financial statements. The independent auditor's direct personal knowledge, from physical examination, observation, computation, and inspection, is more persuasive than information obtained indirectly.
127	**Related Parties**	Related parties are those with whom the client has a relationship that might destroy the self-interest of one of the parties (accounting is based on measurement of arm's length transactions). Related parties include affiliates of the client, principle owners, management (decision makers who control business policy) and members of their immediate families.

128	**Reconcile** (**Reconciliation**)	A schedule establishing agreement between separate sources of information such as accounting records reconciled with the financial statements.
129	**Review Evidence**	Review evidence is information used by the accountant to provide a reasonable basis for the obtaining of limited assurance.
130	**Review**	To examine again. The overall review of audit documentation is completed after field work.
131	**Revenue cycle**	The portion of a company that fills customer orders, accounts for receivables and collects those receivables.
132	**Requisition**	A formal written request for something needed. A purchase by a company is initiated internally by a requisition, resulting in the issuance of a purchase order to the outside supplier.
133	**Remote**	A contingency with only a slight chance of occurring. In computer processing of information, a distant computer.
134	**Risk Analysis**	An analysis of the possibility of suffering loss.
135	**Risk Assessment Procedures**	Risk assessment procedures are the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels.
136	**Sample Size**	The number of population items selected when a sample is drawn from a population.
137	**Sampling Error**	Unless the auditor examines 100% of the population, there is some chance the sample results will mislead the auditor. This risk is sampling error. The larger the sample, the less chance of sampling error and the greater the reliability of the results.
138	**Scope**	The type of engagement. The scope of an engagement might be a review, an audit or a compilation. A scope limitation is a restriction on the evidence the auditor can gather.
139	**Scope Paragraph**	The paragraph in the audit report that explains the scope of the engagement.
140	**Subsequent Events**	Subsequent events affect the client and occur between the balance sheet date and issuance of the financial statements. Some such events provide additional evidence about conditions that existed at the balance sheet date, such as the bankruptcy of a customer with a history of financial difficulty. The financial statements are adjusted to reflect this evidence. Conditions that did not exist at the balance sheet date, such as fire that destroyed the client's plant after the balance sheet date, may be so significant as to require disclosure.

141	**Specialist**	An expert at activities not usually done by auditors (such as an appraiser for valuation).
142	**Significant Risk**	Significant risk is an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.
143	**Significant Deficiency**	Significant deficiency is a deficiency in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.
144	**Segregation Of Duties**	Segregation of duties means assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets. Segregation of duties reduces the opportunities for one person to both perpetrate and conceal errors or fraud.
145	**Successor Auditor**	Successor Auditor he auditor of a client for the current year previous. The auditor who no longer audits that client is the predecessor auditor.
146	**Substantive Audit Procedure**	Substantive audit procedure is a direct test of a financial statement balance designed to detect material misstatements at the assertion level. Substantive procedures comprise tests of details (classes of transactions, account balances, and disclosures) and substantive analytical procedures
147	**Subsidiary Ledger**	The detailed information that totals to the balance in the general ledger account. The total of all customer accounts receivable included in the subsidiary ledger of accounts receivable is the balance in the general ledger accounts receivable account.
148	**Substantiated**	Supported with proof or evidence.
149	**Third Parties**	Third parties are all persons, including those charged with governance, except for members of management.
150	**Tolerable Deviation Rate**	Tolerable deviation rate is the maximum rate of deviation from an internal control that will allow the auditor to place the planned reliance on that control.
151	**Tolerable Error/Deviation**	When planning a sample for a substantive test of details, the auditor considers how much deviation may exist without causing the financial statements to be materially misstated. This maximum acceptable deviation is the tolerable error or deviation for the sample.
152	**Valuation**	An assertion made by management that each asset and liability is recorded at an appropriate carrying value.
153	**Variance**	A statistical measure of dispersion in a population. The variance is the square of the standard deviation. The standard deviation equals the square root of the arithmetic mean of the squares of deviations from the arithmetic mean.
154	**Vendors**	Those who provide goods or services to an entity. These are also called suppliers.

155	**Verify (Verification)**	Prove accuracy of numbers or existence of assets.
156	**Vouch**	Prove accuracy of accounting entries by tracing to supporting documents.
157	**Voucher**	A document in support of expenditure. The signature of an appropriate official on the voucher is authorization for the treasurer to issue a check.
158	**Working Papers**	Records kept by the auditor of procedures applied, tests performed, information obtained and pertinent conclusions in the engagement.
159	**Write-off**	Cancellation of part or all of a balance. Costs incurred that have no future utility are charged (written-off) to an expense or loss account, not carried forward as an asset.
160	**Write-up**	In Auditing, it is an intentional increase in the carrying value of an asset.

EXECUTIVE PROGRAMME

COMPANY ACCOUNTS AND AUDITING PRACTICES

EP-CA&AP

TEST PAPERS

A Guide to CS Students

To enable the students in achieving their goal to become successful professionals, Institute has prepared a booklet 'A Guide to CS Students" providing the subject specific guidance on different papers and subjects contained in the ICSI curriculum. The booklet is available on ICSI website and students may down load from *http://www.icsi.edu/Portals/0/AGUIDETOCSSTUDENTS.pdf*

WARNING

It is brought to the notice of all students that use of any malpractice in Examination is misconduct as provided in the explanation to Regulation 27 and accordingly the registration of such students is liable to be cancelled or terminated. The text of regulation 27 is reproduced below for information:

"27. Suspension and cancellation of examination results or registration

In the event of any misconduct by a registered student or a candidate enrolled for any examination conducted by the Institute, the Council or the Committee concerned may suo motu or on receipt of a complaint, if it is satisfied that, the misconduct is proved after such investigation as it may deem necessary and after giving such student or candidate an opportunity to state his case, suspend or debar the person from appearing in any one or more examinations, cancel his examination result, or studentship registration, or debar him from future registration as a student, as the case may be.

Explanation - Misconduct for the purpose of this regulation shall mean and include behaviour in a disorderly manner in relation to the Institute or in or near an Examination premises/centre, breach of any regulation, condition, guideline or direction laid down by the Institute, malpractices with regard to postal or oral tuition or resorting to or attempting to resort to unfair means in connection with the writing of any examination conducted by the Institute".

EXECUTIVE PROGRAMME

COMPANY ACCOUNTS AND AUDITING PRACTICES

TEST PAPER 1

(This Test Paper is for recapitulate and practice for the students. Students need not to submit responses/answers to this test paper to the Institute.)

Time Allowed : 3 Hours *Maximum Marks : 100*

PART A
(Company Accounts)

1. Answer ***ALL*** of the following questions.

(a) Explain the types of leases in the financial statements of lessors as per Accounting Standard 19.

(b) Calculate the maximum annual remuneration payable to a managing director from the information given below :

	₹
Profit for the year (calculated as per the Companies Act, 2013.	50,00,000
Paid-up capital	3,00,00,000
Reserves and Surplus	1,20,00,000
Securities Premium Reserves	20,00,000
Long-term Loans	1,00,00,000
Investments	60,00,000
Preliminary Expenses not written off	5,00,000
Remuneration paid to the managing director during the year	10,00,000
Share Suspense Account representing application money received on shares the allotment of which is not yet due	15,00,000

(c) What is meant by 'B' list contributories? What is the liability of contributories included in this list?

(d) What do you mean by Shareholder Value added? Discuss its benefits and drawbacks.

(e) HCI Ltd. issued 1,000 shares on January 1, 2013, under ESPS at ₹ 20 when the market price was ₹ 50. Pass journal entry assuming that nominal value of a share is ₹ 10.

(*5 marks each*)

Answer all parts of Q. No.2 or 2A

2. (a) On March 2012 Mahesh Ltd., issued 4,000, 7% debentures of ₹500 each at ₹475 each. Debenture-holders had an option to convert their holding into 8% Preference Shares of ₹100 each at a premium of ₹25 per share. On 31st March 2013 one year's interest had accrued on these debentures and remained unpaid. A holder of 100 Debentures notified his intention to convert his holding into 8% preference shares. Journalise the above transactions. (*6 marks*)

(b) Following is the Balance Sheet of NDLP Ltd. as on 31st March, 2013:

Particulars		Amount (₹)
EQUITIES AND LIABILITIES		
Shareholder's Funds		
8% Preference Share Capital :(20,000 x 50)=	10,00,000	
Less :Calls Unpaid (2,000x10) =	20,000	9,80,000
Equity Share Capital : 1,00,000 Shares of ₹10 each ₹7.50 called up	7,50,000	
Less : Calls unpaid	2,500	7,47,500
Securities Premium Reserve		50,000
General Reserves		6,00,000
Calls in Advance		2,500
	Total	23,80,000
Assets		
Non Current Assets		
Fixed Assets		12,25,000
Investments		2,00,000
Current Assets		
Cash at bank		9,55,000
	Total	23,80,000

(i) Fully paid preference shares are redeemed at a premium of 5%.

(ii) 50,000 equity shares of ₹10 each are issued at par, whole amount due and received on applications.

(iii) 1,000 equity shares on which call @₹2.50 per share is unpaid are forfeited.

(iv) Final call of ₹2.50 per share is made and collected.

(v) Forfeited shares are re-issued @ 9 per share credited as fully paid.

You are required to pass journal entries and prepare the revised balance sheet of the company.

(9 marks)

OR

2A. The following Balance Sheet of X Ltd. is given:

Balance Sheet

as on 31st March, 2013

Particulars	Amount (₹)
EQUITIES AND LIABILITIES	
Shareholder's Funds	
5,000 shares of ₹ 100 each fully paid	50,00,000
Profit and Loss Appropriation A/c	21,20,000

Current Liabilities		
Bank overdraft		18,60,000
Trade Payables		21,10,000
Provision for taxation		5,10,000
	Total	1,16,00,000
Assets		
Non Current Assets		4,00,000
GoodwillLand and building at cost		32,00,000
Plant and machinery at cost		28,00,000
Current Assets		
Trade Receivables		20,00,000
Stock		32,00,000
	Total	1,16,00,000

The Loss/Profit for each of the last 5 years was:

2008-2009 ₹ (5,50,000);

2009-2010 ₹ 9,82,000;

2010-2011 ₹ 11,70,000;

2011-2012 ₹ 14,50,000;

2012-2013 ₹ 17,00,000;

Although income-tax has so far been paid @ 40% and the above profits have been arrived at on the basis of such tax rate, it has been decided that with effect from the year 2012-2013 the Income-tax rate of 45% should be taken into consideration. 10% dividend in 2008-2009 and 2009-2010 and 15% dividend in 2010-2011 and 2011-2012 have been paid. Market price of shares of the company on 31st March, 2013 is ₹ 125. With effect from 1st April, 2013 Managing Director's remuneration has been approved by the Government to be ₹ 8,00,000 in place of ₹ 6,00,000. The company has been able to secure a contract for supply of materials at advantageous prices. The advantage has been valued at ₹ 4,00,000 per annum for the next five years.

On the basis of information given, ascertain goodwill at 3 year's purchase of super profit (for calculation of future maintainable profit weighted average is to be taken).

(*15 marks*)

3. The Balance Sheet of Munna Ltd. on 31st March, 2013 is as under:

Particulars	Amount (₹)
EQUITIES AND LIABILITIES	
Shareholder's Funds	
Share capital	
Equity shares of ₹ 100 each	20,00,000

7% Preference shares of ₹ 100 each		10,00,000
Reserves and Surplus		
General Reserve		Nil
Less: P&L A/c Dr. Balance		(7,00,000)
Non Current Liabilities		
Current Liabilities		
Bank Overdraft		3,00,000
Trade Payables		7,00,000
	Total	33,00,000
Assets		
Non Current Assets		
Plant and machinery		18,00,000
Goodwill		2,00,000
Current Assets		
Stock		3,00,000
Cash at bank		1,50,000
Trade Receivables		7,50,000
Preliminary Expenses		1,00,000
	Total	33,00,000

Two years' preference dividends are in arrears. The company had bad time during the last two years and hopes for better business in future, earning profit and paying dividend provided the capital base is reduced.

An internal reconstruction scheme as follows was agreed to by all concerned:

(i) Creditors agreed to forego 50% of the claim.

(ii) Preference shareholders withdrew arrear dividend claim. They also agreed to lower their capital claim by 20% by reducing nominal value in consideration of 9% dividend effective after reorganization in case equity shareholders' loss exceed 50% on the application of the scheme.

(iii) Bank agreed to convert overdraft into term loan to the extent required for making current ratio equal to 2 : 1.

(iv) Revalued figure for plant and machinery was accepted as ₹ 15,00,000.

(v) Debtors to the extent of ₹ 4,00,000 were considered good.

(vi) Equity shares shall be exchanged for the same number of equity shares at a revised denomination as required after the reorganisation.

Show:

(a) Total loss to be borne by the equity and preference shareholders for the reorganization;

(b) Share of loss to the individual classes of shareholders;

(c) New structure of share capital after reorganization;

(d) Working capital of the reorganized Company; and

(e) A proforma balance sheet after reorganization. *(3 marks each)*

4. The Balance Sheets of Rose Ltd. and its subsidiary Lotus Ltd. as on 31st March, 2013 are as under:

Particulars	***Rose Ltd.* Amount (₹)**	***Lotus Ltd.* Amount (₹)**
EQUITIES AND LIABILITIES		
Shareholder's Funds		
Share capital		
Equity shares of ₹ 10 each	48,00,000	20,00,000
10% Preference shares of ₹ 10 each	7,00,000	3,80,000
Reserves and Surplus		
General Reserve	5,50,000	4,20,000
Profit & Loss A/c	10,00,000	6,00,000
Non Current Liabilities		
Current Liabilities		
Bank Overdraft	1,20,000	70,000
Trade Payables	4,30,000	4,80,000
Bills payables	NIL	1,60,000
Total	76,00,000	41,10,000
Assets		
Non Current Assets		
Plant and machinery	12,00,000	5,00,000
Motor vehicles	9,50,000	7,50,000
Furniture and Fittings	6,50,000	4,00,000
Goodwill	4,50,000	3,00,000
Investments	26,00,000	4,50,000
Current Assets		
Stock	4,50,000	7,20,000
Cash at bank	2,25,000	2,10,000
Trade Receivables	9,30,000	7,80,000
Bills receivable	1,45,000	NIL
Total	76,00,000	41,10,000

Details of acquisition of shares by Rose Ltd. are as under:

Nature of shares	*No. of shares acquired*	*Date of acquisition*	*Cost of acquisition*
Preference shares	14,250	1.4.2010	₹ 3,10,000
Equity shares	80,000	1.4.2011	₹ 9,50,000
Equity shares	70,000	1.4.2012	₹ 8,00,000

Other information:

(i) On 1.4.2012 profit and loss account and general reserve of Lotus Ltd. had credit balances of ₹ 3,00,000 and ₹ 2,00,000 respectively.

(ii) Dividend @ 10% was paid by Lotus Ltd. for the year 2011-2012 out of its profit and loss account balance as on 1.4.2012. Rose Ltd. credited its share of dividend to its profit and loss account.

(iii) Lotus Ltd. allotted bonus shares out of general reserve at the rate of 1 share for every 10 shares held. Accounting thereof has not yet been made.

(iv) Bills receivable of Rose Ltd. were drawn upon Lotus Ltd.

(v) During the year 2012-2013 Rose Ltd. purchased goods from Lotus Ltd. for ₹ 1,00,000 at a sale price of ₹ 1,20,000. 40% of these goods remained unsold at close of the year.

(vi) On 1.4.2012 motor vehicles of Lotus Ltd. were overvalued by ₹ 1,00,000. Applicable depreciation rate is 20%.

(vii) Dividends recommended for the year 2012-2013 in the holding and the subsidiary companies are 15% and 10% respectively.

Prepare consolidated Balance Sheet as on 31st March, 2013.

(15 marks)

PART B
(Auditing Practices)

5. (a) In “Joint Audit”, each joint auditor is responsible only for the work allocated to him. Comment.

(b) Distinguish between CAG audit and special audit.

(c) Mr. Kishore, a practicing Chartered Accountant was appointed by the Central Government to carry out a special audit. He accepted the appointment and proceeded with the work without communicating to the statutory auditor of the company. Comment.

(*5 marks each*)

Answer all parts of either Q. NO.6 or Q. No.6A

6. Answer the following:

(a) What are audit working papers? Explain the contents of permanent and current audit file.

(b) Explain the internal control review points for reviewing the decision making process of management.

(c) Explain the role of internal audit in corporate governance and risk management.

(*5 marks each*)

OR

6A. (a) Define internal control and explain different techniques of internal control system.

(b) What do you mean by verification? State the difference between verification and vouching.

(c) What do you mean by audit plan? State the reasons why audit plan are prepared?

(5 marks each)

TEST PAPER 2

(This Test Paper is for recapitulate and practice for the students. Students need not to submit responses/answers to this test paper to the Institute.)

Time allowed: 3 hours *Max Marks: 100*

NOTE: All working notes should be part of the answer.

PART A
(Company Accounts)

1. Answer ***ALL*** of the following questions.

(a) Santosh Ltd. was formed with a capital of ₹20,00, 000 divided into 2,00,000 equity shares of ₹10 each. All shares were issued to public for subscription. The issue was underwritten as follows: Alok: 80,000 shares; Benny: 60,000 shares; and Chopra : 60,000 shares. Marked applications were received in favour of Alok for 32,000 shares; Benny for 58,000 shares and Chopra for 42,000 shares. Applications for 30,000 shares were not marked. Prepare a statement showing net liability of each underwriter.

(b) Enumerate the grounds on which a company may be wound up by the court.

(c) What are the desirable conditions for internal re-construction.

(d) What do you mean by Economic Value added (EVA)? How is EVA related to valuation?

(e) Discuss the concept of corporate financial reporting and its requirement in India.

(*5 marks each*)

2. Ashok Ltd., invited applications for the issue of 1,00,000 equity shares of ₹10 each payable ₹4 on application, ₹5 (including ₹3 as securities premium) on allotment and balance on first and final call. The prospectus provided that in case of partial allotment, money received in excess on application would be adjusted towards the amounts due on allotment and call. The company received applications for 2,50,000 shares out of which applications for 50,000 shares were rejected out rightly and other applicants were allotted shares on pro-rata basis. The company received all moneys due on allotment and call except from one shareholder (who applied for 2,000 shares) who failed to pay the allotment and the call moneys. The company forfeited his shares.

Out of the forfeited shares, the company reissued 600 shares at the rate of ₹8 per share, fully paid up.

You are required to journalise the above transactions show the relevant items in the balance sheet of the company. (*15 marks*)

OR

Snow View Ltd., was registered with an authorised capital of 1,00,000 Equity Shares of ₹10 each and it acquired the business of Mr. Bansal at an agreed price of ₹2,50,000.

The Balance Sheet of Mr. Bansal at the date of acquisition was as follows:

Liabilities	₹	Assets	₹
Capital	2,00,000	Freehold Premises	1,00,000
Reserve	20,000	Plant and Machinery	80,000
Sundry Creditors	50,000	Stock	20,000
Bills Payable	30,000	Debtors	27,500

		Less: Provisions	2,500
		Cash at Bank	75,000
	3,00,000		3,00,000

The consideration was to be discharged by the issue of 20,000 equity shares of ₹10 each as fully paid-up and the balance in cash.

You are asked to journalise the transactions in the books of Snow View Ltd. Also prepare the opening balance sheet of the company. (*15 marks*)

3. Answer the following questions:

(a) The following is the balance sheet of Soft Ltd. as on 31st March, 2012 :

Liabilities:	(₹)
Share Capital :	
4,00,000 Equity of ₹10 each, fully paid-up	40,00,000
4,00,000 Equity of ₹10 each, paid-up ₹7.50 per share	30,00,000
4,00,000 Equity of ₹10 each, paid-up ₹5 per share	20, 00,000
Reserves and surplus	56, 00,000
Provision for bad debts	1, 20,000
Sundry creditors	20, 40,000
Dividend equalization fund	6, 40,000
	1, 74, 00,000
Assets:	
Patent and Copyrights	8, 00,000
Land and buildings	48, 00,000
Plant and machinery	48, 00,000
Stock	24, 00,000
Investments at Cost	6, 00,000
Debtors	32, 00,000
Bank	6, 40,000
Preliminary expenses	60,000
	1, 74, 00,000

Additional information is as follows:

(i) The normal average profit (after tax) for the company is estimated to be ₹21,60,000.

(ii) The applicable capitalization rate is 12%.

(iii) The revised values of –

- Patent and copyrights are estimated @ 50% of its value; and

- Land and buildings and plant and machinery are revalued at ₹60,00,000 and ₹52,00,000 respectively.

(iv) Investments have a market value of ₹ 7,20,000.

(v) Provision for bad and doubtful debts to be maintained @ 2%.

(vi) The balance sheet as on 31st March, 2012 does not contain a provision for income-tax, which are estimated at ₹3,00,000.

You are required to calculate the value of fully and partly paid-up equity share (per share) by:

- the asset backing method (excluding goodwill) on the notional call method; and
- the earning capacity method.

(*10 marks*)

(b) Mention the basis of apportionment which you will adopt for each one of the following expenses, while calculating profit prior to incorporation and profit after incorporation. Also briefly state your reason in each case.

(i) Salaries

(ii) Bad debts

(iii) Audit fee

(iv) Interest to vendors

(v) Preliminary expenses (*5 marks)*

4. From the following balance sheets of Vipul Ltd. and its subsidiary Vedika Ltd. as on 31st March, 2013 and the additional information provided thereafter, prepare the consolidated balance sheet of the two companies as on that date:

EQUITIES AND LIABILITIES	***Vipul Ltd. Amount (₹)***		***Vedika Ltd. Amount (₹)***	
Shareholders' funds				
Share Capital				
Authorised, Issued subscribed and paid up capital				
Equity shares of ₹ 10 each, fully called up and paid up		10,00,000		2,00,000
Reserve and surplus				
General reserve	3,10,000	-		
Profit and Loss A/c	1,50,000	4,60,000	40,000	40,000
Current Liabilities				
Sundry Creditors	2,30,000	**2,30,000**	69,000	69,000
TOTAL		**16,90,000**		**3,09,000**
ASSETS				
Non-current Assets				
Fixed Assets				

Fixed Assets		11,62,000	1,80,000	
Long term Investment	-			
Shares in Vedika Ltd. (at cost		1,42,000		-
Current Assets				
Current Assets		3,86,000		1,24,000
Discount on issue of shares	-			5,000
TOTAL		16,90,000		3,09,000

On 31st December, 2012 Vipul Ltd. acquired the shares in Vedika Ltd. On 1st April, 2012, Vedika Ltd.'s profit and loss account showed a debit balance of ₹8,000. On 31st March, 2013, Vedika Ltd. decided to revalue its fixed assets at ₹ 2,00,000.

(15 marks)

PART B
(Auditing Practices)

5. (a) Define the term internal audit and differentiate it with statutory audit.
   (b) Explain the basic principles governing an audit
   (c) What is special audit? Under what circumstances special audit is done?

(*5 marks each*)

Attempt all parts of either Q.No. 6 or 6A

6. (a) Define internal control and explain different techniques of internal control system.
   (b) Explain the internal control review points for reviewing the marketing function of an organization.
   (c) S Ltd. issued Bonds to the tune of ₹ 100 lacs and provided security to the tune of ₹ 80 lacs for the same. It insists that it will disclose the Bonds as "Secured" in the Balance Sheet of the Company. Comment.

(*5 marks each*)

OR

6A. (a) As an internal auditor of ABC Ltd. you are required to prepare internal control questionnaire for review of purchase operations.
   (b) What do you mean by verification? Differentiate verification and vouching.
   (c) What do you mean by sampling? Explain the factors to be considered while selecting a sample.

(*5 marks each*)