

# CORPORATE FINANCIAL ACCOUNTING

Lesson 1 to 8

Dr. Kuldeep Kumar Attri



*International Centre for Distance Education &  
Open Learning Himachal Pradesh University,  
Summer Hill, Shimla – 171005*

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**MC 2.1**  
**CORPORATE FINANCIAL ACCOUNTING**

**Max Marks 80**

**Internal Assessment 20**

**Note:** There will be nine (9) questions in all. The first question is compulsory and consists of ten (10) short-questions having two (2) marks each. The candidate will be required to attempt one question from each unit and each question carries fifteen (15) marks.

**Course Contents:**

- Unit I** Accounting for issue, forfeiture and re- issue of shares. Accounting for issue and redemption of debentures.
- Unit II** Final Accounts of Companies. and Insurance Company Accounts.
- Unit III** Accounting issues related to Amalgamation in the nature of merger and purchase and Reconstruction of Companies. Accounts related to Liquidation Of Companies.
- Unit IV** Accounting for Holding and Subsidiary Companies. Royalty Account.

**References**

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**Lesson-1**  
**ACCOUNTING RELATING TO ISSUE AND FORFEITURE OF SHARES**

**STRUCTURE**

- 1.0 Learning Objectives
- 1.1 Introduction
- 1.2 Share Capital and Shares
- 1.3 Issue of Shares
- 1.4 Making Calls
- 1.5 Forfeiture of Shares
- 1.6 Re-Issue of Forfeited Shares
- 1.7 Redemption of Preference Shares
- 1.8 Summary
- 1.9 Glossary
- 1.10 Answers: Self Assessment
- 1.11 Terminal Questions
- 1.12 Suggested Readings

**1.0 LEARNING OBJECTIVES**

After studying the lesson, you should be able to understand:

1. The meaning of share Capital
2. Classes of shares
3. Issue of shares and its procedure
4. Forfeiture of shares
5. Reissue of forfeited shares

**1.1 INTRODUCTION:**

Sec. 209 lays down the rule regarding the maintenance of books of accounts by a company. It states that a company shall maintain such books which will give a true and fair picture in respect of:

(a) all sums of money received and expended by the company and the matter in respect of which the receipt and expenditure take place; (b) all sales and purchases of goods by the company; (c) all assets and liabilities of the company; and (d) such particular regarding utilization of material or labour or to other items of cost as may be prescribed by the Central Government in case the company belongs to a class of companies engaged in manufacturing, processing and mining.

Sub-Section (3) of section 209 requires that the books to be maintained must give a true and fair picture of the state of affairs of the company and to explain its transactions.

Books should be maintained on the Double Entry System. The Books maintained by a company must be preserved for a minimum period of eight years.

These books of accounts are open to inspection of directors, the Registrar and officers authorized by the Central Government. Books of Accounts are to be maintained at the registered office. However, the Board of Directors may decide to keep the Books of accounts at a place other than the registered office (but only in India); and with seven days of the decision of the Registrar should be notified of the full address (where books are kept). Books, relating to various branches of a company can be kept at the branches but proper summarized returns must be sent by the branch officers to the registered office (or where the company is keeping-books of accounts) at least quarterly.

## **1.2 SHARE CAPITAL AND SHARES**

The terms share capital and shares are not defined by the Companies Act. In simple words, the capital which can be subscribed by owners, called shareholders, is known as the share capital of company. This share capital is divided into so many shares. Sec. 2 (46) of Companies Act, 1956 states that a share is a share in the share capital of the company and includes stock except where a distinction between stock and shares is expressed or implied. Shares-are numbered and are transferable like any other moveable property. Different natures of share capital are.

1. **Authorized share capital:** It is maximum amount of share capital which a company is authorized to issue under its memorandum of association.
2. **Issued share capital:** It is the face value of that part of the authorized capital which is issued to the public for subscription.
3. **Called-up share capital:** It is that part of the face value of the issued capital for which payment has been demanded.
4. **Paid up share capital:** It is that part of the called up capital for which payment has been received.

### **Classes of shares:**

After passing, of the Companies Act 1956 a public company can issue only two types of shares. (i) Preference share and (ii) Ordinary or Equity shares.

Preference share capital, according to the Companies Act, is that which fulfils the following two conditions:

1. Has a preferential right as to the payment of dividend.
2. Has a preferential right as to its return if a Company go into liquidation or pays back share capital.

Equity or Ordinary share capital is that part of the share capital which is not preference share capital. However, a private company can issue any type of share. Hence it can issue deferred shares which used to be issued by public companies prior to the Companies Act, 1956. Such shares were issued with the object of controlling the management as these shares carried disproportionate voting rights. By investing a very small amount of funds directors could control the company.

## **1.3 ISSUE OF SHARES**

In the case of public issue of shares following procedure is adopted :

1. **Issue of Prospectus:** The company issuing shares issues prospectus which is an invitation to the general public to subscribe the shares. The Companies Act lays down the contents which must be included in the prospectus.
2. **Receipt of Applications:**  
In response to the prospectus, which also contains an application from people they send their application for the purchase of shares.
3. **Allotment of shares :** On receipt of the application, the Board of Directors meets and allots shares in accordance with the procedure as laid down in Sec. 69 of the Companies Act. It lays down the following conditions for allotment of shares by a public company:
  - (i) Minimum Subscription, the amount which must be raised by a company, has been subscribed.
  - (ii) At least 5% of the nominal value of shares has been paid to and received by the company is cash (Sec. 69).
  - (iii) On the basis of the conditions stated in (i) it is necessary to allot shares within 120 days of the issue of prospectus. If shares cannot be issued within 120 days, the money received must be returned within the next 10 days without interest. After the expiry of one hundred and thirtieth day, directors shall be personally liable to return the money along with interest at the rate of 60% per annum. However, directors may not be liable to pay interest if it is provided that the delay in repayment was not due to misconduct or negligence on their part (Sec. 69).
  - (iv) Where a company does not issue a prospectus it shall not allot any share or debenture unless a statement in lieu of prospectus has been filled with the Registrar Companies at least three days before the allotment of shares (Sec. 70).
  - (v) Allotment can be made only after the expiry of the fourth day of the issue of prospectus or such later day which is given in the prospectus.
4. **Receipt of Shares Money :** They are informed by way of an allotment letter and are asked to pay allotment money on or before a certain day.
5. **Return of Application Money:**  
Application money is returned to an Applicant to whom shares are not allotted.
6. **Deposit in Bank :**  
The Act lays down that money received with applications should be deposited in a Scheduled Bank until the company has obtained certificate to commence business or where such certificate has already been received until the entire amount payable on applications for shares in respect of the minimum subscription has been received by the company.

## **ACCOUNTING ENTRIES FOR THE ISSUE OF SHARES**

A company may issue share for cash and for consideration other than cash. The company issues share for cash in response to their applications which will result from the company's prospectus (only in case of public companies). The prospectus mentions the number of shares offered to the public (known as issued capital) but the number applied for may exceed or fall short of the number of shares offered. When the number of shares applied for exceed the number of share offered, it is known as 'OVER

SUBSCRIPTION' since the 'normal value' of shares is received in various parts like application, Allotment, 1st call etc. The treatment in the accounting entries can be shown as follows:

### 1. WHEN THE NUMBER OF APPLICATION RECEIVED IS EQUAL TO THE NUMBER OF SHARES OFFERED TO THE PUBLIC

#### On the receipt of application money:

- (i) Bank A/c....Dr. (No. of shares applied for)  
       To share application A/c (the application money per share)  
 (Being the sum of money received on this number..... shares) @Rs.....per share)

Since the 'application money' is a part of the share capital therefore, the money should be transferred to "share capital A/c" by passing the following Journal Entry:

- (ii) Share application A/c... Dr.  
       To share capital A/c  
 (The application money being transferred to share capital)

#### On making allotment and receipt of money.

- (i) Share allotment A/c... Dr. (No. of Shares × allotment money per share)  
       To share capital A/c  
 (Being the amount due on allotment on....share @ Rs.....per share)
- (ii) Bank A/c.....Dr.  
       To share allotment A/c  
 (Being the allotment money received on..... shares @ Rs.....per share)

Similarly the entries can be passed for 1st and final call also.

**If the question requires the preparation of 'Cash Book', in that connection the 'Bank' entries are not passed but they are shown in the 'cash book' as follows:**

#### CASH BOOK

Rs.	
<b>To share application Account (Application money on..... share @ Rs.....per share</b> <b>To Share allotment Account (Allotment money on.....shares @ Rs.....per share)</b>	

### 2. OVER-SUBSCRIPTION OF SHARES

Whenever the number of the applicants exceed the number of shares offered to the public in the prospectus, this is called 'over-subscription'. But the Companies Act, lays down that a company cannot issue the shares more than the offered shares in the prospectus. Therefore, a company can adopt any of the following remedies.

**(a) Rejection of the extra-applications :**

Sometimes the company rejects the extra-applications received, with the consequence the application money of these applications has to be returned. The following entry may be made in this connection:

- |      |                             |  |
|------|-----------------------------|--|
| (i)  | Bank A/C.. Dr.              | (No. of application x application money per share) |
|      | To Share application A/c    |  |
| (ii) | Share application A/c...Dr. | (Total amount received)                            |
|      | To share capital A/c        | (Normal amount to be transferred)                  |
|      | To Bank A/c                 | (Amount to be returned)                            |

**(b) Pro-Rata distribution of shares:**

Sometimes the company makes a proportionate distribution of shares in that case the money on extra-application may be adjusted towards the allotment. With the consequence the actual amount to be received on account of allotment will be reduced. For example, a company offers to the public 10,000 shares and the applications are received for 15,000 shares. In this method the ratio will be 15,000 : 10,000 or 15 : 10 i.e. if a person applies for 15 shares, he will get only 10 shares. The Balance application money of five shares will be transferred to 'Allotment A/c'. In this connection the Journal Entries will be:

- |      |                           |   |
|------|---------------------------|---|
| (i)  | Bank A/c Dr.              | (Total application money (received)             |
|      | To share application A/c  |   |
| (ii) | Share application A/c Dr. | (Total application money received)              |
|      | To share capital A/c      | (Nominal value to be transferred)               |
|      | To share allotment A/c    | Extra application on which Pro-rata is applied. |

Partly rejection and party pro-rata of shares : In this connection, the company does not reject all the extra applications but only a part of it and on the rest of the applications 'prorata' is applied. For example if a company invites application for 10000 shares and application are received on 15000 shares. In this case extra applications are 5000. The company returns the 'application money' on 2500 application. Then the prorata will be applied only on 12,500 shares i.e. 12500: 10000 or 5: 4. The journal entry in this connection will be:

- |      |                               |  |
|------|-------------------------------|--|
| (i)  | Bank A/c.. ..Dr.              | Total application money  |
|      | To share application A/c      |  |
| (ii) | Share application A/c.... Dr. | Total money received   |
|      | To Share capital A/c          | Nominal value to be transferred  |
|      | To share allotment A/c        | Application money of the extra application on which pro-rata is applied. |
|      | To Bank A/c                   | Extra application on which money is returned                             |

The student will note that the sums received along with the application for shares must either be transferred to the Share Capital Account (for shares allotted) or transferred to share allotment Account (Surplus money on partially accepted applications or to Calls in Advance Account surplus remaining after adjusting the amount due on allotment) or refunded. The share Application Account will therefore, show no balance after entries on allotment of shares have been completed.

**ILLUSTRATION :** X Ltd., issued a prospectus inviting applications for 1,00,000 equity shares of Rs. 10 each, payable as to Rs. 2 with application, Rs. 3 on allotment and the balance at the discretion of the Directors. The total number of applications amounted to 1, 20,000 shares. The directors allotted as follows:

- to applicants of 80,000 shares...full allotment
- to applicants of 30,000 shares...20,000 shares.
- to applicants of 10,000 shares...nil.

Give journal entries assuming all the sum due on allotment has been received and no call has been made.

**Solution :**

**JOURNAL ENTRIES**

	<b>Dr.</b>	<b>Cr</b>
Bank A/c      ...Dr.	2,40,000	
To Share Applications A/c		2,40,000
(Application money @ Rs. 2 on 1,20,000 shares applied for)		
Share Application. A/c .. Dr.	2,00,000	
To Share Capital A/c		2,00,000
(Application money on 1,00,000 shares allotted transferred to Capital A/c as per Directors resolution no.... dated....)		
Share Allotment A/c      ...Dr.	3,00,000	
To Share Capital A/c		3,00,000
(Amount due on 1,00,000 share on allotment @ Rs. 3 per share).		
Share Application A/c ...Dr.	20,000	
To Share Allotment A/c		20,000 (Transfer of
surplus application money on 10,000 shares (30,000 applied for minus 20,000 shares allotted) to Allotment A/c)		



On Allotment Rs. 3

On first and final call Rs. 4

Applications were received for 30,000 shares. The Board allotted the shares as follows. Application money was returned on 5000 shares. Pro-rata allotment was made for other applications and money received on such applications was transferred to the allotment and call accounts. Various calls were made and received except that on final call money was not received on 200 shares. Record entries in the journal of the company.

**Solution:**

**JOURNAL ENTRIES**

	<b>Dr</b>	<b>Cr</b>
	<b>Rs.</b>	<b>Rs.</b>
Bank A/c Dr.	90,000	
To Equity Share Application A/c (for application money received)		90,000
Equity Share Application A/c Dr.	90,000	
To Equity Share Capital A/c		30,000
To Equity Share Allotment A/c		30,000
To Equity Share Final Call A/c		15,000
To Bank A/c		15,000
(Applications disposed off as per the resolution of the Board of Directors dated.....)		
Equity Share Allotment A/c Dr.	30,000	
To Equity Share Capital A/c (for allotment) money made due)		30,000
Equity Share Final Call A/c Dr.	40,000	
To Equity Share Capital A/c (for final call) money made due)		40,000
Bank A/c Dr.	24,500	
To Equity Share Final Call A/c (for final call) money received)		24,500

**Note:** — the amount received on final call Account arrived at as under:

Total call money	Rs. 40,000
Less call money received in Advance	15,000
(Transferred from the application A/c)	25,000

The 'share call' money being not received on 200 Shares can also be calculated as follows:

Pro-rata ratio is 10,000: 25,000 or 4: 10

The reason who is holding 200 shares must have applied for

$$10/4 \times 200 = 500 \text{ shares.}$$

∴ Total money received is  $500 \times 3 = \text{Rs. } 1500$

∴ The money Share capital a/c on account of share application is  $200 \times 3 = \text{Rs. } 600$

Money transferred to allotment a/c is  $200 \times 3 = \text{Rs. } 600$

Money transferred to first call is Rs. 300

Therefore, the actual amount due for first-final call 200 shares @ Rs. 4 = Rs. 800. The amount already received is Rs. 300. Hence the balance amount not received is  $\text{Rs. } 800 - 300 = \text{Rs. } 500$  Less amount not received on 200 Equity share @ Rs. 2.50 per share

(Rs. 20,000/10,000)	500
Amount received	24,500

Note 2

Bank A/c

To Share Allotment A/c  
(Amount Received on Allotment)

This entry will not be made because allotment money already has been received with the Application money as in excess Rs. 30,000

### Issues of shares at premium:

When share are issued at a price higher than the face value (or par value they are said to be issued at a premium, the premium being the difference between the issue price and the face value. If a share of Rs. 100 is issued for Rs. 105, Rs. 5 is the premium. There are no restrictions on its issue of shares at a premium but there are restrictions on its disposal. The amount received as premium has to be credited to a separate account called "Share Premium Account". It can be applied by the company (according to Sec. 78) for:

- (i) Issuing fully paid bonus shares to the member;
- (ii) Writing of the preliminary expenses of the company;
- (iii) Writing off the expenses or the commission. Paid or discount allowed on any issue of shares or debentures of the company; or
- (iv) In providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company.

If the company wants to utilize the premium for any other purpose it will have to obtain the consent of the court.

### ENTRIES TO BE MADE

The amount should be debited (along with the installment due in respect of share capital) to the particular Call Account (or Allotment Account) and credit to the State premium Account. For example, if

a share of Rs. 100 is issued at Rs. 110, the premium being payable on allotment when Rs. 25 is payable on account of share capital also, the entry will be:

	Rs.	
Share Allotment Account ...Dr.	Rs. 35(25+10)	
To Share Capital Account		25
To Share Premium Account		10

When the amount is received, the whole amount will be credited to the Share Allotment Account Thus:

	Rs.	Rs.
Bank Account Dr.	35	
To Share Allotment A/c		35

Alternatively, the Premium Account may be credited only when cash is received. In the above example, then the following entries will be necessary:

		Rs.
(i) Share Allotment Account ..... Dr.	25	
To Share Capital Account		25
(iii) Bank Account ..... Dr.	35	
To Share Allotment Account		25
To Share Premium Account		10

In view of the restrictions placed by Section 78 it is better to follow the alternative method.

Usually, the Company collects the premium along with allotment. But it may be received with application or with call also.

If Received with Application

Bank A/c ...Dr.

To Share Application A/c  
(Amount Received with Application)

Share Capital A/c

To Share Capital A/c  
To Share Premium A/c  
(Amount Transferred)

### **CALLS IN ARREAR ACCOUNT:**

Certain companies follow the practice of closing the various call accounts by transferring the balance to calls in Arrear Account. The entry in this case will be:

Calls in Arrear Account ...Dr.

To Share First Call Account

To Share Final Call Account

**The accounts still due on these calls:**

If and when cash is received, the credit will go to the calls in Arrear Account.

**Self Assessment**

Fill in the blanks:

1. A Public Company Limited by shares must have at least..... members.
2. A Private Company should have at least..... members.
3. Shareholders are the ..... of the company.
4. Rate of dividend for equity shares is..... fixed.
5. The ..... of the company defines the objectives of the company.
6. Minimum subscription has been determined at ..... of the total issue.
7. The nature of share application account is.....
8. A public limited company must have at least ..... directors.
9. The director of a public limited company must be a.....

**1.5 FORFEITURE OF SHARES**

If a member of the company does not pay the call money as per the demand notice, his shares can be forfeited as per the provisions of the Articles of Table A. But if forfeiture is done, it is necessary for the company to give a proper notice regarding the calls-in-arrear and the interest due thereon. The notice give the shareholder last chance to pay the money on shares up to a given date. If the shareholder is unable to meet his obligation, the directors may pass a resolution, forfeiting his shares. Provisions of Table A shall apply to the obligation of a number whose shares have been forfeited.

Firstly, he shall cease to be a member in respect of forfeited shares. Secondly, however, he shall remain liable to pay money which was due on the date of forfeiture up to the date on which the Shares are fully paid-up. The entries to be made must record the fact that due to the cancellation of the shares, the share capital is reduced. Hence the share capital should be debited with the amount credited to Share Capital Account in respect of the forfeited shares. The credit should be to the various call accounts that are in arrear and to the Shares Forfeited Account (with the amount actually received).

Thus

Share Capital Account	Dr.	No, of shares forfeited x the amount called up per share
To various Calls Accounts		the amount that remains unpaid.
To Share Forfeited A/c.		The amount already received

There are three different situation under which forfeiture is affected. They are :

- (i) when shares are issued al par;
- (ii) when shares are issued at premium and
- (iii) when shares are issued at discount

**FORFEITURE OF SHARES ISSUED AT PAR****ILLUSTRATION 3:**

A company issued shares of Rs. 10 each payable Rs. 2 on application. Rs. 4 on allotment and Rs. 4 on first and final call. All who were holding 100 shares, failed to pay the allotment money and his shares were forfeited. Singh, a holder of 50 shares failed to pay the final call. His shares were also forfeited. Pass necessary journal entries in the books of the company.

**Solution:****JOURNAL ENTRIES**

	Rs.	Rs.
Share Capital A/c ...Dr.	600(100x6)	
To Share Forfeited A/c		200(100x2)
To Share Allotment A/c		400(4x100)
(for forfeiture of 100 shares held by All as per the resolution of the Board of Directors dated.....)		

Share capital A/c ....Dr.	500(50x10)	
To Share Forfeited A/c		300(50x6)
To Share Final Call A/c.		200(50x4)
(for forfeiture of 50 shares held by Singh as per the resolution of the Board of Directors dated.....)		

**FORFEITURE OF SHARES ISSUED AT DISCOUNT**

When shares issued at a discount are forfeited, it is also necessary to make appropriate entry in the discount account regarding the amount of discount allowed on forfeited shares. At the time when discount is allowed, the Discount on issue of shares Account is debited; so when forfeiture takes place, this account is credited.

**ILLUSTRATION :**

Raghvan held 200 shares of Rs. 10 each in a company. These shares were issued at a discount of 10%. He paid the application money, Rs. 3 but failed to pay the allotment call Rs. 3. His shares were forfeited by the company. Pass the journal entry.

**Solution :****JOURNAL ENTRIES**

	Rs	Rs
Share capital Account ...Dr.	1400(200x7)	
This amount also includes Rs. 1 per share of Discount.		
To Share Forfeited A/c		600 (200x3)
To Share Allotment A/c		600(200x3)

To Discount on Issue of Shares A/c 200(200x1)  
 (For forfeiture of 200 shares held by Raghav  
 as per the resolution of the Board dated.....)

### FORFEITURE OF SHARES AT PREMIUM:

The following rules must be noted:

- (i) Amount of premium collected so far cannot be cancelled and shall remain in the Share Premium Account (Sec. 78).
- (ii) Amount of premium not collected so far, but for which the Share Premium Account has been credited, should be ascertained. The Share Premium Account should now be debited with this amount not collected so far.

### ILLUSTRATION:

Chanda Food Ltd. issued shares for Rs. 10 each at a premium of Rs. 2 per share; Rs. 3 on application; Rs. 4 on allotment (including premium); Rs. 2 on 1st and Rs. 3 on final call. Chander holder of 100 shares fails to pay the allotment money and 1st call. Dutta, holder of 200 shares, fails to pay the 1st call. Their shares were forfeited subsequently. Record the entries in the journal of the company.

### Solution:

#### JOURNAL ENTRIES

	Rs.	Rs.
Share Capital A/c ...Dr.	700 (100x7)	
Share Premium A/c ...Dr.	200 (100x2)	
To Share Forfeiture A/c		300
To Share Allotment A/c		400
To Share 1st call A/c		200
(for forfeiture of 100 shares held by Chander as per the resolutions Board of Directors dated.....)		
Share Capital Account ...Dr.	1400 (200x7)	
To Share Forfeiture A/c		1000
To Share 1st call A/c		400

(for forfeiture of 100 shares held by

Dutta as per the resolutions Board of Directors dated.....)

**Note:** Student is advised to note the difference between the two entries. In the first case, the amount of premium is yet to be realized and hence the Share Premium Account has been debited. In the second case, the amount of premium has been realized and this amount is involved in the forfeiture process.

### 1.6 RE-ISSUE OF FORFEITED SHARES:

The Companies Act allows the re-issue of forfeited shares subject to the provisions of the Articles Association. For accounting purposes, the following facts should be noted:

**1. Re-issue price:** The Companies Act states that a company can re-issue such shares at any price it likes except that in no case the concession or discount allowed on reissue should be more than the amount forfeited on relevant share.

**Example:**

- (i) Rs. 4 have been received on a forfeited share of 10. It can be re-issued as fully paid up share at Rs. 6 (Rs. 10-Rs. 4 the amount forfeited).
- (ii) Rs 4 have been received on a forfeited share of Rs. 10 on which Rs. 8 have been called up. It can be reissued at Rs. 8 paid up share for Rs. 4.

**2. Entry For Re-issue and Concession or Discount :** The new shareholder gets the benefit, a concession which should now be charged to the Forfeited Account. The following entry is passed at the time of re-issue.

Bank Account ...Dr.	(for cash received)
Share Forfeited A/c ...Dr.	(for concession)
To Share Capital' Account	(for the paid up value)

**3. Treatment of Surplus in the Forfeited Account after Re-issue:** Surplus left in the Share Forfeited Account after the re-issue should be transferred to the capital Reserve Account of the company. Although this surplus is profit, yet is not a profit in the ordinary course of business. Entry for transfer is :

Share-Forfeited Account ...Dr.

To Capital Reserve Account.

**4. Re-issue of Shares originally Issued at Discount:** The new allottee of such shares also gets the benefit of the discount plus any other benefit that he may get out of the forfeited amount. The entry in such a case is:

Bank Account ..	.Dr.	(Amount Received)
Discount Account ..	.Dr.	(Amount of Discount)
Share forfeited account ..	.Dr.	(Amount of Concession)
To Share capital Account.		

**5. Re-issue of Shares original Issued at Premium:**

Following points are worth noting in this case:

- (i) Share Premium Account shall not be touched for re-issue, if premium has been received.
- (ii) if premium has not been received, the company may charge or may not charge the premium. If it charges the premium and also allows concession, the amount of premium and concession should be debited to the Share Forfeited Account and the Share Premium Account shall be credited with the amount of premium,
- (iii) Any surplus left in Forfeited Account should now be transferred to the Capital Reserve Account.

**ILLUSTRATION :**

X Limited company issued a prospectus inviting applications for 2,000 shares of "Rs. 10 each at a premium of Rs. 2 per share payable as follows:

On Application Rs. 2

On Allotment Rs. 5 including premium

On First Call Rs. 3

On Second Call Rs. 2

Applications were received for 3,000 shares and allotment made prorata to the applicants of 2,400 shares. Money overpaid on applications was employed on account of sums due on allotment.

Romesh to whom 50 shares were allotted, failed to pay the allotment money and on his subsequent failure to pay the First call, his shares were forfeited. Mohan the holder of 60 shares failed, to pay the two calls, and his share were forfeited after the second call.

Of the shares forfeited, 80 shares were sold to Krishna credited as fully paid for Rs. 9 per share, the whole of Romesh's shares being included. Show that journal entries and cash book entries.

### JOURNAL ENTRIES

- |  |               |             |
|--|---------------|-------------|
| 1. Share application A/c ...Dr.  | Rs. 4000.00   |             |
| To share capital A/c   |               | Rs. 4000.00 |
| (Being the allotment to 2000 shares to the applicants of 2400 shares proportionately as per directors resolution __)   |               |             |
| 2. Share allotment A/c ....Dr.   | Rs: 10,000.00 |             |
| To share capital A/c   |               | Rs. 6000.00 |
| To share premium A/c   |               | Rs. 4000.00 |
| (Being the amount due on the allotment @ Rs. 6 Rs. 3 for capital and Rs. 2 for premium on 2000 shares allotted)  |               |             |
| 3. Share application A/c ...Dr.  | Rs. 800.00    |             |
| To share allotment A/c   |               | Rs. 800.00  |
| (The surplus application money on 400 shares transferred to allotment A/c)   |               |             |
| 4. Share First Call A/c ...Dr.   | Rs. 6000.00   |             |
| To Share Capital A/c ...Dr.  |               | Rs. 6000.00 |
| (Being the first call due on 2000 shares @ Rs. 3 each)   |               |             |
| 5. Share Capital A/c ...Dr.  | Rs. 320.00    |             |
| Share Premium A/c ...Dr.   | Rs. 80.00     |             |
| To Share Allotment A/c   |               | Rs. 184.00  |
| To Share First Call A/c  |               | Rs. 120.00  |
| To Share Forfeited A/c   |               | Rs. 96.00   |
| (Being the forfeiture of 40 shares held by Romesh for non-payment of the allotment money and the first call; share capital it debited @ Rs. 8 per share called up and share premium debited @ Rs. 1 per share) |               |             |

6. Share 2nd and Final call A/c ...Dr.	Rs. 3920.00	
To Share Capital A/c Rs.		3920.00
(The amount on 1960 share @ Rs. 2 per share)		
7. Share Capital A/c ...Dr.	Rs. 600.00	
To Share First Call A/c		Rs. 180.00
To Share 2nd and Final Call A/c		Rs. 120.00
To Share Forfeited A/c		Rs. 300.00
(Being the forfeiture of Mohan's share i.e. 60 per for the nonpayment of two calls)		
8: Share Forfeited A/c ...Dr.	Rs. 80.00	
To Share Capital A/c		Rs. 80.00
(Being the discount allowed on the re-issue of shares)		

Note: — The amount of the discount is calculated as

		Rs.
Paid up Value of 50 share	=	800
Less cash received	=	720
	=	Rs. 80

Share Forfeited A/c ...Dr.	Rs. 216.00	
To Capital Reserve A/c		Rs. 216.00
(Being the profit on the re-issue of 80 shares transferred to capital Reserve A/c leaving a balance of Rs. 100 in the share forfeited A/c Rs. 5 per share on 20 share of Mohan not yet raised)		

**Note:** — The total application being 3000 shares and the total number of the shares offered to the public is 2000 shares. Since the allotment cannot exceed 2000 shares therefore pro-rata is made to 2400 shares. The balance 600 shares are returned basic the application money which is @ As. 2 per share i.e. Total amount is 600x2 = Rs. 1200. Money due from Romesh on account of allotment is not Rs. 200 i.e. 40x5 but Rs. 184 calculated as follows:

Total (Gross sum due on the allotment of 40 shares Rs. 200.00 Romesh must have applied for $\frac{400 \times 2400}{2000}$	= 48 shares	Rs. 2.00.00
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as per pro-rata arrangement. Therefore, the amount received on extra 8 share @ Rs. 2.00 per share is (which is transferred to allotment (a/c) Rs. 160

Amount not received = Rs. 184.00

Therefore, the total sum received on account of allotment is Rs. 10,000-800-184 or Rs. 9016.00.

**Solution:****CASH BOOK**

Dr			Cr		
Particulars	Rs.	P	Particulars	Rs.	P.
To Share Application a/c (Rs. 2 on 3000 shares applied for)	6000	00	By Share Application a/c Refund of Rs. 2 per share on 600 Shares applied for but not given any allotment	1200	00
To Share allotment a/c (Receipt of allotment money on 2000 Share Less Romesh 's shares)	9016	00			
To Share First call a/c Receipt of First call on 2000 shares Less Shares of Romesh and Mohan	5700	00	By Balance c/d	24036	00
To Second and Final call a/c (Receipt of Second call on 1900 Shares Less Mohan 's and Romesh's shares)	3800	00			
To Share capital a/c (Rs. 9 on 80 shares which are reissued)	720 00	00			
	25236	00		25236	00
To Balance b/d	25236	00			

**Issue of Shares at a Discount:** Ordinarily, shares cannot be issued at a discount (unless the shares to be issued are those which were previously forfeited or surrendered). Section 79 of the Companies Act allows a company to issue shares at a discount subject to the following conditions:

- The issue of the shares at a discount is authorized by a resolution passed by the company in general meeting and sanctioned by the Court.
- The resolution specifies the maximum rate of discount at which the shares are not issued. (The rate must not exceed 10 percent or such higher percentage as the Central Government may permit in any special case).
- Not less than one year has, at the date of the issue, elapsed since the date on which the company was entitled to commence business.
- The shares are of a class which has already been issued.
- The shares are issued within two months of the date of which the issue is sanctioned by Court or within such extended time as the Court may allow.

It follows that a new company cannot issue shares at a discount Nor can a new class, of shares be issued at a discount. When a company has issued shares as discount and subsequently issues a prospectus for further issue shares, such a prospectus must contain particulars of the discount allowed on issue of shares or of so much of the discount as has not been written off at the date of the issue of the prospectus. The entry for discount being debited to "Discount on Shares Account". It appears in the balance sheet until it is written off. Discount on Shares Account is a fictitious asset. It should be written off as early as possible. The entry to write off is to debit the Profit and Loss Account and to credit the Discount on Shares Account. However, there is no legal compulsion to write off this account

### **Issue of Shares for consideration other than cash:**

Shares can also be, and are, issued to vendors who sell some assets to the company or to the promoters for their services. When shares are issued to vendors, the entry will be

Sundry Assets	Dr.
To Vendor	
Vendor	Dr.
To Share Capital A/c	
To Share Premium A/c	

(If the shares are considered for worth)

### **Self Assessment**

#### **Fill in the blanks:**

10. If a shareholder fails to pay the due amount on shares, the board of directors may decide to..... shares.
11. The authority to forfeit shares is given by company's.....
12. The Board of Directors has to give at least..... days notice to the defaulting members.

### **1.7 Redemption of Preferences Shares:**

Ordinarily a company is not allowed to purchase its own shares (nor the shares of .its holding company). A refund of money to shareholders on Capital Account, while the company is in existence, requires court sanction in addition to a special procedure. But section 80 of the Companies Act allows a company, if authorized by its Articles, to issue preference shares which, at the option of the company may be redeemed; but such redemption is subject to legal restrictions. These are stated below :

- (a) No such shares shall be redeemed except out of 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 purpose of the redemption.
- (b) No such shares shall be redeemed unless they are fully paid.
- (c) The premium, if any, payable on redemption must be provided for out of the profits of the company or out of the company's Shares Premium Account before the shares are redeemed.
- (d) Where any such shares are redeemed out of profits, a sum equal to the nominal amount of the shares so redeemed must be transferred out of the profit of the company to a reserve called the "Capital Redemption Reserve Account"

- (e) The Capital Redemption Reserve Account can be utilized for the issue of fully paid bonus shares to the shareholders. Otherwise, the Account must be maintained intact unless otherwise sanctioned by the Court. The provision regarding reduction of share capital will apply.

The reader will note that if a company does not have profits available for dividend and does not issue new shares for the specific purpose of redemption of preference shares, the redemption would be illegal. It should be noted that an issue of debentures is not considered for this purpose. If the preference shares are to be redeemed at a premium, the premium must be debited to the Profit and Loss account or Share Premium Account.

Many authorities believe that though Section 80 mentions "proceeds of a fresh issue of shares," only the nominal value of shares issued should be considered for determining the amount to be credited to Capital Redemption Reserve Account. This means that any premium received on issue of shares should be disregarded. This is supported by provisions of Section 78 which does not specify redemption of Preference Shares for which the Shares Premium Account can be used. Suppose a company issues 2000 Equity Shares of Rs. 100 each, at a premium of Rs. 20 and redeems 3,000 Preference Shares of Rs. 100 each. If the view expressed above is accepted, the company should credit Rs. 1,00,000 to the Capital Redemption Reserve Account (by debit to the Profit and Loss A/c), i.e. Rs. 3,00,000 (the amount redeemed) less the value of new shares issued.

This view is not free from controversy in view of the meaning of the word "proceeds" which should mean actual amount realized and also because, if premium is disregarded, any discount allowed on issue of shares should also be disregarded. This would be patently wrong.

Of course, if share premium has been used for some other purpose (say for providing premium payable to redeemable preference shares), it must be disregarded for determining the amount to be credited to Capital Redemption Reserve Account. One should note that within thirty days of the redemption of shares, the Registrar has to be notified of the fact. [Section 95 (i)]. The redemption does not operate as reduction of capital; if new shares are issued for the purpose, it will not be treated as increase of capital.

### Self Assessment

#### Fill in the blanks:

13. Dividend on preference shares is always \_\_\_\_\_.
14. The \_\_\_\_\_ preference shares cannot be issued by a limited company.
15. The redemption of preference shares can be from \_\_\_\_\_.

**ILLUSTRATION:** A limited company issued at par, on 1st July 1969, 1000 Redeemable Preference Shares of Rs. 100 each. Such shares being redeemable at a premium of 5%. One half of the issue was redeemed out of the profits on 10th January, 1975, on 15th December 1975 the company issued 10,000 equity shares of Rs. 10 each at a premium of Rs. 3 per share, and out of the proceeds it redeemed the balance of Redeemable Preference Shares.

Make Journal Entries to record all these transactions in the books of the company.

**Solution:****JOURNAL ENTRIES**

		Rs	Rs.
1969 July	Bank A/c ...Dr	1, 00,000	
	To Preference Share Capital A/c		1,00,000
	(Being the amount received on 1000 shares (Redeemable Preference) of Rs. 100 each)		
1969 July 1	Loss on the issue of Preference Share A/c ...Dr.	5,000	
	To Premium on Redemption of Preference		5,000
	Share Capital A/c (Being the premium payable on the redemption of Redeemable Preference Share of Rs. 100 each @ Rs. 5 per share).		
1975 Jan. 10	Profit and Loss A/c .. Dr	2,500	
	To Loss on the issue reference Share A/c		2.500 (Being
	half of the loss on the issue of Redeemable Preference Share written against Profit and Loss A/c @ Rs. 500 per (annum).		
1975 Jan. 10	Shareholders A/c ...Dr.	52,500	
	To Bank A/c		52,500
	(Being the redemption of 500 Preference Share @ Rs. 100 each at a premium of 5%)		
1975 Jan. 10	Preference Share Capital A/c ...Dr.	50,000	
	Premium on Preference Share A/c ...Dr	2,500	
	To shareholders A/c		52,500
	(Being the transfer of the money to preference shareholder' A/c)		
1975 Jan. 10	Shareholders A/c ...Dr.	52,500	
	To Bank A/c		52,500
	(Being the redemption of 500 Preference Share @ Rs. 100 each at a premium of 5%)		
1975 Dec. 15	Bank A/c ...Dr.	1,50,000	

	To Equity share Capital A/c		1,00,000
	To Premium on Share A/c		50,000
	(Being the cash received on the issue of 10,000 equity shares @ Rs. 10 each at a premium of Rs. each))		
1975 Dec. 15	Profit and Loss A/c...Dr.	2,500	
	To Loss on the issue of preference shares A/c		2,500
	(Being Loss written off against Profit and Loss A/c)		
1975 Dec. 15	Preference Share Capital A/c ... Dr.	5,000	
	Premium on Redemption of preference shares A/c .....Dr	2,500	
	To Preference Share Holders A/c		2,500
	(Being due to Preference Shareholders)		
1975 Dec. 15	Preference Shareholders A/c...Dr.	52,500	
	To bank A/c		52,500
	(Being the payment made to Preference Shareholders)		

### 1.8 SUMMARY:

The Capital which can be subscribed by owners or shareholders is known as the share capital of Company. There are different natures of share capital like authorized share capital, Issued share capital, called-up share capital and paid-up share capital etc. A Public Company can issue only two types of shares i.e. preference share and Equity shares. A company may issue share for cash and for consideration other than cash. Shares can be issued at premium or at a discount. If a member of the company does not pay the call money as per the demand notice, his shares can be forfeited.

### 1.9 Glossary:

1. **Share Capital:** Share capital means the capital raised by the company by issue of shares.
2. **Application for shares:** An application for shares is an offer made by the applicant.
3. **Allotment of Shares:** It means the acceptance of the application of a person who has applied for shares and who has paid the required application money after due compliance of the relevant provisions of the Companies Act and SEBI guidelines.
4. **Capital Reserve:** Capital reserves are those reserves which are created out of Capital Profits.
5. **Forfeiture of Shares:** If any shareholder fails to pay the amount due on allotment or on any call within the specified period, the Directors may cancel his shares. This is called Forfeiture of Shares.

### 1.10 Answers: Self-assessment:

- |          |                               |           |
|----------|-------------------------------|-----------|
| 1. Seven | 2. Two                        | 3. Owners |
| 4. Not   | 5. Memorandum of Association, | 6. 90%,   |

7. Personal Account, 8. Three 9. Shareholder  
10. Forfeit 11. Articles of Association 12. Fourteen  
13. Fixed 14. Irredeemable 15. General reserve

### **1.11 Terminal Questions:**

1. When can a company issue shares at discount? What conditions must a company satisfy for issuing shares at discount?
2. State the meaning of forfeiture of shares. When can shares be forfeited?
3. What do you mean by forfeiture of shares? How are shares forfeited? Pass journal entries regarding forfeiture and reissue of shares.
4. Explain briefly the following:
  - (a) Issue of Shares at premium
  - (b) Forfeiture of Shares
  - (c) Calls-in-arrear and Calls-in-advance.

### **1.12 SUGGESTED READING:**

1. R.L. Gupta: Advance Accountancy.
2. S.P. Jain, K.L. Narang : Advanced Accountancy.
3. S.N. Maheshwari : Advanced Accountancy.
4. Monga, J.R. : Advanced Accounting.

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## Lesson-2

**ACCOUNTING FOR ISSUE AND REDEMPTION OF DEBENTURES****STRUCTURE:**

- 2.0 Learning Objectives
- 2.1 Introduction
- 2.2 Kinds of Debentures
- 2.3 Issue of debentures
- 2.4 Redemption of debentures
- 2.5 Summary
- 2.6 Glossary
- 2.7 Answers: Self Assessment
- 2.8 Terminal Questions
- 2.9 Suggested Readings
- 2.0 **LEARNING OBJECTIVES:**

After studying the lesson, you should be able to understand:

1. What is debenture?
2. How a debenture can be issued?
3. What are the different provisions for redemption of debentures?

**2.1 INTRODUCTION:**

A debenture is a written acknowledge of a debt under the seal of the company. It is usually secured by a charge on the company's assets, bearing a fixed rate of interest. It is repayable within a specified period or on or after a specified date or irredeemable during the existence of the company.

**2.2 Kinds of Debentures:** Debentures can be classified according to security, permanence, priority, convertibility and records point of view.

1. Security Point of view	Naked debentures and Mortgage debentures
2. Permanence Point of view	Redeemable debentures and Irredeemable debentures
3. Priority Point of view	First debentures Second debentures
4. Convertibility Point of view	Convertible debentures Non-convertible debentures
5. Records Point of view	Bearer debentures Registered debentures

**1. Permanence or redemption:** On the basis of permanence or redemption, debentures can be classified into two:

- (a) Redeemable debentures: These are those debentures which are redeemed/repaid either at the expiry of a specific period or within a period by the company. The redemption of these debentures takes place either by annual drawings in lump sum or by purchase in the open market at any time at the prevailing rate in the market.
- (b) Irredeemable or perpetual debentures: In this case, the company does not fix any date for repayment of debentures. The holder of these debentures cannot demand payment from the company during its lifetime. Generally, the debentures are repayable after a long period or on liquidation of the company.

**2. Security:** On the basis of security, debentures can be classified into two:

- (a) Secured or mortgage debentures: These are those debentures which are secured by a charge on the assets or properties of the company. When the charge is of a particular asset, such as land or buildings, it is called a fixed charge. When the charge is on all the fee assets of the company, it is called general charge or floating charge. The terms of debentures or trust deed will decide the rights of the debenture-holders in the case of default of a company.
- (b) Naked or simple debenture: Those debentures which carry no security are unsecured. The debenture-holders of these debentures have no priority over other creations of the company. Their position is equal to that of unsecured creditors.

**3. Priority in payment:** On the basis of priority in payment of interest and principal amount of debenture, they can be classified into:

- (a) First debentures: Those debentures that are to be repaid and on which interest is to be paid in priority to other debentures, are called first debentures.
- (b) Second debentures: Those debentures that are repaid and in which interest is to be paid after the payment of first debentures, are called second debentures.

**4. Record or Negotiability:** On the basis of records, debentures may be classified into:

- (a) Registered debentures: Those debentures whose debentures-holders are registered in the books of the company. According to the provisions of the Companies Act (Sections 108 to 118), transfer of registered debentures requires a transfer deed, which has to be lodged with the company for the necessary changes to be recorded in the register of debenture-holders. The register of debenture-holders is similar to the register of shareholders containing names, addresses and holding of debentures. Interest on debenture is paid only to that person whose name appears in the register of the debenture-holders.
- (b) Bearer debentures: Those debentures which can be transferred by mere delivery, because the company does not maintain any records of names and addresses of the debenture-holders. These are like negotiable instruments. On producing the coupons attached to the debentures, interest is paid to the bearer. The bearer is also entitled to obtain the payment of the principal sum on presenting the document at the time to its redemption.

**5. Convertibility:** From the point of convertibility, debentures may be classified into

- (i) Convertible debentures and
- (ii) Non-convertible.

- (a) Convertible debentures: Those debentures which can be converted into shares of the company on certain dates, or during a certain period at the option of the debenture holder according to the terms of issue. These debentures can be fully convertible (FCD) or partly convertible (PCD).
- (b) Non-convertible debentures: Those debentures whose debenture-holders do not have a right to convert them into equity or preference debentures.

### 2.3 ISSUE OF DEBENTURES:

Debentures may be issued at par, premium or at a discount. The account procedure relating to applications and allotment of debenture is similar to that of shares.

#### Journal Entries

- (i) Debentures issued at par, redeemable at par.

Bank Account Dr.	With face value
To Debentures Account	

- (ii) Debentures issued at a discount, but redeemable at par.

Bank Account Dr.	With amount received
Discount on Debentures A/c Dr.	With discount allowed
To Debentures Account	With face value

- (iii) Debentures issued at a premium, but redeemable at par.

Bank Account Dr.	With amount received
To Debentures Account	With face value
To Premium on Debentures A/c	With premium

- (iv) Debentures issued at par (or discount), but redeemable at premium.

Bank Account Dr.	With amount received
Loss on Issue of Debentures A/c Dr.	With difference
	between amount repayable and amount received
To Debentures A/c	With face value
To Premium on Redemption or Debenture A/c	With premium payable on redemption

'Discount on Debentures Account' and 'Loss on Issue of Debentures A/c' are Capital losses and should be shown on the assets side of the Balance Sheet until written off. It is advisable to write it off as soon as possible.

The entry is to debit the Profit and Loss Account and Credit the Discount on issue of debentures or loss on Issue of Debentures. If the debentures are to be redeemed at the end of a period say five years, it is desirable, but not obligatory under law, -to write off every year one-fifth of the discount. On the other hand, if the debentures are to be repaid by installments the amount to be written off should be in proportion to the amount outstanding at the end of each year.

Suppose X Ltd. issue 1,500, 5% debentures of Rs. 100 each at a discount of 10% redeemable at par by equal drawings in four years. Show the amounts of discount to be written of each year.

Discount allowed on issue of debentures. Rs.  $1,50,000 \times 10/100 = \text{Rs. } 15,000$

Year	Amount Outstanding (Rs.)
1.	1,50,000
2. (1,50,000 - 30,000)	1,20,000
3. (1,20,000 - 30,000)	90,000
4. (90,000 - 30,000)	60,000
5. (60,000 - 30,000)	30,000

The-rates for each year is 10: 8 : 6 : 4 : 2 or 5 : 4 : 3 : 2 : 1

Year	Amounts to be written off
1	$1,50,000 \times 5/15 = \text{Rs. } 5,000$
2	$1,50,000 \times 4/15 = \text{Rs. } 4,000$
3	$1,50,000 \times 3/15 = \text{Rs. } 3,000$
4	$1,50,000 \times 2/15 = \text{Rs. } 2,000$
5	$1,50,000 \times 1/15 = \text{Rs. } 1,000$
<b>Total</b>	<b>Rs 15,000</b>

### Debentures Issued as Collateral Security:

Debentures are given to the lenders say a bank with the understanding that if the company repays loan and interest, the bank shall return the debentures to the company which will be cancelled by the Company. In case of default, however, the bank treat the debentures as live and dispose it in the market or keep them with itself (bank) to be treated as debenture holder. Such issue of debentures is called as 'Debentures Issued as Collateral Security'.

We can make two alternative accounting records:

- No entry for such issue except that the loan Account is credited as shown in the Balance Sheet. However, the fact of such issue is also state in the Balance Sheet
- The following entry is made :

Debentures Suspense Account	Dr.	With face value of debenture
To Debentures A/c		

The Debenture Suspense Account shall appear on the assets side and 'Debentures Account' on the liability side of the Balance Sheet.

### Interest on Debentures:

Interest on debentures, is usually paid six-monthly. This point, in this connection, worth noting is that income tax must be deducted before paying interest Its accounting treatment will be as follows:

(i)	Debenture interest Account Dr.	(Gross amount of interest)
	To Income Tax Payable Account	(Income tax of Interest)
	To Debenture holders Account	(Gross amount less tax)
(ii)	Debentures holders Account Dr.	
	To Bank	
(iii)	Income Tax Payable Dr.	(Payment of Income Tax )
	To Bank	

### Self Assessment

Fill in the blanks:

1. Debenture-holders are entitled to get ..... at a fixed rate.
2. Debentures are shown under the heading of ..... in the liability side of the balance sheet.
3. Debenture-holders are the ..... of a public limited company.
4. The procedure for issue of ..... is exactly similar to the procedure of issue of shares.
5. A 10% debenture of nominal value of 100 has been issued at 90 is said to be issued at .....
6. A 9% debenture of a nominal value of 100 has been issued at 120 debentures are said to be issued at .....
7. 100 8% debentures of 100 each has been issued to vendors for plant purchased the debentures are said to be issued .....

### 2.4 Redemption of Debentures :

The redemption of debentures involves huge sums of money. In the Company's own interest it should make arrangement for the accumulation of additional funds for the purpose of redemption. The Government of India through a notification on 14-1-1987 issued by Controller of Capital Issues has laid down certain guidelines. The guidelines, in brief, have the following implications:

- (1) The creation of 'Debenture Redemption Reserve' is Compulsory only for non-convertible debentures.
- (2) A Company cannot redeem its debentures purely out of Capital or out of profits.
- (3) The creation of Debenture Redemption Reserve equal to 50% of the amount of debenture issue before debenture redemption commences, it means that 50% of redemption may be, carried out either from the accumulated profits or out of Capital.
- (4) When a Company has created a sinking fund equal to the debenture issue, it means that there is no need to create debenture redemption reserve. However, no redemption can begin unless sinking fund accumulates a sum of 50% of the amount of debenture issue.
- (5) It is clear that no debenture redemption reserve is required in case of convertible debentures.

**Redemption of debentures means discharge of the liability in respect of the debentures issued by a Company. Redemption can take any of the following three forms:**

**1. By Annual Drawings :**

A specific portion of the total debentures are redeemed every year over their life time. At the end of the life time of the debentures, they are fully redeemed. The question of redeeming which debentures in a particular year is resolved by 'drawing by lot'.

**2. Payment in lump sum at the expiry of the specific period or at the opinion of the Company at a date falling within the specific period :**

When redemption is to be done at the expiry of the specific period in one lumpsum to avoid huge withdrawals as such date, every year a part of the profits is set aside and invested in readily convertible securities together with Compound interest. It will provide for redemption on the expiry of the period. This is known as 'Sinking Fund method'.

**3. Purchase in the open market :**

When the company finds market value of the debentures favourable, (i.e., below par), if the term of issue allow it, the company may purchase its own debentures in the open markets and cancels it. The company may also if it chooses so keep them alive after purchasing them in die open market

For redemption, the Company may follow any of the following methods:

- (1) Redemption out of Capital (now not possible).
- (2) Redemption out of profits.
- (3) Redemption by converting the existing debentures into new debentures or shares.
- (4) Redemption by purchase of own debentures.

**Journal Entries**

**When redemption is made at par**

Debentures Account	Dr.	With the face value
To Bank		

**When redemption is made at a premium**

Debentures Account	Dr.	With the face value
Premium on Redemption of Debentures A/c	Dr.	With the premium
To Bank Account		With amount paid

**When redemption is made at a discount**

Debentures Account	Dr.	With the face value
To Bank Account		With amount paid
To Profit on Redemption of Debentures a/c		With discount

**Illustration 1:**

A Company issued 1000 debentures of Rs. 100 each at 98 x 1/2% on 1-1-1984 repayable out of profits by equal annual drawings over 5 years. Prepare Debentures Account, Discount on Issue of Debentures Account and General Reserve at for the first two years.

**Solution:****Debenture Account**

Dr.			Cr.		
1984.		Rs	1984		Rs.
Dec.31	To Bank	20,000	Jan.1	By Bank A/c	98,500
Dec.31	To Balance c/d	80,000	Jan.1	By Discount on issue of Deb.A/c	1,500
		1,00,000			1,00,000
1985			1985		
Dec.31	To Bank	20,000	Jan.1	By Balance b/d	80,000
Dec.31	To Balance c/d	60,000			
		80,000			80,000

**Discount on issue of Debentures Account**

Dr.			Cr.		
1984.		Rs	1984		Rs.
Jan. 1	To Debentures A/c	1500	Dec. 31	By General Reserve	500
			Dec. 31	By Balance c/d	1,000
		1500			1500
1985			1985		
Jan. 1	To Balance b/d	1000	Dec- 31	By General Reserve	400
			Dec- 31	By Balance c/d	600
		1000			1000

**General Reserve Account**

Dr			Cr		
1984		Rs	1984		Rs
Dec. 31	.. To Discount on Issue of Deb. A/c	500	Dec. 31	By Profit & Loss A/c	20,000
Dec. 31	To Balance c/d	19,500			
		20,000			20,000
1985			1985		
Dec. 31	To Discount on	400	Jan. 1	By Balance b/d	19,500



(d) Sinking Fund Investment A/c Dr. (Annual installment along with interest invested )  
 To Bank

In the year of redemption entry 2(d), should not be recorded but the following further entries should be passed:

3. (a) Bank A/c Dr. Amount realized on sale of investment  
 To Sinking Fund Investment A/c

These two entries of interest received on S.F. accounts can be combined as:—

Bank A/c Dr  
 To Sinking fund A/C

(b) Debentures A/c Dr. Amount paid to Debenture holders  
 To Bank

(c) Sinking Fund Investment A/c Dr. Transfer of profit on sale of investment  
 To Sinking Fund

However, in case of loss, this entry should be reversed

(d) Sinking Fund A/c Dr. Balance in the Sinking Fund transferred to General Reserve  
 To General Reserve

### Illustration 2:

A Company issued 10,000 debentures of Rs. 100 each at par on 1st January, 2008 redeemable at par on 31st December, 2012. A Sinking Fund was instituted for the purpose. It was expected that investment would earn 5% net. Sinking Fund tables show that Rs. 1,80,975 amount to Re.1 at the end of 5 years @ 5%; On 31st December, 2012, the investments realized Rs. 7,80,000, on that date the company's bank balance was Rs. 3,00,000. The debentures were duly redeemed. The Company invested to the nearest Rs. 10.

Give Journal entries and show Sinking Fund and Sinking Fund Investment Account.

### SOLUTION:

		Rs.	Rs.
2008 Jan.1	Bank A/c Dr.  To Debentures Account (Issue of 10,000 debentures of Rs. 100 each at par).	10,00,000	10,00,000
Dec. 31	Profit & Loss (Appropriation) A/c Dr. To Sinking Fund Account (Annual amount required for redemption transferred to	1,80,975	1,80,975

	S.F.) (180975 x 10,00,000)			
Dec. 31	Sinking Fund Investments A/c To Bank Account (Investment made to the nearest ten rupees)	Dr.	1,80,980	1,80,980
2009 Dec. 31	Bank A/c Dr. To Interest on Sinking Fund 9,049 (Interest @ 5% received on investments)		9,049	9,049
Dec. 31	Interest on S.F. Investments A/c Dr. To Sinking Fund Account (Transfer of interest to S.F.)		9,094	9,094
Dec. 31	Profit & Loss (Appropriation) A/c To Sinking Fund Account (Annual installment transferred to S.F.)	Dr.	1,80,975	1,80,975
Dec. 31	Sinking Fund Investment A/c To Bank Account 1,90,020 (Interest and Annual installment to the nearest ten rupees invested)	Dr.	1,90,020	1,90,020
2010 Dec. 31	Bank A/c Dr. To Interest on S.F. Investment A/c (Interest on investment @5% received)		18,550	18,550
Dec. 31	Interest on S.F. Investment A/c Dr. To Sinking Fund A/c (Interest transferred to S.F.)		18,550	18,550
Dec. 31	Profit & Loss (Appropriation) A/c To Sinking Fund A/c (Annual installment transferred to S.F.)	Dr.	1,80,975	1,80,975
Dec. 31	Sinking Fund Investment A/c To Bank A/c (Interest and instalment Invested)	Dr.	1,99,530	1,99,530

2011 Dec. 31	Bank A/c Dr.  To Interest of S.F. Investment A/c (Interest @ 5 %received)	28,526.50	28,526.50
Dec. 31	Interest on S.F. Investment A/c Dr.  To Sinking Fund A/c (Interest transferred to S.F.)	28,526.50	28,526.50
Dec. 31	Profit & Loss (Appropriation) A/c Dr. To Sinking Fund A/c (Annual instalment transferred to S.F.)	1,80,975	1,80,975
Dec. 31	Sinking Fund Investment A/c Dr. To Bank A/c (Interest and installment invested)	2,09,500	2,09,500
2012 Dec. 31	Bank A/c Dr.  To interest on S.F. Investment A/c (Receipt of Interest)	39,001,50	39,001,50
Dec. 31	Interest of S.F. Investment A/c Dr. To Sinking Fund A/c (Interest transferred to S.F.)	39,001,50	39,001,50
Dec. 31	Profit & Loss (Appropriation) A/c Dr. To Sinking Fund Account (Annual instalment transferred)	1,80,975	1,80,975
Dec. 31	Bank Account Dr.  To Sinking Fund Investments A/c (Sales of Investment for redeeming the debentures)	7,80,000	7,80,000
Dec. 31	Debenture Account Dr.  To Debentures holders A/c	10,00,000	10,00,000

	(Transfer of debentures to debentures holders)		
Dec. 31	Debentures holders A/c Dr. To Bank (Payment to debentures holders)	10,00,000	10,00,000
Dec. 31	Sinking Fund investment A/c To Sinking Fund Investment A/c (Loss on sale of Investment transferred to S.F.)	Dr. 3,000	3,000
Dec.31	Sinking Fund Account To General Reserve Account (After redemption, S.F. transferred to General Reserve)	Dr. 9,99,972	9,99,972

### Sinking Fund Account

2008		Rs.	2008		Rs.
Dec. 1	To Balance c/d	1,80,975	Dec.31	By Profit & Loss Appropriation A/c	1,80,975
		1,80,975			1,80,975
2009 Dec. 31	To Balance c/d	3,70,999	2009 Jan.31 Dec.31	By Balance b/d By Interest on S.F. Investments A/c By Profit & Loss Appropriation A/c	1,80,975 9,049 18,975
		3,70,999			3,70,999
2010 Dec.31	To Balance c/d	5,70,524	2010 Jan.1	By Balance b/d By Interest on S.f. Investment A/c By P& L Appropriation Account	3,70,999 18,550 1,80,975
		5,70,524			5,70,524
2011 Jan.1	To Balance c/d	7,80,025.50	2011 Jan.1	By Balance b/d By Interest on S.F.	5,70,524 28,526.50

				Investment A/c By P&L Appropriation A/c	1,80,975
		7,80,025.50			7,80,025.50
2012 Dec.31	To S.F. Investment (transfer of loss on sale)	30.00	2012 Jan.1 Dec.31	By Balance b/d By Interest on S.F. Investment	7,80,025.50 39,001.50
Dec.31	To G.Reserve trans	9,99,972	Dec.31	By P&L Appropriation	1,80,975.00
		10,00,002			10,00,002

### Sinking Fund Account

2008 Dec. 31	To Bank Account	1,80,980	2008 Dec 31	By Balance c/d	1,80,980
		1,80,980			1,80,980
2009 Jan. 1 Dec.31	To Balance b/d To Bank Account	1,80,980 1,90,020	2009 Dec. 31	By Balance C/d	3,71,000
		3,71,000			3,71,000
2010 Jan. 1	To Balance b/d To Bank Account	3,71,000 1,99,530	2010 Dec. 31	By Balance c/d	5,70,530
		5,70,530			5,70,530
2011 Jan. 1 Jan.1	To Balance b/d To Bank Account	5,70,530 2,09,500	2011 Dec. 31	By Balance c/d	7,80,030
		7,80,030			7,80,030
2012			2012		

Jan. 1	To Balance b/d	7,80,030	Dec. 31	By Bank (Sale of Investment)	7,80,000 30
				By Sinking Fund (Loss on Sale)	
		7,80,030			7,80,030

**(b) Insurance Policy Method :**

Under, this method, the Insurance Company receives the premium regularly in installments and returns the accumulated money at the expiry of period. This money received from the insurance company is used for the redemption of the debentures.

**III. Purchase of Debentures in the open Market:** Debentures can be purchased in the open market, if the contract stipulates it. The Company can:

- (i) cancel them, or
- (ii) Keep them as investment and may be utilized for re-issue.

**(1) Purchase for immediate Cancellation:**

**Journal records:**

Debentures Accounts Dr  
To Bank

As a matter of fact, there is no difference as regards accountings records is concerned whether purchased in the open market or paid directly to the debenture holders.

(b) where the company purchases the debentures in the open market and keeps them as investment, the journal entry will be :

Own debentures a/c Dr.  
To Bank Account

But since some times the amount actually paid is more than, and some times less than, the face value of the debentures the above simple entry will not be passed. The various entries, are given below:—

If the amount paid is more than the face value (at a premium), the entry would be :—

Debenture Account	Dr.	Nominal Values of the Debentures
Premium or Redemption of Debenture Account		Premium paid on Redemption (loss on Redemption)
To Bank Account		Actual amount paid

If the debentures are redeemed at a discount, that is the amount paid is less than the face value of debentures, the entry will be :—

Debentures Account	Dr.	Nominal value of the Debenture
To Bank Account		Amount paid

To Debentures Account      Discount earned or profit made

The profit on redemption of debentures is a Capital Profit but if at the time of the issue of the debentures there was a discount and if such discount has not yet been written off, the profit on redemption of debentures may be used to write off the discount on debentures.

At the time of cancellation of own Debentures, Debentures Account should be debited and "Own Debentures Account" credited. The Debentures Account should be debited with the face value of cancelled debentures, any difference between this and the value of "Own Debentures" being debited to "Loss on Redemption of Debentures Account" (if it is a loss) or credited, if it is a profit, to "Profit on Redemption of Debentures Account". It is to be remembered that profit or loss on redemption on debentures arises only on cancellation of debentures.

### **Ex-Interest and cum-Interest:**

It is not necessary that the debentures are purchased on the date which interest on it is due. So the question arises, whether the purchase price includes the interest or not. If it includes this interest, it is called as cum interest. However, if interest is to be paid in addition to purchase price, it is known as ex-interest.

### **Self Assessment**

Fill in the blanks:

8. .... can be issued at par, at premium, or at discount, but redemption will be either at par or at premium.
9. If a company ..... its debentures by purchasing them from the open market at a price below the par value the, difference (par value and purchase price) is treated as profit on redemption or redemption of debentures at discount.
10. The ..... of debentures by public limited companies is regulated by Companies Act 1956.
11. Profit on cancellation of debentures is transferred to ..... account.
12. .... is maintained for the redemption of debentures.
13. Debentures cannot be ..... by a company.
14. Loss on issue of debentures is a ..... loss for the company.

### **Self Assessment**

State whether the following statements are true or false:

15. A company cannot purchase its own debenture.
16. Profit on sale of sinking fund investment is transferred to general reserve.
17. If a debenture is issued at a discount it cannot be redeemed at premium.
18. A company is bound to write off 'The Discount on Issue of Debentures' to profit and loss account.
19. Profit on cancellation of debentures is transferred to Debenture Redemption Fund A/c.
20. Own debentures cannot appear in the asset side of the balance sheet.

**ILLUSTRATION 3:**

On 1st July, 2011, E, Ltd issued 20,000 7x1/2 % debentures of Rs. 1,000 each at Rs. 990. At the time of issue, it was provided that they can be redeemed by purchase in the market. In subsequent year, the entire discount on debentures was written off. On 1st March 2013, the X Ltd, purchased debentures worth Rs. 20,00,000 at Rs. 975 and in May, 2013 worth Rs. 10,00,000 at Rs. 980 cum-interest payable on 30th June, 2013. The interest is payable on 30th June and 31st December. Give Journal for 2013.

**Journal of X Ltd.**

2013	Own debentures A/c	Dr	19,25,000	
March 1	Debentures Interest A/c	Dr	25,000	
	To Bank A/c			19,50,000
	(Purchase of 2,000 debentures of Rs. 1,000 each at Rs. 975 cum (interest))			
May 31	Own Debentures A/c		9,48,750	
	Dr.		31,250	
	Debentures Interest A/c	Dr.		9,80,000
	To Bank A/c			
	(Purchase of 1,000 debentures of Rs. 1,000 each at Rs. 980 cum (interest))			
June 30	Debentures Interest A/c	Dr.	6,37,500	
	To Debentures holders A/c			4,90,875
	To income Tax payable A/c			1,46,625
	(Interest due on (2,00,000 - 30,00,000) Rs. 1,70,000 debentures @ 7x1/2% for 6 months Income Tax @ 23% deducted)			
June 30	Debentures holders A/c		4,90,875	
	Dr.		1,46,625	
	Income Tax Payable A/c			6,37,500
	Dr.			
Dec. 31	To Bank		6,37,500	
	(Payment of Interest and Income Tax)			
	Debenture Interest A/c			4,90,875
	Dr.			1,46,625
	To Debentures holders A/c			
	To Income Tax Payable A/c			

Dec. 31	(Interest due on Rs. 1,70,000 debentures and Income Tax deducted at source)		4,90,875	
	Debitures holders A/c Dr.		1,46,625	6,37,500
Dec.31	Income Tax Payable A/c Dr.		13,31,250	
	To bank A/c (Payment of Interest and income tax)			13,31,250
	Profit & Loss A/c To Debitures Interest A/c	Dr.		
	(Transfer of Debitures Interest)			

**Illustration 4:**

A Ltd. hand 1,000 - 9% Debitures of Rs. 100 each as on 1-1-91. The Co. made the following purchases in the open market.

31-3-1989—200 debentures cum-interest at Rs. 97.

1-10-1989—500 debentures cum-interest at Rs. 102.

1-11-1989—150 debentures ex-interest at Rs. 98 x1/2.

All the debentures purchased were immediately cancelled except those purchased on 31-3-1989 which the company has not yet cancelled.

Interest is-payable on 30th June and 31st December. Journalize the above.

**Journal (ignoring narration)**

1985 31-1-89	Own Debitures L.F. Dr.	18,950	
	Debitures Interest Dr.	450	
	To Bank		19,400
30-6-89	Debitures Interest Dr.	4,050	
	To Debiture holders		3,600
	To Interest on Own Debitures		450
	Debitures Dr.	3,600	
			3,600

	To Bank		
1-10-89	9% Debentures Dr. Debenture Interest Dr. To Bank To Capital Reserve	50,000 450	50,225 225
31-12-89	Debenture Interest Dr. To Debenture holder To Interest on Own Deb.	1,575	675 900
	Debenture holders Dr. To Bank	675	675
	P&LA/c Dr. To Bank	7,650	7,650
	Interest on Own Debentures Dr. To P&L A/c-	1,350	1,350
	Debentures Redemption Reserve Dr. To General Reserves	65,000	65,000

## 2.5 SUMMARY:

Debentures have got a significant place in the financial plan of a company. A company has to use this source of finance for its initial needs and also for its expansion and development schemes. Debentures may be issued for cash, for consideration other than cash and as collateral security. The redemption of debentures refers to the discharge of liability on account of debentures. For redemption, the company may adopt any method like redemption out of profiles, out of capital, by conversion or out of provision.

## 2.6 Glossary:

**Debenture:** It is a written acknowledgement of a debt taken by the Company as these are issued under the seal of the Company. It includes debenture stock, bonds and any other securities of a company.

**Collateral Security:** Collateral security means secondary security in addition to the principal security.

**Redemption of Debentures:** The repayment of debenture is called the redemption of debentures.

**Convertible Debentures:** Those debentures which can be converted into shares of the company on certain dates, or during a certain period at the option of the debenture-holder according to the terms of issue.

**Debenture Holder:** A person having a debenture is called a debenture-holder, who is creditor of the company.

**Debenture:** A debenture is a document that either creates a debt or acknowledges it, and it is a debt without collateral.

**First Debentures:** Those debentures that are to be repaid and on which interest is to be paid in priority to other debentures, are called first debentures.

**Irredeemable or Perpetual Debentures:** In this case, the company does not fix any date for repayment of debentures. The holder of these debentures cannot demand payment from the company during its lifetime.

**Naked or Simple Debenture:** Those debentures which carry no security are unsecured. The debenture-holders of these debentures have no priority over other creations of the company. **Non-**

**convertible Debentures:** Those debentures whose debenture-holders do not have a right to convert them into equity or preference debentures.

**Redeemable Debentures:** These are those debentures which are redeemed/repaid either at the expiry of a specific period or within a period by the company.

**Registered Debentures:** Those debentures whose debentures-holders are registered in the books of the company.

**Second Debentures:** Those debentures that are repaid and in which interest is to be paid after the payment of first debentures, are called second debentures.

**Secured or Mortgage Debentures:** These are those debentures which are secured by a charge on the assets or properties of the company. When the charge is of particular assets, such as land or buildings, it is called a fixed charge.

## 2.7 Answers: Self Assessment:

- |               |                   |                                       |               |
|---------------|-------------------|---------------------------------------|---------------|
| 1. Interest,  | 2. Secured Loans, | 3. Members,                           | 4. Debentures |
| 5. Discount   | 6. Premium        | 7. For considerations other than cash | 8. debentures |
| 9. Redeems    | 10. Issue         | 11. Capital Reserve                   | 12. D.R.R.    |
| 13. Forfeited | 14. Capital       | 15. False                             | 16. False     |
| 17. False     | 18. True          | 19. True                              | 20. False     |

## 2.8 Terminal Questions:

1. Enumerate and describe the various ways of issuing debentures.
2. Explain the following:
  - (a) Redemption of debentures out of Capital.
  - (b) Redemption of debentures out of Profit.
3. Explain in brief the various methods of redemption of debentures.

**2.9 SUGGESTED READINGS:**

Jain, S.P., Narang, K.L.: Advanced Accountancy.

Goyal, Bhushan. Kumar. Fundamentals of Corporate Accounting, International Book House Pvt. Ltd. New Delhi.

Arulanandam, M.A. & Raman, K.S. Advanced Accountancy, Himalaya Publishing House.

Gupta, R.L., Corporate Accounting, Sultan Chand & Sons.

Monga, J.R., Corporate Accounting, Mayur Paperbacks, New Delhi.

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**Lesson-3****FINAL ACCOUNTS OF COMPANIES****STRUCTURE**

- 3.0 Learning Objectives
- 3.1 Introduction
- 3.2 Meaning of Final Accounts
- 3.3 Components of Final Accounts
- 3.4 Relevant Provisions of Companies Act.
- 3.5 Structure of Final Accounts
- 3.6 Profit and Loss Account
- 3.7 Important Items
- 3.8 Summary
- 3.9 Glossary
- 3.10 Answers: Self Assessment
- 3.11 Terminal Questions
- 3.12 Suggested Readings

**3.0 LEARNING OBJECTIVES**

After study the lesson you should be able to:

1. Discuss the meaning and components of final accounts
2. Explain the relevant provisions of Companies Act for the preparation of final accounts
3. Discuss the various structure of final accounts of a company
4. Discuss some important terms which are used in the preparation of final accounts.
5. Prepare the final accounts

**3.1 INTRODUCTION**

In the 'Financial Accounting' you have learnt how to prepare final accounts of sole proprietorship and partnership firms. You also know that every business organization is interested to know (i) the results of its operation performed during a particular period and (ii) the financial position on the date of close of the accounting period. These could be known through the preparation of Final Accounts. The term 'Final Accounts' include Trading Account, 'Profit & Loss Account' and 'Balance Sheet'. Section 210 of the Companies Act, 1956 governs the preparation of final accounts for companies. This section makes it compulsory for companies to prepare Profit and Loss Account and Balance Sheet at the end of each accounting year.

**3.2 MEANING OF FINAL ACCOUNTS**

Financial Statements are the end products of the accounting system. So these are called Final Accounts. Final accounts include (i) Trading and Profit and Loss A/c (ii) Balance Sheet. Trading and

Profit and Loss Account are prepared to find out the profit or loss of a certain period. They are also called as 'Income Statement'. The 'Balance Sheet' portrays the financial position of the firm on a particular date. It is also called as 'Position Statement'. These two statements i.e. Trading and P&L Account and Balance Sheet are prepared to give the final results of the business that is why both are collectively called as 'Final Accounts'. 'Final Accounts' are prepared from the figures appearing in Trial Balance' and additional information.

### **3.3 COMPONENTS OF FINAL ACCOUNTS**

Components of 'Final Accounts' depend on the nature of the business entity. It should be kept in mind that the final accounts are prepared after the preparation of trial balance. The nature of the business entity may be Sole proprietorship, Partnership, Joint Stock Company and so on. Following are the components of final accounts of sole proprietorship business carrying on trading activities:

- (i) Income statement which is divided into two parts:
  - (a) Trading Account which shows the gross profit or gross loss;
  - (b) Profit and Loss Account which shows the net profit or net loss; and
- (ii) Balance Sheet If the business entity carries on manufacturing activities, a Manufacturing account is also prepared by such business entity before the preparation of Trading Account.

### **3.4 RELEVANT PROVISIONS OF COMPANIES ACT:**

Final account is known as financial statements which is divided into two parts:

- (i) Income or Revenue Statement; and
- (ii) Position Statement

The term 'income statement' is traditionally known as profit and loss account and the 'position statement' as Balance Sheet.

The procedure of finalization of accounts of companies is not different from that of other non-corporate business entities except certain statutory requirements and some items peculiar to company form of business organization. The financial statements of companies are required to be presented by the Board of Directors at the Annual General Meeting of the company in accordance with the provisions of Section 210 of the Indian Companies Act, 1956. This Section speaks about preparation of Profit & Loss Account and the Balance Sheet only.

Section 209 to 220 of the Companies Act, 1956 deal with the legal provisions relating to preparation and presentation of final accounts by companies. Section 209 provides that proper books of accounts must be maintained following accrual basis of accounting so that such books of account give a true and fair view of the state of affairs of the company.

Section 210 deals with preparation of final accounts by companies while Section 211 deals with the form and contents of the Balance Sheet and the Profit and Loss Account. Section 211 further requires that final accounts of companies are prepared and presented in accordance with Schedule VI of the Companies Act, 1956.

### **Compliance with Accounting Standards :**

The Companies (Amendment) Act, 1999 which came into force w.e.f. 31.10.1998, has made it mandatory on the part of the companies to comply with the applicable accounting standards

recommended by the Institute of Chartered Accountants of India and as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards. In case of non-compliance, the reason and the financial effect, arising out of such non-compliance should be disclosed.

### **Approval and authentication of the Final Accounts:**

Section 215 of the Companies Act states that the balance sheet and the profit and loss account of every company should be approved by the Board of Directors. After approval, these should be signed by the manager or Secretary and at least two Directors, one of whom should be the Managing Director. After approval by the Board and proper authentication, final accounts shall be submitted to the auditors for their approval thereon

### **3.5 STRUCTURE OF FINAL ACCOUNTS**

The structure of final accounts as prescribed in Schedule VI is divided into four parts. Part I deals with disclosure of information relating to share capital, liabilities and assets in a statement known as the Balance Sheet of the company. There are two alternative forms for preparing this statement. These are Horizontal form and Vertical form. A company has the option to adopt any of the alternative forms. Now a day, almost all the companies prepare this statement in Vertical form.

Part II of the Schedule deals with the information to be disclosed in the Profit & Loss Account of a company but no form has been specifically prescribed for it. Part III contains interpretation and explanation of certain terminologies while Part IV requires disclosure of certain details, which are to form part of the Annual Report of the company to be published for providing information to various interested groups.

It may be mentioned here that the following companies do not prepare their final accounts as per the provisions of the Companies Act:

- (i) Insurance Companies;
- (ii) Banking Companies; and
- (iii) Electricity Companies.

They prepare their final accounts according to their requirements as per the provisions of their respective regulating Acts.

### **Form of Balance Sheet Section**

211 requires the balance sheet to be prepared in the prescribed form (except banking, insurance, electricity and other companies governed by any other special Act).

Part I of Schedule VI of the Companies Act, 1956 has laid down two forms for preparation of balance sheet viz:

- (a) Horizontal Form; and
- (b) Vertical Form of presentation of Balance Sheet.

A company may adopt either horizontal form or vertical form. But, now-a-days companies follow vertical form to present balance sheet and profit and loss account.

## Schedule VI Part I

[See Sec, 211]

## (Horizontal) Form of Balance Sheet

BALANCE SHEET OF .....[Here enter the name of the Company] as at.

..... [Here enter the date as at which the balance sheet is made out].

Figures for the previous year Rs	LIABILITIES	Figures for the current year Rs.	Figures for the previous year Rs	ASSETS	Figures for the current year Rs.
	<p><b>SHARE CAPITAL :</b></p> <p>Authorized .....shares of Rs..... each.</p> <p>Issued: (distinguishing between the various classes of capital and stating the particulars specified below, in respect of each class) ..... shares of Rs. ....each).</p> <p>Subscribed: (distinguished between the various classes of capital and stating the particulars specified below, in respect of each class) ..... shares of Rs.....each/ Rs..... called up.</p> <p>Of the above shares .....shares are allotted as fully paid up pursuant to contract without payments beings received in cash. Of the above shares.....shares are allotted as fully paid up' by way of bonus shares. (Specify the</p>			<p><b>FIXED ASSETS:</b></p> <p>Distinguishing as far as possible between expenditure upon :</p> <p>(a) goodwill</p> <p>(b) land</p> <p>(c) building</p> <p>(d) railway siding</p> <p>(e) leaseholds</p> <p>(f) plants and fitting</p> <p>(g) furniture and fittings</p> <p>(h) development of property</p> <p>(i) patents trademarks and designs</p> <p>(i) livestock</p> <p>(ii) vehicles etc</p> <p>[Under each had the original cost and the additions there to and deductions therefore during the year, and the total depreciation written off or provided up the end of the year are to be stated. Depreciation written off or</p>	

	<p>source from which bonus shares are issued, e.g. capitalization of profits or reserves or from shares premium account).</p> <p>Less: Calls unpaid</p> <p>(i) By directors.</p> <p>(ii) By others.</p> <p>Add: Forfeited shares : (amount originally paid up)</p> <p>(Any capital profit on re-issue or forfeited shares should be transferred to capital reserve).</p> <p>1. Terms of redemption or conversion (if any) of any redeemable preference capital are to be stated together with earliest date of redemption or conversion.</p> <p>2. Particulars of any option and un-issue share capital are to be specified.</p> <p>3. Particulars of the different classes of preference shares are to be given.</p> <p>These particulars are to be given with share capital.</p> <p>In the case of subsidiary companies the number of shares held by the holding company as well as by the ultimate holding company</p>			<p>provided shall be allocated under, the different asset heads and deducted in arriving at the value of fixed assets].</p> <p>In every, case where the original cost cannot be ascertained, without reasonable expense or delay, the valuation shown by the books is to be given. For the purpose of this paragraph such valuation shall be the net amount at which an asset stood in the company's book at the commencement of this Act after deduction of the amounts previously provided or written off for depreciation or diminution in value, and where any such asset is sold the amount of sale proceeds shall be shown as deduction.</p> <p>Where sums have been written off on a reduction of capital or a revaluation of assets every balance sheet (after the first balance sheet) subsequent to the reduction or revaluation shall show the reduced figures and with the date of the reduction place in of the original cost. Each balance sheet for the first five years subsequent to the date of the reduction shall show</p>	
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	<p>and its subsidiaries shall be separately stated in respect of subscribed share capital. The auditor is not required to certify the correctness of such share holdings as certified by the management.</p> <p><b>RESERVES AND SURPLUS:</b></p> <ol style="list-style-type: none"> <li>1. Capital reserves.</li> <li>2. Capital redemption reserve.</li> <li>3. Share premium account (showing details of its utilization in the manner provided in Sec. 78 in the year of utilization).</li> <li>4. Other reserves specifying the nature of each reserves and the amount in respect thereof.</li> </ol> <p>Less : Debit balance in profit and loss account (if any). [The debit balance in the profit and loss account shall be shown as a deduction from the uncommitted reserves, if any]</p> <ol style="list-style-type: none"> <li>5. Surplus i.e., balance in profit and loss 'account after providing for proposed allocations, namely dividend, bonus or reserves.</li> </ol>			<p>also the amount of the reduction made. Similarly, where sums have been added, by writing up the assets, every balance sheet subsequent to such, writing up shall show the increased figures with the date of the increase in dace of die original cost. Each Balance sheet of the first five years subsequent to the date of the writing up shall also show the amount of increase made.</p> <p><b>INVESTMENTS:</b></p> <p>Showing nature of investment and mode of valuation, for example, cost or market value, and distinguishing between:</p> <ol style="list-style-type: none"> <li>1. Investments in government or trust securities.</li> <li>2. Investments in shares, debentures or bonds. [Showing separately shares, fully paid up and partly paid up and also distinguishing the different classes of shares and showing also in similar details investments in shares, debentures or bonds of subsidiary companies].</li> <li>3. Immovable properties.</li> <li>4. Investment in the capital</li> </ol>	
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	<p>6. Proposed additions to reserves.</p> <p>7. Sinking Funds [Additions and deductions since last balance sheet to be shown under each of the specified heads. The word “fund” in relation to any “reserve” should be used only where such reserve is Specifically represented by earn-market investments).</p> <p><b>SECURED LOANS :</b></p> <ol style="list-style-type: none"> <li>1. Debentures.</li> <li>2. Loans and advances from banks.</li> <li>3. Loans and advances from subsidiaries.</li> <li>4. Other loans and advances. {Loans from directors and manager should be shown separately}.</li> </ol> <p>Interest accrued and due on secured loans should be included under the appropriate sub-heads under the head “secured loans”.</p> <p>The nature of security to</p>		<p>of partnership firms. [Aggregate amount of company’s quoted investment and also the kit value thereof shall be shown.</p> <p>Aggregate amount of company’s unquoted investments shall also be shown.]</p> <p><b>CURRENT ASSETS, LOANS AND ADVANCES:</b></p> <p><b>(A) CURRENT ASSETS:</b></p> <ol style="list-style-type: none"> <li>1. Interest accrued on investments.</li> <li>2. Stores and spare parts.</li> <li>3. Loose tools.</li> <li>4. Stock-in-trade.</li> <li>5. Work-in-progress. [In respect of (2) and (4) mode of valuation of stock shall be stated and the amount in respect of raw materials shall also be stated separately where practicable. Mode of valuation of works-in-progress shall be stated].</li> <li>6. Sundry debtors.       <ol style="list-style-type: none"> <li>(a) Debts outstanding for a period exceeding six months.</li> <li>(b) Other debts.</li> </ol> </li> </ol> <p><b>Less Provision</b></p> <p>[The amounts to be shown under-sundry debtors shall</p>	
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	<p>be specified in each case.</p> <p>Where loans have been guaranteed by managers and/ or directors, a mention thereof shall also be made and also the aggregate amount of such loans under each head.</p> <p>(in case of debentures, terms of redemption or conversion (if any) to be stated together with earliest date of redemption or conversion].</p> <p><b>UNSECURED LOANS :</b></p> <ol style="list-style-type: none"> <li>1. Fixed deposit.</li> <li>2. Loans and advances from subsidiaries.</li> <li>3. Short-term loans and advances       <ol style="list-style-type: none"> <li>(a) From banks. (b) From others.</li> </ol> <p>{Short-term loans include those which are due for repayment not later than on year as the date of the balance sheet].</p> </li> <li>4. Other loans and advances:       <ol style="list-style-type: none"> <li>(a) From banks.</li> <li>(b) From others.</li> </ol> <p>[Loans from directors and manager should be shown normally].</p> <p>Interest accrued and due on unsecured loans</p> </li> </ol>			<p>include the amounts due in respect of goods sold or services rendered or in respect of other contractual obligation but shall not include the amounts which are in the nature of loans or advances. In regard to sundry debtors particulars to be given separately of—</p> <ol style="list-style-type: none"> <li>(a) debts considered good are in respect of which the company is fully secured;</li> <li>(b) debts considered 'good for which the company holds no security other than the debtors' personal security; and</li> <li>(c) debts considered doubtful or bad, Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member to be separately stated, Debts due from other companies under the same management within the meaning of sub section (IB) of Sec, 370 to be disclosed with the name of the companies. The maximum amount duty by directors or other officers of the</li> </ol>	
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	<p>should be included under the appropriate sub-head under the head "Unsecured Loans".</p> <p>[Where loans have been guaranteed by manager, and/ or directors, a mention thereof shall also be made together with the aggregate amount of such loans under each head. This does not apply to fixed deposits].</p> <p><b>CURRENT LIABILITES AND PROVISIONS:</b></p> <p><b>A:CURRENT LIABILITIES</b></p> <ol style="list-style-type: none"> <li>1. Acceptances.</li> <li>2. Sundry creditors.</li> <li>3. Subsidiary companies.</li> <li>4. Advance payments and unexpired discounts for the portion for which value has still to be given. e.g., in the " cash of the following companies :</li> </ol> <p>Newspaper, fire insurance, theaters; clubs, banking, steamship companies, etc.</p> <ol style="list-style-type: none"> <li>5. Unclimbed dividends.</li> <li>6. Other liabilities (if any)</li> <li>7. Interest accrued but not due on loans.</li> </ol> <p><b>B. PROVISIONS</b></p> <ol style="list-style-type: none"> <li>8. Provision for taxation</li> <li>9. Proposed dividends.</li> </ol>			<p>company at any time during the year to be how by way of a note. [The provision to be shown under this head should not exceed the amount of debts stated to be considered doubtful or bad and any surplus of such provision, if already created, should be shown at every closing under "Reserves and Surplus" on the Liabilities side) under a separately subhead "Reserve for doubtful or Bad Debts." ] (7A) Cash balance on hand (7E) Bank balances—</p> <ol style="list-style-type: none"> <li>(a) With Scheduled banks.</li> <li>(b) With others.</li> </ol> <p>[In regard to bank balances particulars to be given separately—</p> <ol style="list-style-type: none"> <li>a) the balance lying with scheduled banks on current account call account and deposit accounts :</li> <li>(b) the names of the bankers other than scheduled banks and the balances lying with each such banker on current account : call account and deposit account and the maximum amount outstanding at any time during the year with each such banker, and.</li> </ol>	
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	<p>10. For contingencies.</p> <p>11. For provident fund scheme.</p> <p>12. For insurance, pension and similar staff benefit scheme.</p> <p>13. Other provisions.</p> <p>A footnote to the balance sheet may be added to show separately:</p> <p>1. Claims against the company not acknowledge as debts.</p> <p>2. Uncalled liability on shares partly paid.</p> <p>3. Arrears of fixed cumulative dividends. [The period for which the dividends are in arrear or if there is more than one class of. shares, the dividends on each such class are in arrear, shall be stated. The amount shall be stated before deductions of income tax, except mat in the case of tax-free dividends the amount shall be shown free of income tax and the fact that it is so shown shall be stated].</p> <p>4. Estimated amount of contracts remaining to be executed on capital account and not provided</p> <p>5. Other moneys for which</p>			<p>(c) the nature of the interest, if any, of any director or his relative in each of the bankers (other than scheduled banks referred to in (b) above.]</p> <p><b>(B) LOANS AND ADVANCES:</b></p> <p>8. (a) Advances and loans to subsidiaries.</p> <p>(b) Advances and loans to partnership firms in which the company or any of its subsidiaries is a partner.</p> <p>9. Bills of exchange.</p> <p>10. Advances recoverable in cash or in kind or for value to be received e.g., rates, taxes insurance, etc.</p> <p>11. Balance with Cisterns, Port Trust, etc. (where payable on demand).</p> <p>[The instructions, regarding sundry debtors apply to "Loans Advances" also. The amounts due from other companies under the same management within the meaning of subsection (IB) of sec. 370 should also be given with the names of the companies; the maximum amount due from everyone of these at any time during the year must be shown.]</p> <p><b>MISCELLANEOUS EXPENDITURE :</b></p>	
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	<p>the company is contingently liable.</p> <p>[The amounts of any guarantees given by the company of behalf of directors or other officers of the company shall be stated and, where practicable, the general nature and amount of each such contingent liability, if material, shall also be specified]:</p>		<p>(To the extent not written off or adjusted):</p> <p>(1) Preliminary expenses.</p> <p>(2) Expenses including commission or brokerage on underwriting or subscription of shares or debenture.</p> <p>(3) Discount allowed on the issue of shares or debentures.</p> <p>(4) Interest paid out of capital during construction (also stating the rate of Interest).</p> <p>(5) Development expenditure not adjusted.</p> <p>(6) Other 'sums (specifying nature).</p> <p><b>PROFIT AND LOSS ACCOUNT</b> Show here the debit balance of profit and loss account carried forward after deduction of the uncommitted reserves, if any]</p>	
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### Vertical Form:

The vertical form of Balance Sheet inserted by Notification No. GSR 220(E), dated 12-3-1979, is given below. The companies are at liberty to present their balance sheet under any of the formats i.e. Horizontal or Vertical, although most of the companies, now a day, present their balance sheet under Vertical format. Under vertical form, share capital and long term liabilities are classified as sources of funds. Application of funds are shown under the heads fixed assets; investment; current assets, loans & advances less current liabilities & provisions and miscellaneous expenditure. Details of above mentioned heads are given in schedules which form part of the balance sheet.

### Vertical Form of Balance Sheet

Name of the Company.....

Balance Sheet as at.....

Particulars	Schedule No	Figures as at the end year (Rs.)	Figures as at the end of Previous Financial Year (Rs.)
<b>I. Sources of Funds</b>			
(1) Shareholders' funds			
(a) Capital	-----	-----	-----
(b) Reserves & Surplus	-----	-----	-----
(2) Loan Funds			
(a) Secured loans	-----	-----	-----
(b) Unsecured loans	-----	-----	-----
Total:	-----	-----	-----
<b>II. Application of Funds</b>			
(1) Fixed assets	-----	-----	-----
(a) Gross Block	-----	-----	-----
Less : Depreciation	-----	-----	-----
(a) Net Block	-----	-----	-----
(c) Capital Work in Progress			
(2) Investments			
(3) Current Assets, Loans and Advances	-----	-----	-----
(a) Inventories	-----	-----	-----
(b) Sundry Debtors	-----	-----	-----
(c) Cash and Bank Balance	-----		
(d) Other Current Assets			
(e) Loans and Advances			
	-----		
<b>Less: Current liabilities and Provisions</b>	-----		

(i) Liabilities	-----		
(ii) (ii) Provisions	-----		
<b>(iii) Net Current Assets</b>			
(4) (a) Miscellaneous expenditure to the extent not written off or adjusted	-----		
(b) Profit & Loss Account	-----		
<b>Total:</b>			

- Details under each of the above items shall be given in separate Schedules.
- The Schedules, referred to above, accounting policies and explanatory notes that may be attached shall form an integral part of the balance sheet.
- The figure may be rounded off (vide notification No. GSR 545 (E), dated 1-8-2002) as under: Where the turnover of the company in any financial year is:
  - less than one hundred crore rupees: to the nearest hundreds or thousands, or decimals thereof.
  - one hundred crore rupees or more but less than five hundred crore rupees: to the nearest hundreds, thousands, lakhs or millions, or decimals thereof.
  - five hundred crore rupees or more: to the nearest hundreds, thousands, lakhs, millions, or crores, or decimals thereof.
- A foot-note to the balance sheet may be added to show separately contingent liabilities.

### Self Assessment

#### Fill in the blanks:

- The Board of Directors is required to present its Profit and Loss Account and Balance Sheet in every ..... of the company.
- Preparation of balance sheet in the prescribed format is required u/s ..... of the Companies Act.
- Capital Redemption Reserve and ..... can be utilized only for the issue of fully paid bonus shares and not meeting the partly paid equity shares into.....

### Illustration:

From the following balances taken from the books of Asian Products Ltd. Prepare Company's Balance Sheet as at 31st March, 2010 in: (a) Horizontal Form, and (b) Vertical Form.

	Rs.		Rs.
Land and Buildings	3,25,000	Patents	7,200
Plant and Machinery	2,90,000	Investments	70,000
Sundry Debtors	65,000	Preliminary Expenses	7,000
50,000 Equity Shares		Securities Premium	25,000

of Rs. 10 each, Rs. 9 called-up		Provision for Income Tax	24,000
15% Debentures	4,50,000	Closing Stock	1,28,000
Reserve	1,00,000	Cash	12,000
Prepaid Insurance	50,000	Advance Income Tax	4,000
Profit & Loss (Cr.)	4,800	Sundry Creditors	15,200
Bank Overdraft	1,13,000	Outstanding Expenses	4,800
General Reserve	15,000	Proposed Dividend	16,000
	1,00,000		

**Further Information:**

- (i) Bills discounted but not yet matured Rs. 12,000.  
(ii) There is a claim against the company not acknowledged as debt Rs. 16,000

**Solution:**

(a) (In Horizontal form)

**Balance Sheet of Asian Product Ltd. as at 31st March, 2010**

<b>Liabilities Amount</b>	<b>Amount Rs.</b>	<b>Assets</b>	<b>Amount Rs.</b>
<b>Share Capital:</b>		<b>Fixed Assets :</b>	
Authorized..shares of Rs.... each		Land and Building	3,25,000
<b>Issued &amp; Subscribed:</b>		Plant and Machinery	2,90,000
50,000 Equity Shares of Rs. 10 each	5,00,000	Patents	7,200
Called-up & Paid-up		<b>Investments</b>	70,000
50,000 Equity Shares of Rs. 10 each, Rs.9 called-up	4,50,000	<b>Current Assets,</b>	
<b>Reserve and Surplus :</b>		<b>Loan and Advances :</b>	
Securities Premium		<b>(A) Current Assets:</b>	1,28,000
General Reserve	25,000	Closing Stock	65,000
Profit & Loss A/c	1,00,000	Sundry Debtors	12,000
Debenture Redemption	1,13,000	Cash	
	50,000	<b>(B) Loans and Advances :</b>	4,800
		Prepaid Insurance	4,000
		Advance Income Tax	

Reserve		<b>Miscellaneous</b>	7,000
<b>Secured Loans :</b>	1,00,000	<b>Expenditure:</b>	
15% Debentures		Preprimary Expenses	
<b>Unsecured Loans</b>			
<b>Current Liabilities</b>			
<b>and Provisions:</b>			
<b>(A) Current</b>			
<b>Liabilities:</b> Bank	15,000		
Overdraft	15,200		
Sundry Creditors	4800		
Outstanding			
Expenses	24,000		
<b>(B) Provisions :</b>			
Provision for Income	16,00		
Tax			
Proposed Dividends			
	<b>9,13,000</b>		<b>9,13,000</b>

**Note:** (i) Bills discounted but not yet matured Rs. 12,000.

(ii) There is a claim against the company not acknowledged as debt Rs.16,000.

**(b) In Vertical Form**

**Balance Sheet of Asian Products Ltd. as on 31st March, 2010**

Particulars	Sch. No	Figures in Rs. as the end of current Financial year	Figures as at the end of Previous Financial Year (Rs.)	
<b>1. Sources of Funds : 1.</b>				
<b>Shareholder's Funds:</b>				
(a) Capital			4,50,000	
(b) Reserves and Surplus:				
Securities Premium		25,000		
General Reserve		1,00,000		
Profit & Loss A/c		1,13,000		
Debenture Redemption				

Reserve		50,000	2,88,000	7,38,000
<b>2. Loan Funds:</b>				
(a) Secured Loans (15% Debentures)		1,00,000		1,00,000
b) Unsecured Loans				
<b>Total</b>				<b>8,38,000</b>
<b>II. Application of Funds :</b>				
<b>1. Fixed Assets :</b>				
Land and Buildings		3,25,000		
Plant and Machinery		2,90,000		6,22,200
Patents		7,200		
<b>2. Investments:</b>			70,000	70,000
<b>3. Current Assets:</b>				
Loans & Advances :				
(a) Closing Stock		1,28,000		
(b) Sundry Debtors		65,000		
(c) Cash		12,000		
(d) Other Current Assets		—		
(e) Loans and Advances				
Prepaid Insurance		4,800		
Advance Income Tax		4,000	2,13,800	
<b>Less, Current Liabilities and Provisions :</b>				
(a) Current Liabilities :				
Bank Overdraft		1,500		
Sundry Creditors		15,200		
Outstanding Expenses		4,800		

(b) Provisions :				
Provision for Income Tax		24,000		
Proposed Dividends		16,000		
Net Current Assets:			(-) 75,000	1,38,000
<b>4. Miscellaneous: Expenditure : Preliminary Expenses</b>				7,000
<b>Total</b>				<b>8,38,800</b>

**Note:** (i) Bills discounted but not yet matured Rs. 12,000.

(ii) There is a claim against the company not acknowledged as debt Rs.16,000

### 3.6 PROFIT AND LOSS ACCOUNT

Now let us know about the Profit and Loss Account of a company. The Companies Act, 1956 has not prescribed any format for presentation of Profit and Loss Account. Therefore, the Profit and Loss Account of a company should be prepared in such a way that it furnishes as detail information as possible about each item of expense, income, loss or profit during a particular accounting period. Again, the Companies Act, 1956 speaks about preparation of Profit and Loss Account and Balance Sheet only. It does not speak about preparation of Trading Account and Profit and Loss Appropriation Account.

However, keeping in view the requirements of Part II of Schedule VI of the Companies Act, 1956, and in order to furnish detailed information to the users of financial statements, the Profit and Loss Account is normally divided into the following three parts viz, Trading Account, Profit and Loss Account and Profit and Loss Appropriation Account.

It may be kept in mind that the items which are considered as charge against profits are shown above the line i.e. in the Trading and Profit and Loss Account part and the items which are in the nature of appropriations are shown below the line i.e. in the Profit and Loss Appropriation Account part of the Profit and Loss Account.

It may be noted that it is not necessary to divide the profit and loss account into three parts viz. Trading Account, Profit and Loss Account and Profit and Loss Appropriation Account, but it must be divided into two parts to show the items above the line and below the line.

However, on the basis of requirements as to Profit and Loss Account as required under Part II of Schedule VI of the Companies Act, a specimen of Profit and Loss Account as given for your ready reference.

#### Profit And Loss Appropriation Account

After ascertaining net profit through profit and loss account, the mode of disposal of such profit is decided by the directors in the Board Meeting. The decision of the board of directors is given effect through the preparation of a separate account known as Profit and Loss Appropriation Account,

although preparation of this account is not compulsory as per law and the Companies Act does not speak about the preparation of this account. This account is debited with the items which are shown only in case of profits.

**Profit & Loss Account for the year ended.....**

<b>Dr.</b>		<b>Cr.</b>	
<b>Particulars</b>	<b>Amount Rs.</b>	<b>Particulars</b>	<b>Amount Rs.</b>
To Opening Inventory		<b>By Sales..</b>	
To Purchases		<b>Less, returns</b>	
Less : Returns		<b>By Closing Inventory</b>	
To Wages		<b>By Gross loss (if no gross profit is there)</b>	
To Power and Fuel			
To Other Direct Expenses			
To Gross Profit c/d			
To Gross Loss b/d(if any)		<b>By Gross Profit b/d</b>	
To Salaries		<b>Investment</b>	
To Depreciation :		<b>By Interest on</b>	
Machinery		<b>By other Interest</b>	
Building etc.		<b>By Miscellaneous</b>	
To Repairs to Buildings		<b>Receipts</b>	
To Repairs to Machinery		<b>By Profits on Sale of</b>	
To Insurance		<b>Investments</b>	
To Rent			
To Rates & Taxes			
To General Expenses			
To Interest on Debentures		<b>By Net Loss (if any) If no net profit is there)</b>	
Add : Outstanding			
To Provision for Bad and Doubtful Debts, etc			
To Contribution to Provident and Pension Funds			
To Stationery, Printing and			

Postage			
To Commission, Brokerage and Discounts			
To Loss on Sale of Investments			
To Discount on Debenture (Written off)			
To Auditors' Fees			
To Net Prof its (if any			

**Profit & Loss Appropriation Account  
For the year ended 31st March.....**

Dr.		Cr.	
Particulars	Amt. Rs	Particulars	Amt. Rs
To Opening balance of Profit and Loss Account		By Opening balance of Profit and Loss Account	
To Debenture Redemption Reserve fund or Sinking fund		By Net Profit (after tax) for the current year	
To Interim Dividend		By Excess provision for income tax written back	
To Reserve		By Transfer from General Reserve	
To Proposed Dividend		By Transfer of provisions no longer required.	
To Corporate Dividend Tax		By Any (materiel) adjustment related to previous years.	
To Bonus to shareholders		By Balance c/d	
To Short provision for income tax for previous years.			
To Balance c/d			

**Vertical Form**

**Profit and Loss Account for the year ending.....**

Particulars	Figures as at the end of Current	Figures as at the end of Previous
	Financial Year	Financial Year
1. Income Sales/services rendered (Details to be given separately as per annexure)		

Dividend		
Interest		
Other income		
Total		
II. Expenditure		
Cost of goods consumed/sold		
Manufacturing expenses		
Selling expenses		
Salaries, wages and other employee benefits		
Managerial remuneration		
Interest		
Depreciation		
Auditor's remuneration		
Provisions for		
(i) doubtful debts; and		
(ii) other contingencies (to be specified) Any other expenses		
Total		
III. Prof/Loss before tax (I-II)		
IV. Provision for taxation		
V. Profit/loss after tax		
Balance of profit brought forward from last year Profit available for Appropriation		
VI. Appropriations:		
Transfer to reserves/surplus		
Proposed dividend:		
Preference shares		
Equity shares		
Balance of profit carried to the balance sheet		

### **3.7 IMPORTANT ITEMS**

#### **1. Preliminary Expenses:**

The portion of Preliminary Expenses to be written off in a certain year is debited to the profit and loss account and the balance amount is shown on the assets side of the balance sheet under the head 'Miscellaneous Expenditure'.

#### **2. Stock Exchange Listing fee:**

It is a recurring expenditure and is revenue in nature. Hence, it is shown on the debit side of the Profit and Loss Account.

#### **3. Filing fee with the Registrar (ROC):**

This is a recurring expenditure and is revenue in nature. Therefore, it is shown on the debit side of the Profit and Loss Account.

#### **4. Discount/ cost of issue / loss on the issue of debentures:**

The portion of the discount/loss to be written off in a certain year should be shown on the debit side of the Profit and Loss Account of that year and the balance not written off will be shown on the assets side of the balance sheet under the head 'Miscellaneous Expenditure'.

#### **5. Directors fees:**

Any fee paid to the directors for attending meeting of the Board of Directors or any committee thereof is treated as an expense and is shown on the debit side of the Profit and Loss Account.

#### **6. Managerial Remuneration:**

Managerial remuneration is treated as business expenditure and is shown on the debit side above the line i.e. in the Profit and Loss Account.

#### **7. Interest on Debenture:**

It is treated as business expense and therefore, it is a charge against profit. The profit and loss account will be debited with the total amount of interest for the accounting year without considering the fact whether the amount is paid or not.

#### **8. Income tax on interest on debentures:**

If the company has deducted income-tax on debenture interest and the same has not been deposited with the Government at the end of the accounting period, the same will appear on the credit side of the Trial Balance and be shown on the liabilities side of the Balance Sheet under the sub-head 'Current Liabilities' the main head 'Current Liabilities & Provisions'.

#### **9. Provision for Taxation:**

Provision for Taxation is considered as a charge against profit and, as such, it is shown above the line. The amount of Provision for Taxation is again shown on the Liabilities side of the balance sheet under the head 'Current Liabilities & provisions'.

#### **10. Calls-in-arrear:**

Calls-in-arrear represents the amount not paid by the shareholders on the calls made on them by the company. The treatment of calls in arrear while preparing the balance sheet will be as under:

- (a) Where Calls-in-arrear appear as an item in the trial balance: If 'Calls-in-Arrear' account appears in the trial balance, it is shown as deduction from the called up amount of share capital on the liabilities side of the balance sheet under the main head of Share Capital.
- (b) Where Calls-in-arrear appears as an item of adjustment: If this item is given as an adjustment, it means that the trial balance shows only the paid up capital (and not called up capital). In such cases, the amount of calls-in-arrear is added to the paid up capital first to make the later as 'called up capital' and then again shown as deduction from the called up capital to arrive at the paid up capital.

### **11. Dividend received / Interest received:**

This item appears on the credit side of the trial balance and is transferred to the credit side of the profit and loss account.

### **12. Dividend:**

A Dividend is a part of divisible profit of a company distributed among its members according to the number of shares held by each of them and the rights attaching thereto. Dividend is paid only to the shareholders both Preference and Equity. Dividend can be paid by a company only out of its profits. Whether dividend will be paid on the basis of paid up value of shares or nominal value depends on the provisions contained in the Articles of the company.

Various issues relating to declaration and payment of dividend by a company are:

#### **(i) Interim Dividend :**

Interim Dividend represents the amount of dividend declared and paid by the company during the year before the preparation of final accounts. Interim dividend is declared and paid by the board of directors and there is no necessity of calling a meeting of the shareholders to sanction the payment of such dividend. The Companies (Amendment) Act, 2000 has inserted new sub-section (14A) in Section 2 of the Companies Act which states that 'interim dividend' is included in the definition of 'dividend'. Where interim dividend has been paid, the item appears on the debit side of the trial balance. It is an item of appropriation of profits and, therefore, it is shown on the debit side below the line i.e. in the Profit and Loss Appropriation Account.

#### **(ii) Final Dividend :**

Final Dividend appearing in the trial balance should be debited in the Profit and Loss Appropriation Account. (iii) Proposed Dividend: Clause 85 of Table A, Schedule I to the Companies Act provides that the company in general meeting, may declare dividend, but no dividend shall exceed the amount recommended by the Board of Directors. Although, the shareholders in general meeting have been given the power to declare dividend, the discretion as to whether to declare dividend or not has entirely been left with the Board of Directors. If the directors, at their discretion, think that dividend should not be declared and as such do not recommend the declaration of the same, the shareholders in general meeting cannot declare dividend. It is, therefore, the directors who, at their discretion, recommend declaration of dividend at a particular rate and the shareholders in general meeting can, of course, declare the dividend at a lower rate than that recommended by the Board, but, in no case, can they increase the rate of dividend. The item 'Proposed Dividend' always appears in the adjustment. Since it is always an adjustment item, double effect should be completed for which, first it is shown in the debit

side of the Profit and Loss Appropriation Account and then on the liabilities side of the balance sheet under the head 'Current Liabilities and Provisions'.

**Note: Interim dividend is not adjusted when the final dividend is declared unless the resolution declaring the dividend states otherwise. In other words, in the absence of any clear mention in the resolution declaring final dividend regarding adjustment of interim dividend paid, the final dividend/ proposed dividend will be in addition to the interim dividend already paid during the year. It should be kept in mind that no dividend is payable on calls in advance.**

**(iv) Dividend on Preference Shares:**

Preference shareholders enjoy a preferential right over the equity shareholders in the matter of dividend. Normally, dividend on preference shares is paid at a fixed rate before any dividend is paid to equity shareholders. But they can exercise their preferential right only when the company has distributable profits and the Board of directors recommends distribution of such profits. If any dividend is proposed on Preference Shares, it will appear in the adjustment. Therefore, first it is shown in the debit side of the profit and loss appropriation account and then on the liabilities side of the balance sheet under the head 'Current Liabilities and provisions-Provisions'.

Again, if the preference shares are participating, additional dividend shall be paid to preference shareholders as per the provisions in the articles of association of the company.

**13. Transfer to Reserves :**

Section 205 (2A) of the Companies Act, 1956 inserted by the Companies (Amendment) Act, 1974 provides that before declaration and payment of dividend out of current year's profit, a company is required to transfer such percentage of its profit for the current year to reserves not exceeding 10 per cent, as may be prescribed.

According to Rule 2 of Companies (Transfer of profits to reserves) Rules 1975, prescribed by the Central Government, before payment of any dividend, the company must transfer the percentage of its profits for that year as specified below:

<b>Rate of Dividend</b>	<b>Transfer to Reserves</b>
Exceeds 10% but not 12 <sup>1</sup> / <sub>2</sub> %	2 <sup>1</sup> / <sub>2</sub> % of profit after tax
Exceeds 12 <sup>1</sup> / <sub>2</sub> % but not 15%	5% of profit after tax
Exceeds 15% but not 20%	7 <sup>1</sup> / <sub>2</sub> % of profit after tax
Exceeds 20%	10% of profit after tax

From the above it is clear that if the rate of dividend does not exceed 10%, the transfer to reserve is not mandatory. However, a company has the liberty to transfer a higher percentage of profits, than the ones stated above, to reserves. Therefore, transfer to reserves may be either statutory or voluntary.

**14. Corporate Dividend Tax :**

The Finance Act, 1997 has introduced, with effect from 1st June, 1997, a provision for taxation on dividend on companies. This tax is termed as 'Corporate Dividend Tax'. Any domestic company declaring, distributing or paying dividends is required to pay this tax at the rates applicable for the concerned year. It may be mentioned here that the Corporate Dividend Tax was withdrawn by the Finance Act, 2000 but has been reintroduced by the Finance Act, 2003 which has fixed the rate of corporate dividend tax at twelve and one half per cent (12.5%) from 1.4.2003. Corporate dividend tax is

paid in addition to the income tax chargeable in respect of total income. Corporate dividend tax is calculated on the amount of dividend declared including interim dividend both on Preference and Equity capital. The amount of tax payable as corporate dividend tax may be paid out of the current profits or accumulated profits and, therefore, the amount of Corporate Dividend Tax should also be shown on the Debit side of the Profit and Loss Appropriation Account and shown on the liabilities side of the balance sheet under the head 'Current Liabilities and Provisions', and sub-head 'Provisions' till the amount is paid to the Central Government. Sometimes Corporate Dividend Tax account may appear in the trial balance. It means that the company has paid Corporate Dividend Tax on the interim dividend paid by the company. In such a case, Corporate Dividend Tax will be shown only on the debit side of the Profit and Loss (Appropriation) Account.

### **15. Unpaid dividend :**

If there is any unpaid dividend, it will appear on the credit side of the trial balance. While preparing the balance sheet, it is shown on the liabilities side of the Balance Sheet under the sub-head 'Current Liabilities' under the main head 'Current Liabilities & Provisions'.

### **16. Unclaimed dividend :**

If there is any unclaimed dividend, it will appear on the credit side of the trial balance. While preparing the balance sheet, it is shown on the liabilities side of the Balance Sheet under the sub-head 'Current Liabilities' under the main head 'Current Liabilities & Provisions'.

### **Self Assessment**

Fill in the blanks:

1. The Board of Directors is required to present its Profit and Loss Account and Balance Sheet in every ..... of the company.
2. Preparation of balance sheet in the prescribed format is required u/s ..... of the Companies Act.
3. Capital Redemption Reserve and ..... can be utilized only for the issue of fully paid bonus shares and not meeting the partly paid equity shares into.....
4. .... account enables the trader to find out Gross Profit or Loss.
5. .... account enables the trader to find out the Net Profit or Loss.
6. Direct Expenses appears on ..... side of ..... account.
7. Indirect Expenses appears on ..... side of ..... account.
8. If the Trial Balance contains both Trade Expenses and Office Expenses, the Trade Expenses.
9. Posted to ..... account and office expenses posted to ..... account.
10. Interim dividend is declared between two.....
11. The difference between dividend received and dividend receivable is debited.....
12. 30 days after the declaration of dividend the amount of unpaid dividend is deposited in a.....
13. Interest out of ..... may be paid u/s 208 of the Companies Act.
14. Unpaid dividend is shown under the heading of\_\_\_\_\_.

15. Advance payment of income tax is shown under the heading of Advance in the \_\_\_\_\_ of the balance sheet.

**Illustration:**

The following is the trial balance of Laxmi Industries Ltd. as on 31st March, 2010. Prepare a Trading and Profit and Loss Account for the year ended 31st March, 2010 and a Balance Sheet as on that date in the form prescribed under the Companies Act, 1956.

Dr.		Cr.	
Particulars	Rs.	Particulars	Rs.
Investment	35,000	Share Capital	4, 00,000
Calls in Arrear	1,000	Sales	3, 00,000
Land & Building	45,000	Sundry Creditors	17,000
Machinery	3,00,000	General Reserve	25,000
Furniture	15,000	Profit on Consignment	13,000
Custom Duty	3,800	Loan from Bank	45,000
Wages	31, 400	Dividend	3,000
Salaries	45,200		
Insurance	2,800		
Purchases	1, 60,000		
Bills Receivable	21,200		
General Expenses	6,900		
Sundry Debtors	60,000		
Opening Inventory	65,000		
Cash at Bank	8,800		
Cash in hand	900		
Directors Fees	1,000		
	8, 03,000		8, 03,000

The following information are to be taken into consideration:

- Closing Inventory Rs. 86,000
- Depreciate Machinery at 10%
- Outstanding Salary Rs. 4,000
- Transfer Rs. 5,000 to General Reserve
- The authorized capital of the company is Rs. 6,00,000 divided into Equity Shares of Rs. 10 each.

Solution :

**Laxmi Industries Ltd.**  
**Trading and Profit and Loss Account for the year ended 31st March,**  
**2010**

Dr			Cr
Particulars	Rs	Particulars	Rs
To Opening Inventory	65,000	By Sales	3,00,000
To Purchases	1,60,000	By Closing Inventory	86,000
To Custom Duty	3,800		
To Wages	31,400		
To Gross Profit c/d	1,25,800		
	-----		-----
	3,86,000		3,86,000
	-----		-----
To Salaries 45,200		By Gross Profit b/d	1,25,800
Add. Outstanding <u>4000</u>	49,200	By Profit on Consignment	13,000
To Insurance	2,800	By Dividend	3,000
To General Expenses	6,900		
To Directors' fees	1,000		
To Depreciation on Machinery 10% x 3,00,000	30,000		
To Provision for Income Tax@ 30% on Rs. 51,900 To	18,165		
Net Profit c/d	33,735		
	-----1		-----
	,41,800		1,41,800
	-----		-----
To General Reserve	5,000	By Net Profit b/d	33,735
To Balance c/d	28,735		
	-----		-----
	<u>33,735</u>		<u>33,735</u>
	-----		-----

**Laxmi Industries Ltd.**  
**Balance Sheet as on 31st March, 2010**

<b>Liabilities</b>	<b>Rs.</b>	<b>Assets</b>	<b>Rs.</b>
Share Capital:		<b>Fixed Assets:</b>	
Authorized: 60,000		Land and Building	45,000
Equity shares of Rs. 10 each	6,00,000	Machinery	3,00,000
Issued and Subscribed :		Less: Depreciation 30,000	
40,000 equity shares of Rs. 10		(10%×3,00,000)	2,70,000
each fully called 4,00,000		Furniture	15,000
Less : Calls in arrear 1,000	3,99,000	<b>Investments:</b>	35,000
<b>Reserves and Surplus:</b>		<b>Current Assets,</b>	
General Reserve(25,000+ 5,000)	30,000	<b>Loans &amp; Advances:</b>	
Profit and Loss Account	28,735	<b>(A) Current Assets:</b>	
<b>Secured Loans :</b>		Closing inventory	86,000
Loan from bank	45,000	Sundry Debtors	60,000
Unsecured Loans :		Cash at bank	8,800
<b>Current Liabilities &amp;</b>		Cash in hand	900
<b>Provisions:</b>		<b>(B) Loans &amp; Advances:</b>	
<b>(A) Current Liabilities :</b>		Bills Receivable	21,200
Sundry Creditors	17,000	<b>Miscellaneous Expenditure :</b>	
Outstanding Salary	4,000		
<b>(B) Provision :</b>			
Provision for Income Tax	18,165		
	5,41,900		5,41,900

**Note: Loan from bank is assumed to be secured**

## Vertical Form:

**Profit and Loss Account of Laxmi Industries Ltd.  
for the year ended 31st March, 2010**

Particulars	Amount Rs
1. INCOME :	
Sales	3,00,000
Dividend	3,000
Interest	—
Other income	13,000
	-----
<b>Total</b>	<b>3,16,000</b>
	-----
II. EXPENDITURE :	
Cost of goods sold	1,74,200
Salaries	49,200
Insurance	2,600
General Expenses	6,900
Directors fees	1,000
Depreciation on Machinery	30,000
	-----
<b>Total</b>	<b>2,64,100</b>
	-----
III. Prof it before Tax (I-II)	51 ,900
IV. Provision for Taxation	
(35% of Rs. 51 ,900)	18,165
V. Net Prof it for the year	33,735
Profit brought forward from Previous year	—
Profit available for Appropriation :	
VI. APPROPRIATION :	33,735
Transfer to General Reserve	5,000
Proposed Dividend	—

Corporate Dividend Tax	—
	-----
<b>Balance of profit carried to Balance</b>	<b>28,735</b>
	-----
<b>Sheet</b>	

**Balance Sheet of Laxmi Industries Ltd.  
as on 31st March 2004**

Particulars	Schedule No	Figure as at the end of the current year		
		Amount Rs.	Amount Rs.	Amount Rs.
1. Sources Of Funds:				
1. Shareholders Fund:				
a) Capital			3,99,000	
b) Reserves and surplus			58,735	
			-----	4,57,735
2. Loan Fund :				
a) Secured loan			45,000	
b) Unsecured loan			---	45,000
			-----	-----
<b>Total</b>				<b>5,02,735</b>
				-----
II. Application Of Funds :				
1. Fixed Assets:				
a) Gross Block			3,60,000	
b) Less : Depreciation			30,000	
c) Net Block			-----	
d) Capital work in progress			3,30,000	
			-----	3,30,000
2. Investment:				
3. Current Assets, Loan. Advances :				35,000

a) Inventories				
b) Sundry Debtors		86,000		
c) Cash and Bank balances		60,000		
d) Other current Assets		9,700		
e) Loans and Advances		21,200		
		---	1,76,900	
Less : Current liabilities and provisions :				
a) Liabilities				
b) Provisions		21,000		
		18,165	39,165	
Net Current Assets		-----	-----	
4. a) Miscellaneous Expenditure to the extent not written of f or adjusted				1,37,735
		----		
b) Profit a Loss Account				
<b>Total</b>				----- <b>5,02,735</b>

**Statement showing the grouping of various items:**

<b>PROFIT &amp; LOSS A/C:</b>	Rs.
1. Other Income	
Profit on Consignment	13,000
<b>2. Cost of goods sold</b>	
Opening Inventory	65,000
Purchases	1,60,000
Wages	31,400
Custom Duty	3,800
	-----
	2, 60,200
Less: Closing Inventory	86,000
	-----
	1, 74,200

<b>BALANCE SHEET: I. Share Capital:</b>	
40,000 equity shares of Rs. 10 each fully called	400,000
Less : Calls in Arrear	1,000
	-----
	3,99,000
	-----
<b>Reserves &amp; Surplus</b>	
General Reserve	25,000
Add, Transfer	5,000
Balance of Profit & loss A/c	28,735
	-----
	58.735
	-----
<b>3. Gross Block</b>	
Land & Building	45,000
Machinery	3,00,000
Furniture	15,000
	-----
	3,60,000
	-----
<b>4. Current Liabilities</b>	
Sundry creditors	17,000
Outstanding salary	4,000
	-----
	21,000
	-----

Note : (i) It is assumed that Bank Loan is a Secured loan.

### 3.8 SUMMARY:

Final account is the end product of accounting system which include—

- (i) Trading and Profit and Loss account;
- (ii) Balance Sheet.

The structure of final account is prescribed in Schedule VI which divides into four parts as

- (i) Part-1 (information to be disclosed relating to share capital).

- (ii) Part-11 (information to be disclosed relating to profit and loss account);
- (iii) Part-111 (contains interpretation and explanation of certain terminologies) and
- (iv) Part-IV (information to be disclosed relating to Annual Report)

The decision of Board Meeting after ascertaining profit through profit and Loss account is shown in profit and loss appropriation account.

### 3.9 Glossary:

**Divisible Profits:** All profits are not divisible profits. Only those profits which are legally available to shareholders for dividend are known as divisible profits. This is the profits left after meeting all expenses, losses, depreciation on fixed assets, fall in the price of current assets, taxation, and writing of past losses and after transferring a reasonable amount to reserve.

**Interim Dividend:** Dividend paid during the year, before ascertainment of the profits for the year is called 'Interim Dividend'.

**Asset:** Anything, tangible or intangible, of monetary value to a business entity.

**Contingent Liability:** A liability which has not been recognised as such by the entity. It becomes a liability only on the happening of a certain future event. An example could be the liability which may arise out of a pending law suit.

**Current Assets:** All of the assets held by a firm with the objective of conversion to cash within the operating cycle or within one year whichever is longer. Current Assets include items such as cash, receivables, inventory and prepayments.

**Current Liabilities:** All those claims against the assets of the firm to be met out of cash or other current assets within one year or within the operating cycle, whichever is longer. Usually include items such as accounts payable, tax or other claims payable and accrued expenses.

**Fixed Asset:** Tangible long-lived asset. Usually having a life of more than one year. Includes items such as land, building, plant, machinery, motor vehicles, furniture and fixtures.

**Intangible Assets:** Any long-term assets useful to the business and having no physical characteristics. Include items such as goodwill, patents, franchises, formation expenses and copyrights.

**Liability:** Any amount owed by one person (the debtor) to another (the creditor). In a balance sheet all those claims against the assets of the entity, other than those of the owners.

**Owner's Equity:** It is the owner's claim against the assets of a business entity. It could be expressed as total assets of an entity less claims of outsiders or liabilities, includes both contributed capital and retained earnings.

**Gross Profit:** It is calculated by comparing the sales and cost of sales. It is the excess of sales over cost of sales.

**Net Profit:** It is the excess of revenues over expenses. It is depicted by P. & L. A/c.

**Net Loss:** Excess of expenditures over revenues is called net loss. Trial Balance: It is the list of accounts taken from the ledger.

### 3.10 Answers: Self Assessment:

1. Annual General Meeting,

2. 211,
3. Share Premium A/c and fully paid equity shares,
4. Trading
5. Profit & Loss
6. Debit, Trading
7. Debit, Profit & Loss
8. Trading
9. Trading, P & L A/c
10. Annual General Meetings,
11. T.D.S A/c,
12. Unpaid Dividend A/c,
13. Capital,
14. Current liabilities
15. Assets side

### **3.11 Terminal Questions:**

1. How would you deal with the following items while preparing the final accounts of a company?
  - (a) Directors Fees
  - (b) Dividend Received
  - (c) Provision for Tax
  - (d) Transfer to Reserve
  - (e) Unpaid Dividend
2. Prepare in a summarised form the Balance sheet of a Company as per Schedule III of Companies Act, 2013, taking imaginary figures.
3. What is the structure of final accounts as prescribed in Schedule VI Companies Act 1956?

### **3.12 SUGGESTED READING**

1. Advanced Accounting by Dr. A Sehgal and Dr. D Sehgal, Taxman
2. Corporate Accounting by B B Dam , H C Gautam, Capital Publishing;
3. Advanced Accountancy, by S N Maheshwari, Vani Educational Books;
4. Modern Accountancy, by Mukherjee and Hanif, Tata Mcgraw

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**Lesson-4****AMALGAMATION, ABSORPTION AND RECONSTRUCTION****Structure:**

- 4.0 Learning Objectives
- 4.1 Introduction
- 4.2 Amalgamation
- 4.3 Absorption
- 4.4 Reconstruction
- 4.5 Difference between Amalgamation, Absorption and Reconstruction
- 4.6 Purchase consideration
- 4.7 Accounting Consideration
- 4.8 Absorption (Accounting Procedure)
- 4.9 Inter-Company Owings
- 4.10 Payment of Dividend before Absorption
- 4.11 Sale of Shares received as Purchase Consideration
- 4.12 Dissenting Shareholders
- 4.13 External Reconstruction
- 4.14 Summary
- 4.15 Glossary
- 4.16 Answers: Self Assessment
- 4.17 Terminal Questions
- 4.18 Suggested Readings
- 4.0 **LEARNING OBJECTIVES**

After studying the lesson, you should be able to understand.

1. The meaning of Amalgamation, Absorption and Reconstruction.
2. Computation of Purchase Consideration.
3. Accounting treatment in the books of Transferor and Transferee Company.

**4.1 INTRODUCTION**

Amalgamation refers to combination or merger. In amalgamation two or more organizations combine their resources to take such advantages as economies of large scale production, employing qualified and efficient persons by offering high salaries, avoiding competition, expansion and so on. The combination or merger may take place in any one of the three ways, namely; amalgamation, absorption and external reconstruction.

## 4.2 AMALGAMATION

An amalgamation takes place where two or more companies carrying on business of a like nature combine together and form a new company. The object usually would be to secure economical working by reducing establishment and management charges and to eliminate competition and control the market in a particular line of trade. The companies forming part of such a combine all go into liquidation, and sell their business to a new company, which is formed solely to take over the assets and assume the liabilities of the companies going into liquidation. No return of capital is involved, as the shareholders are usually given fully paid shares in the new company in proportion to their holding in the old company.

## 4.3 ABSORPTION :

The term absorption generally applies where an existing company buys or absorbs another smaller company doing similar business for a consideration as may be agreed upon with the vendor company. The object again here may be to reduce competition and enhance profits by effecting economy in management. The company bought over goes into liquidation, and the absorbing company purchases the business from the liquidator. The creditors of the absorbed company may either be paid off or the purchasing company may take over the liabilities. The shareholders in the absorbed company may be given shares or cash in return for their holdings.

## 4.4 RECONSTRUCTION:

The term 'reconstruction' as a rule, indicates that an existing company on account of past losses in trading and also due to financial difficulties goes into liquidation with a view to form another company to take over the existing firm.

## 4.5 DIFFERENCE BETWEEN AMALGAMATION, ABSORPTION AND RECONSTRUCTION:

The difference between Amalgamation, Absorption and Reconstruction is that in Amalgamation, two existing companies go into liquidation and a new company is started to carry on the business whereas, in absorption one company or more go into liquidation and no new company is started. On Reconstruction, one company goes into liquidation and one new company is started to carry on the business. The company that goes into liquidation is called 'VENDOR CO.' and the company that takes over the business, may be old or new, is called 'PURCHASING COMPANY'. The amount that is being given by the purchasing company to the vendor company is called 'PURCHASE CONSIDERATION'. The Purchase consideration may be paid in cash or shares or debentures or partly in these forms. Besides in the case of an absorption the shareholders of the absorbed company generally stand to profit from the sale of their business while a reconstruction will usually result in a loss to the shareholders on account of the company having financially hard hit due to losses, the reconstruction scheme may provide for the existing creditors to be satisfied either by cash composition or by the issue of debentures and even sometimes shares in the new company. The shareholder may also be called upon to accept partly paid shares in exchange for the new company. As the balance on the partly paid shares will necessarily have to be called up at any time this would put the shareholders with a further liability, and it may be that some of them may refuse to accept such a scheme of reconstruction, and in such a circumstance, the liquidator will have to purchase their interest at a price as may be mutually agreed upon. In short a reconstruction scheme presents an opportunity to obtain a new lease of life for the old company by writing off past losses and obtaining further working capital resulting from the creditors and the member all agreeing to sacrifice equitably.

From accounting point of view, there is no difference in Amalgamation, Absorption and External Reconstruction because in all these three cases the accounting procedure is the same.

In case of Internal Reconstruction, the accounting procedure is entirely different.

Accounting for amalgamation is governed by Accounting Standard 14 (AS-14), issued by the Institute of Chartered Accountants of India. This accounting standard has been made effective in respect of accounting periods commencing on or after 1st April, 1995 and is mandatory in nature.

The following terms with specified meaning have been used in Accounting Standard:-

- (a) **Transferor Company** means the Company which is amalgamated into another Company.
- (b) **Transferee Company** means the Company into which a Transferor Company is amalgamated.
- (c) **Amalgamation:-** According to the new meaning, amalgamation may be of two types:-
  1. Amalgamation in the nature of merger, and
  2. Amalgamation in the nature of purchase.

#### 1. Amalgamation in the nature of merger: -

According to AS-14 on Accounting for Amalgamation, the following conditions must be satisfied for an amalgamation in the nature of merger:

- A. All the assets and liabilities of the transferor company becomes the assets and liabilities of the transferee company.
- B. Shareholders holding not less than 90% of the face value of the equity shares of the transferor company become the equity shareholders of the transferee company by virtue of amalgamation.
- C. The business of the transferor company is intended to be carried on after the amalgamation by the transferee company.
- D. Purchase consideration should be discharged only by issue of equity shares in the transferee company except that cash may be paid in respect of any fractional shares.
- E. No adjustments are required to be made in the book values of the assets and liabilities of the transferor company, when they are incorporated in the financial statements of the transferee company. If any one of the condition is not satisfied in a process of amalgamation, it will not be considered as amalgamation in the nature of merger.

#### 2. Amalgamation in the nature of Purchase:-

An amalgamation will be treated as "Amalgamation in the nature of purchase" if any of the above mentioned conditions is not satisfied.

#### 4.6 PURCHASE CONSIDERATION

Purchase consideration means the price payable by the Transferee (Purchasing or Vendee) Company to the Transferor Company for taking over the business of the Transferor (Vendor) Company.

Accounting Standard (AS)-14 defines the consideration for amalgamation as: the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company. It is clear that consideration does

not include payments made to or for creditors or any other person. It means that payments made by the transferee company to or for creditors, or debenture holders or any other outside liabilities or for the cost of winding up of the transferor company shall not be included in the purchase consideration.

- (i) Purchase consideration generally implies the agreed value of the net assets taken over. The amount depends upon the agreement between the transferor company and the transferee company.
- (ii) Purchase consideration consists of shares and other securities like debentures, cash and the other assets and the amount of purchase consideration would depend upon the fair value of securities and other assets.
- (iii) Where a liability item has not been taken over by the transferee (purchasing) company, the same will be paid by the transferor (vendor) company.

### COMPUTATION OF PURCHASE CONSIDERATION

The following methods of calculation of purchase consideration are:

- (i) Lump-sum Payment Method
- (ii) Net Assets Methods
- (iii) Net Payment Method (Also called Total Payments Method)
- (iv) Intrinsic-worth Method or Swap Method

### LUMP-SUM PAYMENT METHOD:

The examination problem may mention the amount of purchase consideration to be paid by the transferee company to the transferor company for amalgamating (merger or purchase) its business e.g. Yamini Ltd. takes over the business of Anshita Ltd. for Rs. 50 lakhs. Hence the purchase consideration is the sum of Rs. 50 lakhs and there is no need for any calculation.

### NET ASSETS METHOD

Under net assets method, purchase consideration is arrived at by adding the agreed (or market) values of the assets taken over by the transferee (purchasing) company and deducting there from the agreed values of the liabilities taken over by the transferee (purchasing) company.

### PRO-FORMA NET ASSETS METHOD

	Rs	Rs
<b>Assets taken over [Agreed Values]</b>		
Goodwill	Xx	
Land and Building	xx	
Plant and Machinery	xx	
Furniture and Fixtures	xx	
Stock	xx	
Debtors	xx	
Bills Receivable	xx	

Cash/Bank Balance	xx	Xxx
<b>Less : Liabilities taken over [Agreed Values]</b>		
Creditors	xx	
Bills Payable	xx	
Bank Overdraft	xx	
Outstanding Expenses	xx	
Debentures	xx	xxx
<b>Purchase Consideration</b>		xxx

### Illustration (Net Assets Method)

A Ltd. and B Ltd. decided to amalgamate and form a New Company called A B Ltd. as on 1st April, 2004 when their Balance Sheets were as follows:

#### BALANCE SHEET OF A LTD.

Liabilities	Rs	Assets	Rs
50,000 Equity Shares of Rs. 10 each fully paid	<b>5,00,000</b>	Plant & Machinery	<b>3,75,000</b>
<b>Securities Premium</b>	50,000	Computers	1,25,000
General Reserve	60,000	Motor Van	85,000
Capital Reserve	10,000	Stock	2,15,000
Dividend Equalization Fund	30,000	Debtors	1,50,000
9% Debentures	2,00,000	Cash at Bank	25,000
Trade Creditors	80,000	Preliminary Expenses	20,000
Employees Profits Sharing Fund	25,000		
Provident Fund	40,000		
	<u>9,95,000</u>		<u>9,95,000</u>

#### BALANCE SHEET OF B LTD.

Liabilities	Rs.	Assets	Rs.
30,000 Equity Shares of Rs. 10 each fully paid	3,00,000	Goodwill	20,000
General Reserve	25,000	Plant & Machinery	2,30,000
		Stock	1,20,000

Profit & Loss Account	75,000	Debtors	80,000
10% Debentures	50,000	Bills Receivable	10,000
Sundry Creditors	20,000	Cash at Bank	13,000
Bills Payable	10,000	Cash in hand	2,000
		Discount on Issue of Debentures	5,000
	4,80,000		4,80,000

A B Ltd. took over the assets and liabilities of both the Companies as follows:

	A Ltd.	B Ltd.
Plant & Machinery at	10% less	20% less
Computers at	Rs. 1,20,000	—
Motor Van at	Rs. 75,000	—
Debtors	Subject to 5% Provision against bad & doubtful debts.	
Stock	20% higher than the Book values.	

### Solution:

#### Calculation of Purchase Consideration

	A Ltd. Rs.	B. Ltd. Rs.
Plant & Machinery	3,37,500	1,84,000
Computers	1,20,000	—
Motor Van	75,000	—
Stock	2,58,000	1,44,000
Debtors	1,42,500	76,000
Bills Receivable	—	10,000
Cash at Bank	25,000	13,000
Cash in hand	—	2,000
	-----	-----
	9,58,000	9,58,000
	-----	-----
Less Liabilities	(2,00,000)	(50,000)
Debentures	(80,000)	(20,000)
Creditors	--	(10,000)

Bills Payable	(25,000)	--
Employees Profit Sharing Fund	(40,000)	---
Provident Fund	-----	-----
	6,13,000	3,49,000
Net Assets before goodwill	61,300	34,900
Add Goodwill (10% of net assets)	-----	-----
Purchase Consideration	6,74,300	3,83,900

### SHARE EXCHANGE METHOD OR SWAP METHOD

Sometime, purchase consideration is to be discharged in shares based on certain ratio which is determined by their respective intrinsic values. The purchase consideration is arrived at by multiplying the number of shares to be issued to shareholders of transferor company by the agreed value of the share which may either be face value, market value or the intrinsic value itself. Fractional shares should be valued at market price unless otherwise stated. Following steps are taken.

- (i) Calculate the net assets of the transferor company and divide the same by the number of equity shares to ascertain the intrinsic value of share of transferor company.
- (ii) Calculate the net assets of the transferee company and ascertain the intrinsic value as per step first.
- (iii) Determine the ratio of exchange between the shares of transferor and transferee company. Suppose intrinsic values of A Ltd. and B Ltd. are Rs. 80 and Rs. 60 respectively. Then the ratio of exchange will be determined as follows:

	A Ltd.	B Ltd.
Intrinsic Value	Rs. 80	Rs. 60
Ratio of intrinsic Value	4	: 3

It means 3 shares of A Ltd. are equal to 4 shares of B Ltd.

A Ltd.'s 3 shares @ Rs. 80 = B Ltd.'s 4 shares @ Rs. 60

$$\text{Rs. 240} = \text{Rs. 240}$$

Alternatively the Net assets of Transferor company may be divided by intrinsic value of Transferee company to get the number of shares to be issued to transferor company and multiplied by the agreed value of share.

Following are the Balance Sheets of P Ltd. and Q Ltd. as on 31st March, 2004.

Liabilities	PLtd. Rs.	QLtd.
Equity Share Capital (Shares of Rs. 10 each)	5,00,000	4,00,000
	1,75,000	25,000
Revenue Reserve	1,00,000	50,000

9% Debentures		
<b>Current Liabilities :</b>	60,000	45,000
S. Creditors	40,000	25,000
Provision for Taxation	-----	-----
	8,75,000	5,45,000
	-----	-----
<b>Assets</b>		
Net Block	3,75,000	2,45,000
Investments	1,00,000	50,000
<b>Current Assets :</b>		
Stock	2,15,000	1,40,000
Debtors	1,50,000	85,000
Bank Balance	35,000	25,000
	<u>8,75,000</u>	<u>5,45,000</u>

P Ltd. takes over the business of Q Ltd. on the following terms :

- (i) Fixed assets of P Ltd. and Q Ltd. are to be considered worth Rs. 5,00,000 and Rs. 3,00,000 respectively.
- (ii) P Ltd. agreed to discharge 9% Debentures of Q Ltd.
- (iii) Shares of both the companies are to be valued on the basis of its' intrinsic value. Determine the ratio of exchange and calculate purchase consideration if:
  - (a) Shares are to be issued at par
  - (b) Shares are to be issued on the basis of it's intrinsic value.
  - (c) Shares are issued on the basis of it's market price of Rs. 20 each.

### Solution: 2

#### Calculation of ratio of exchange of shares

	PLtd. Rs.	Q Ltd. Rs
Net Block	5,00,000	3,00,000
Investments	1,00,000	50,000
Stock	2,15,000	1,40,000
Debtors	1,50,000	85,000
Bank Balance	35,000	25,000

	10,00,000	6,00,000
Less Liabilities		
9% Debentures	(1,00,000)	(50,000)
S. Creditors	(60,000)	(45,000)
Provision for Taxation	(40,000)	(25,000)
Net Assets	8,00,000	4,80,000

16

12

[Intrinsic Value = Net Assets/No. of Shares]

4

:

3

On the basis of intrinsic value 3 shares of P Ltd. will be equal to 4 shares of Q Ltd. Therefore, ratio of exchange will be 3:4.

Therefore P Ltd. will issue to the shareholders of Q Ltd.  $40,000 \times \frac{3}{4} = 30,000$  shares

- Now if P Ltd. issues shares at par purchase consideration will be 30,000 shares @ Rs. 10 = Rs. 3,00,000
- If shares are issued by P Ltd. at its intrinsic value then purchase consideration will be Rs. 4,80,000 i.e. 30,000 @ Rs. 16 and P Ltd. will issue 30,000 shares of Rs. 10 each at Rs. 6 per share as premium.
- If P Ltd. issues shares at the market value of Rs. 20 per share, then the purchase consideration will be Rs. 6,00,000 i.e. 30,000 @ Rs. 20 each. Thus P Ltd. will issue 30,000 shares of Rs 10 each at Rs. 10 per share as premium.

### TOTAL PAYMENTS METHOD OR NET PAYMENTS METHOD

Under this method, the purchase consideration is calculated by adding up the total amount (money value) of equity shares, preference shares and cash received from the transferee (purchasing) company for the shareholders (equity and preference) of the transferor (vendor) company.

**The procedure is summarized below:**

- Amount of Preference shares i.e., Number of Shares x Issue Price
- Cash for preference shareholders
- Amount of Equity shares i.e. Number of Equity Shares x Issue Price
- Cash for Equity shareholders (for fractional shares)

**Purchase consideration** = Total Payments under (a) + (b) + (c) + (d)

### Essential Points

- Whatever is received from the purchasing company for the shareholders of the vendor company is added. Unlike net assets method, nothing is deducted.

- (ii) The purchase consideration will not include the payments made by the transferee (purchasing) company in any form to the debenture holders and other forms of liabilities. Such liabilities will be transferred by the transferor (vendor) company to the transferee (purchasing) company and paid by the latter company after the takeover.

### Illustration (Purchase Consideration: Total or Net Payments Method)

Rajnigandha Ltd. is absorbed by Vasundhara Ltd., the consideration being the takeover of liabilities; the payment of cost of absorption as a part of purchase consideration not exceeding Rs. 20,000 (actual cost Rs. 17,000); the payment of the debentures of Rs. 1,00,000 at a premium of 10% in 9% debentures issued at par; and the payment of Rs. 16 per share in cash and allotment of one 14% preference share of Rs. 10 each and 6 equity shares of Rs. 10 each fully paid for every 4 shares in Rajnigandha Limited. The number of shares of the vendor company are 2, 00,000 of Rs. 10 each fully paid. Calculate purchase consideration as per Accounting Standard-14 assuming it is an absorption in the nature of purchase.

### Solution

#### CALCULATION OF PURCHASE CONSIDERATION AS PER AS-14

	Rs.
Cash Payment to Shareholders 2,00,000 × 16	32,00,000
Payment to Shareholders in shares of purchasing company: 14% Preference Shares of Rs. 10 each for every 4 shares held in Rajnigandha	
i.e. =2,00,000 × 10/ and 6 Equity Shares of 10 each for every 4 shares held in Rajnigandha,	5,00,000
	30,00,000
Purchase Consideration	67,00,000

**Payments for cost of absorption and debenture holders are not to be included in the purchase consideration as per AS-14.**

## 4.7 ACCOUNTING TREATMENT

### Books of Transferor Company

Transferor company goes into liquidation because assets and liabilities are taken over by the transferee company, and the same are transferred to Transferee company. In case, if some of the assets or liabilities are not taken over the same are realized or discharged by the transferor company.

The account of shareholders is settled after the receipt of purchase consideration from transferee company. For this purpose accumulated profits or losses in whatever form these may be, including fictitious assets are transferred to Shareholders Account. It is to be noted that besides share capital the profit or loss arising from transfer of assets and liabilities takeover including disposal or discharge of

assets or liabilities not takeover, are transferred to Shareholders' Account. Thus the transferor company prepares mainly:

1. Realization Account
2. Shareholders' Account
3. Transferee Company's Account

The accounting treatment can be studied under two stages:

- (a) Journalisation of Transactions.
- (b) Preparation of relevant ledger Accounts.

### Journal Entries

1. On transfer of assets:

Realization A/c	Dr.	
To Sundry Assets *		Total
		with book value of all individual assets

**\* In case Cash or Bank balance is not taken over by the Transferee company the same shall not be transferred to Realization Account. Similarly fictitious assets will not form part of Sundry Assets but these will be transferred to Shareholders Account.**

2. On transfer of liabilities

Sundry Liabilities A/c	Dr.	
To Realization A/c		with book value of individual liability (Total)

3. On recording the purchase consideration receivable

Transferee Company's A/c	Dr.	
To Realization A/c		with total P.C.

4. On realization of assets not taken over

Bank A/c	Dr.	
To Realization A/c		with sale proceeds

5. On payment of liabilities not taken over

Realization A/c	Dr.	
To Bank A/c Amount paid*		with book value*

**\*It is to be noted that if liabilities not takeover are not transferred to Realization A/c then the difference between book value of the liability and the amount paid is transferred to Realization A/c.**

6. Realization expenses borne by Transferee company

No Entry. If however, actual expenses exceed the amount paid by the Transferee Company the excess will be debited to Realization Account.

7. Realization expenses paid by Transferor Company



To Shares in Transferee Co. A/c  
 To Debentures in Transferee Co. A/c  
 To Bank A/c

**LEDGER ACCOUNTS**  
**Realization A/c (A Format)**

	Rs.		Rs.
To Sundry Assets (Each individual asset except: Fictitious assets Cash & bank balance, if not taken over.) *To Bank (Liability not take over) To Bank (Expenses) If paid by Transferor Company *To Liability (Loss on discharge of liability not taken over) To Preference Shareholders' Account (Premium on Redemption) To Equity Shareholders' A/c (Profit)	At Book Value      Or  Or  or	By Sundry Liabilities (Each Individual)  By Transferee Company  By Bank (Disposal of assets not taken over) *By Liability (Profit on discharge of liability not take over) By Preference Shareholders' A/c (Discount on redemption, if any) By Equity Shareholders' A/c (Loss)	At Book Value  Purchase consideration
	xxx		xxx

**\*Only one entry.**

**EQUITY SHAREHOLDERS' A/C**

	Rs.		Rs.
To Fictitious Assets	---	By Equity Share Capital	----
To Realization A/c (Loss)	---	By Revenue Reserves	-----
To Shares in Transferee Co.	---	By Capital Reserve	-----
To Other Securities in Transferee Co	----	By Other accumulated Profits	-----
To Bank A/c	----	By Realization A/c (Profit)	-----

	***		***
--	-----	--	-----

### TRANSFEEE COMPANY'S A/C

	Rs.		Rs.
To Realization A/c.	P.C.	By Shares in Transferee Co	—
		By Debentures in Transferee Co.	----
		By Bank A/c	----
	<b>XXX</b>		<b>XXX</b>

### Accounting Treatment in the Books of Transferee company (Purchasing Company)

As per AS-14 there are two methods of accounting for amalgamation, namely:

1. The pooling of Interests Method
2. The Purchase Method

### ACCOUNTING PROCEDURE FOR POOLING OF INTERESTS METHOD

The following journal entries are made in the books of the transferee (purchasing) company for recording the taking over of the business of transferor (vendor) company under the **pooling of interests method**:

#### 1. For recording the purchase of business of transferor (purchasing) company

Business Purchase Account	Dr.
To Liquidators of Transferor Company.	

This entry will be made with the amount of purchase consideration.

#### 2. For recording or incorporating the assets, liabilities and reserves taken over of the transferor (vendor) company.

Various Sundry Assets (Individual) Accounts	Dr.
To Sundry Liabilities (Individual) Accounts	
To Securities Premium Account	
To Capital Redemption Reserve Account	
To Revaluation Reserve Account	
To Export Profit Reserve Account	
To Development Rebate Reserve Account	
To Investment Allowance Reserve Account	
To Workman Compensation Reserve Account	
To Debenture Redemption Reserve Account	
To Profit and Loss Account (Surplus)	





Account Discount on the Issue of shares Account Dr.  
(if any)

To Bank Account  
To Equity Share Capital Account  
To Preference Share Capital Account

**(c) Issue of securities at premium**

Liquidator(s) of Transferor Company Account Dr.  
To Bank Account  
To Equity Share Capital Account  
To Preference Share Capital Account  
To Securities Premium Account [with premium on equity shares  
and preference shares]

**(iv) For recording statutory reserves of transferor company**

Amalgamation Adjustment Account Dr. [with the total amount of statutory reserves]  
To Particular Statutory Reserves Account [Individually and with their names]

**Under the New Schedule VI, Amalgamation Adjustment Account is shown under: Non-current Assets: other non-current Assets.**

**(v) For recording discharge of debentures of transferor company**

Debentures in Transferor Company Account Dr. [with the takeover value]  
Discount on Issue of Debentures (if any) Dr.  
To Debentures in Transferee Company Account  
To Securities Premium Account (if any)  
To Bank Account (if paid in cash)  
To Equity Preference Share Capital Account (if any)

**(vi) For recording of liquidation expenses paid and borne by transferee company**

Goodwill Account Dr. [with the amount of  
To Bank Account expenses]

**(vii) For recording formation expenses, if a new company is formed (e.g. in External Reconstruction)**

Preliminary Expenses Account Dr.  
To Bank Account

When Goodwill Account and Capital Reserve Account both appear in the books of account of Transferee Company, Goodwill Account must be set off against the Capital Reserve Account. The entry is:

Capital Reserve Account

Dr.

To Goodwill Account

### **BALANCE SHEET OF PURCHASING COMPANY**

In an examination problem, the requirement of the examiner is generally on two aspects.

**(i) Opening journal entries in the books of the purchasing (transferee) company, and**

**(ii) Preparation of Balance Sheet of the new company after amalgamation. The following points, must be noted in connection with the balance sheet:**

1. Format: The Balance Sheet of the new company has to be prepared strictly in accordance with the New Schedule VI of the Companies Act with minor modifications where the information is not clearly given.

**Disclosure of Assets:** When the purchase consideration is based on 'Net Assets Method", the agreed or new values of the assets, are automatically available in the statement of purchase consideration in the examination problem itself. Otherwise the information is available as Additional Information. Further, if the new company raises additional funds by issue of new shares or debentures to the public, the students must be careful about the following points

**(a) Calculation of revised amount in the Bank Account, and**

**(b) Cost of Issue of Shares/Debentures**

**(iii) Disclosure of liabilities:** The liabilities are also reflected in the balance sheet as per New Schedule VI format. Share capital is disclosed as Authorized Capital, Issued, subscribed and paid up value of shares. Similarly the items of Capital Reserve, premium collected on issue of shares/debentures are to be disclosed along with other Reserves under the heading: Reserves and surplus.

**(iv) Other disclosures under AS - 14 :** The following disclosures should be stated in the first final accounts prepared after amalgamation :

- (a) Names and nature of the business of the amalgamating companies.
- (b) Date of amalgamation for accounting purpose.
- (c) Methods of accounting use
- (d) Particulars of scheme sanctioned under law
- (e) Additional disclosure in case of amalgamation is by way of the merger such as
  - (i) shares issued and
  - (ii) difference between purchase consideration and net assets.
- (f) Additional disclosures when amalgamation is by way of purchase such as :
  - (i) purchase consideration and its payment and
  - (ii) difference between the purchase considerations and net assets.

**PART I-Form of BALANCE SHEET**

Name of the Company.....

Balance Sheet as at .....

(Rupees in.....)

<b>Particulars</b>	<b>Note No.</b>	<b>Figures as at the end of the current reporting period</b>	<b>Figures as at the end of the previous reporting period</b>
<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
<p><b>1. EQUITY AND LIABILITIES</b></p> <p>1. Shareholders' funds</p> <p>(a) Share capital</p> <p>(b) Reserves and surplus</p> <p>(c) Money received against share warrants</p> <p>2. Share application money pending allotment</p> <p>3. Non-current liabilities</p> <p>(a) Long-term borrowings</p> <p>(b) Deferred tax liabilities (Net)</p> <p>(c) Other Long term liabilities</p> <p>(d) Long-term provisions</p> <p>4. Current liabilities</p> <p>(a) Short-term borrowings</p> <p>(b) Trade payables</p> <p>(c) Other current liabilities</p> <p>(d) Short-term provisions</p> <p style="text-align: right;"><b>TOTAL</b></p> <p><b>II. ASSETS</b></p> <p><b>1. Non-current Assets</b></p> <p><b>(a) Fixed assets</b></p> <p>(i) Tangible assets</p> <p>(ii) Intangible assets</p> <p>(iii) Capital work-in-progress</p> <p>(iv) Intangible assets under development</p> <p><b>(b) Non-current investments</b></p>			

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

#### 4.8 ABSORPTION [ACCOUNTING PROCEDURE]

Meaning : In absorption, one existing company takes over (i.e. absorbs) the business of another existing company (or companies).

The vendor (transferor) company may be called as the absorbed company while the purchasing (transferee) company may be termed as absorbing company.

**Accounting treatment by Vendor Company:** The accounting procedure adopted by the absorbed company is the same as explained earlier.

Accounting treatment by purchasing company: The accounting entries made by the absorbing company are similar to those explained earlier in connection with amalgamation in the nature of merger or amalgamation in the nature of purchase. **The procedure in the books of purchasing company is common whether the absorption is in the nature of merger or purchase.**

#### 4.9 INTER-COMPANY OWINGS

At the time of absorption, it might be found that absorbing (transferee) company and the absorbed (transferor) company are debtors and creditors of each other. The reason may be purchase and sale of goods or loans and advances or bills of exchange given by one company to another company. After the takeover, books of purchasing (transferee or absorbing) company show both the accounts, namely: amount payable and amount receivable. On absorption both the companies become one single legal entity with the result that these amounts are neither receivable nor payable. Hence these common debts have to be cancelled by debiting the Payable (Creditors and Bills Payable) Accounts and Crediting the Receivable (Debtors and Bills Receivable) Accounts. In other words, the sundry debtors must be set off against sundry creditors and bills receivable against bills payable with the lower of two figures. The journal entries in the books of purchasing company are:

**(i) Elimination of Common debts:** There is no effect of such transaction on the entries relating to purchases of business, calculation of purchase consideration, incorporation of assets and liabilities and

payment of purchase consideration. After recording the routine entries the following additional entry will also be recorded to eliminate the common debts.

**(a) In case of Loan:**

Loan from (one company) A/c	Dr.
To Loan to (Other Company A/c)	

**(b) In case of bills:**

Bills payable of (one company)A/c	Dr.
To Bills receivable of (Other company) A/c	

**(c) In case of debtors & Creditors**

Creditors (of one company) A/c	Dr.
To Debtors (of one company)	

**(2) Cancellation of Un-realized Profits.**

When goods purchased by the transferor company from the transferee company remain unsold at the time of takeover of business then the unsold stock of transferor company become the part of stock of the transferee company.

(a) Profit & Loss A/c	Dr.	(In case of merger)
To Stock		

(b) Goodwill A/c	Dr.	
To Stock A/c		Absorption in case of purchase

Capital reserve A/c	Dr
To stock A/c	

**4.10 PAYMENT OF DIVIDEND BEFORE ABSORPTION**

When the transferor or transferee company pays dividend to its shareholders, the transaction is recorded as:

Profit and Loss Appropriation or Surplus Account	Dr.	[With the Amount of
General Reserve Account	Dr.	Dividend]
To Bank Account		

However if the proposed dividend account appears in the balance sheet, the entry would be:

Proposed Dividend Account	Dr.
To Bank Account	

**4.11 SALE OF SHARES RECEIVED AS PURCHASE CONSIDERATION**

It is possible that the shareholders of the vendor company may request the liquidator to sell in the market (stock exchange) some of the shares received as a part of purchase consideration from the purchasing or Transferee Company. The journal entries are:

**(i) For sale of shares in the purchasing company**

Bank Account	Dr.	[With the amount
To Shares in Purchasing Company		of sale]

**(ii) For profit on sale**

Shares in Purchasing Company Account	Dr.	[With the profit on
To Equity Shareholders Account		sale)

**(iii) For loss on sale**

Equity Shareholders Account	Dr.	[With the loss on
To Shares in Purchasing Company		sale]

**Alternatively, the profit or loss on sale may be transferred to Realization Account.**

**4.12 DISSENTING SHAREHOLDERS**

These are the shareholders who do not approve the scheme of amalgamation and refuse to transfer their shares. They constitute an insignificant number as compared to total number of shareholdings. Since majority of shareholders agree, there is no legal hitch or hurdle in implementing the scheme of amalgamation whether that of merger or purchase. However, section 395 of Companies Act 1956 states that the shares of dissenting shareholders may be acquired by the amalgamated company in any of the manners:

- (i) As per the terms and conditions as set by dissenting shareholders or
- (ii) As per mutual agreement between the dissenting shareholders and amalgamated company, or
- (iii) As per the terms set or ordered by the court on an application moved by the amalgamated company or by the dissenting shareholders.

**Accounting Treatment**

- (i) The Share Capital held by the dissenting shareholders is transferred to a separate account known as "Dissenting shareholders" Account. The sum so agreed upon between the amalgamated company and dissenting shareholders is paid to them. The difference between the amount so paid and the amount of share capital held by them is transferred to Realization Account. It is to be noted that these dissenting shareholders do not have any share/claim in the accumulated profits or losses including loss or profit arising from Realization Account,
- (ii) While calculating purchase consideration the shares held by dissenting shareholders are deducted out of the total shares of vendor company before calculating the number of shares to be issued by purchasing company.

**4.13 EXTERNAL RECONSTRUCTION**

In external reconstruction, the assets and liabilities of the old company are taken over by the new company at their true or revised values and not at their book values. Hence, it is an amalgamation in the nature of purchase. The reason is that external reconstruction is resorted to only when most of the assets are overvalued and thus do not reflect their true values.

Accounting by vendor or old company: The vendor company will make the accounting entries to close its books of account in the usual manner as explained earlier.

Accounting by purchasing or new company: The purchasing company usually adopts basically the same accounting procedure as is applicable to amalgamation in the nature of purchase.

### Self assessment

#### State whether the following statements are true or false:

1. In the case of amalgamation, two or more companies go into liquidation to form a new company.
2. Absorption of companies is also included into amalgamation.
3. Taking over the business of one company by another company, is called amalgamation.
4. External reconstruction of company means the reduction of its share capital.

#### Fill in the blanks:

5. An amalgamation in the nature of merger, \_\_\_\_\_ of interest method is used.
6. Accumulated losses in the transferor company are transferred to\_\_\_\_\_.
7. The business of the \_\_\_\_\_ company is intended to be carried on, after the amalgamation by the transferee company.
8. All the assets and liabilities of the transferor company become, after \_\_\_\_\_, the assets and liabilities of the transferee company.
9. Excess payment to preference shareholders or debenture-holders in liquidation is adjusted to\_\_\_\_\_.
10. \_\_\_\_\_ is computed by net payment method and net assets method.
11. Under the Net Assets Method, purchase consideration is calculated by considering the \_\_\_\_\_ values of assets and liabilities.

### Illustration

The balances of assets and liabilities of W Ltd. and S Ltd. as at 31 March, 2013 were as follows:

#### W Ltd.

Liabilities	Rs	Assets	Rs
Equity Share Capital (Shares of Rs. 10 each)	30,00,000	Land and Building	15,00,000
General Reserve	40,000	Plant and Machinery	9,00,000
Sundry Creditors	2,00,000	Stock	2,80,000
		Debtors	3,60,000
		Cash at Bank	2,00,000
	<b>32,40,000</b>		<b>32,40,000</b>

**S Ltd.**

<b>Liabilities</b>	<b>Rs</b>	<b>Assets</b>	<b>Rs</b>
Equity Share Capital (Shares of Rs. 10 each)	15,00,000	Land and Building	9,00,000
General Reserve	3,60,000	Plant and Machinery	6,00,000
Sundry Creditors	90,000	Sundry Debtors 1,65,000	
		Less: Provision 15,000	1,50,000
		Stock	1,95,000
		Cash at Bank	1,05,000
	<b>19,50,000</b>		<b>19,50,000</b>

W. Ltd. agreed to absorb the business of S Ltd. on the following terms:

- (i) W Ltd. would acquire all assets and liabilities of S Ltd. at book value.
- (ii) W Ltd. agreed to issue six shares of Rs.10 each for every five shares of S Ltd.

The expenses of absorption amounting to Rs.30, 000 were paid by W. Ltd. Pass journal entries in the books of W Ltd. according to pooling of interests (merger) method and prepare its balance sheet after absorption.

**Solution****Purchase Consideration**

Equity Shares:

$$6/5 \times 1,50,000 \times \text{Rs.}10 = 18,00,000$$

**In The Books of W LTd. Journal Entries**

<b>Date</b>	<b>Particulars</b>	<b>Debit Rs.</b>	<b>Credit Rs.</b>
(i)	Business Purchase Account Dr To Liquidators of S Ltd. (Being the purchase consideration for taking over the business of S Ltd.)	18,00,000	18,00,000
(ii)	Land & Building Account Dr. Plant & Machinery Account Dr. Sundry Debtors Account Dr. Stock Account Dr. Cash at Bank Account	9,00,000 6,00,000 1,65,000 1,95,000 1,05,000	18,00,000

	Dr.		90,000
	To Business Purchase Account		15,000
	To Sundry Creditors Account		60,000
	To Provision for Doubtful Debts Account		
	To General Reserve Account		
	<b>(Balancing Figure)</b>		
	(Being the transfer of all assets and all liabilities including reserves; the difference is the balancing figure of general reserve)		
(iii)		18,00,000	
	Liquidators of S Ltd. Dr.		18,00,000
	To Equity Share Capital Account		
((iv)	(Being payment of purchase price)	30,000	
	Liquidation Expenses Account Dr.		30,000
	To Bank Account		
(v)	(Being payment of liquidation expenses)	30,000	
	General Reserve Account		30,000
	Dr.		
	To Liquidation Expenses Account		
	(Being liquidation expenses transferred to general reserve)		

**W Ltd.**

**Balance Sheet As at 31 March 2013**

	Particulars	Note	
<b>I</b>	<b>EQUITY AND LIABILITIES</b>		
	<b>1. Shareholders' fund</b>		
	(a) Share capital	1	48,00,000
	(b) Reserves and Surplus	2	70,000
	<b>Sub Total</b>		<b>48,70,000</b>
	<b>2. Current Liabilities</b>		

	Trade Payables	3	2,90,000
	<b>Total Equality and Liabilities</b>		<b>51,60,000</b>
<b>II</b>	<b>ASSETS</b>		
	<b>1. Non-current Assets</b>		
	(a) Fixed Assets		
	(i) Tangible Assets	4	<u>39,00,000</u>
	<b>2. Current Asset</b>		
	(a) Inventories	5	4,75,000
	(b) Trade Payables	6	5,10,000
	(c) Cash and Cash Equivalents	7	2,75,000
	<b>Sub Total</b>		<b>12,60,000</b>
	<b>Total Assets</b>		<b>51,60,000</b>

	<b>Notes to Accounts</b>	<b>Rs</b>	<b>Rs</b>
<b>1.</b>	<b>Share Capital</b>		
	<b>Equity Share Capital</b>		
	Issued, subscribed and fully paid 4,80,000 Shares of Rs 10 each.		<u>48,00,000</u>
<b>2.</b>	<b>Reserves and Surplus</b>		
	<b>General Reserves :</b>		
	Balance b/d		40,000
	Add: S Ltd. portion		60,000
			<u>1,00,000</u>
	<b>Less : Liquidation Expenses</b>		<u>30,000</u>
			<u>70,000</u>

<b>3.</b>	<b>Trade Payables</b>		
	Creditors for Goods		2,90,000
<b>4.</b>	<b>Tangible Assets</b>		
	Land and Building		24,00,000
	Plant and Machinery		15,00,000
			39,00,000
<b>5.</b>	<b>Inventories</b>		
	Stock of Goods		4,75,000
<b>6.</b>	<b>Trade Receivables</b>		
	Debtors for Goods		5,25,000
	Less: Provision for Doubtful Debts		15,000
			5,10,000
<b>7.</b>	<b>Cash and Cash Equivalents</b>		
	<b>Cash at Bank</b>		2,75,000

## ACCOUNTING NOTES

### According to the Expert Committee appointed by ICAI:

- (i) The difference between the share capital of transferor company and the share capital issued by the transfer company on amalgamation should be treated as capital reserve which is not available for distribution as dividend.
- (ii) Accordingly the difference between the share capital issued and the amount of the share capital of the transferor (Vendor) company should be treated as capital loss as shown below:

Share capital issued by W Ltd	18, 00,000
Less: Share capital of S Ltd (Vendor Company)	15, 00,000
	-----
Capital loss	3, 00,000
	-----

- (iii) This capital loss should be first adjusted against the capital reserve and then against the revenue reserve.

So the net position of general reserves is:

General Reserves of W Ltd.	40,000
Add: General Reserves of S Ltd.	3, 60,000
	-----
	4, 00,000
Less: Capital Loss	3, 00,000
	-----
	1, 00,000
Less: Liquidation expenses	30,000
	-----
(General Reserve) To be shown in the Balance Sheet	70,000
	-----

### Illustration (External Reconstruction-Net Payment Method)

The following is the list of assets and liabilities of Rana Ltd. as at 31 March 2011:

Equity and Liabilities	Rs	Assets	Rs
50,000 Equity Shares of Rs 10 each, fully called up	5,00,000	Patents	50,000
30,000, 10% Preference Shares of Rs.10 each	3,00,000	Freehold premises	2,40,000
12% Debentures	2,00,000	Stock in trade	2,50,000
Unsecured Loan	36,000	Debtors	1,90,000
Creditors	1,40,000	Furniture	30,000
Accrued interest on debentures	24,000	Investments	75,000
		Bank	10,000
		Profit and Loss Account(Loss)	3,55,000
	<u>12,00,000</u>		<u>12,00,000</u>

The following scheme of reconstruction was approved:

- (i) A new company by the name of Rana (2013) Ltd. to be the entire business of Rana Ltd.
- (ii) One equity share of Rs 10, Rs6 paid up is to be given in exchange of every two equity shares of Rana Ltd.
- (iii) One 11% preference share of Rs100 each is to be given in exchange for 15 preference shares of Rana Ltd.

- (iv) 12% Debentures of Rana Ltd. would be discharged together with the amount of accrued interest by the issue of equity shares of Rs 10 each fully paid.
- (v) The creditors will receive 60% of their dues in cash and 25% in equity shares of Rs 10 each and the balance to be foregone.
- (vi) The partly paid equity shares are to be made fully paid by receiving cash from the holders.
- (vii) Furniture is subject to depreciation by 25%.
- (viii) The freehold premises were revalued at 20% more while the stock was revalued at Rs, 60,000. The investments are to be brought up to a market value of Rs 90,000 and debtors reduced by 10%. The preliminary expenses amounted to Rs 5,000.

**Required:**

- (i) Close the accounts in the books of Rana Ltd.
- (ii) Opening entries in the books of Rana (2013) Ltd.
- (iii) Opening balance sheet of Rana (2013) Ltd. utilizing any profits on taking over to write down the value of patents.

**Solution:****Calculation of Purchase Consideration**

<b>Equity Shareholders</b>	<b>Rs</b>
25,000 Equity Shares of Rs 10 each, Rs 6 paid	1,50,000
<b>10% Preference Shareholders</b>	
2,000, 11% Preference Shares of Rs 100 each fully paid up	2,00,000
	-----
	3, 50,000
	-----

**Consideration means payments to shareholders only In the Books of Rana Ltd.**

**Realization Account**

	<b>Rs</b>		<b>Rs</b>
Patents Account	50,000	12% Debentures Account	2,00,000
Freehold premises Account	2,40,000	Unsecured Loans Account	36,000
Stock Account Debtors Account	2,50,000 1,90,000	Creditors Account	1,40,000
Furniture Account	30,000	Accrued Interest on Debentures Account	24,000

Investments Account	75,000	Rana (2013) Ltd. Account	3,50,000
Bank Account	10,000	10% Preference Shareholders Account (Discount)	1,00,000
Equity Shareholders Account	5,000		
	8,50,000		8,50,000

#### Equity Shareholders Account

	Rs		Rs
Profit and Loss Account	3,55,000	Equity Share Capital Account	5,00,000
Equity Shares in Rana (2013) Ltd.	1,50,000	Realization Account	5,000
	5,05,000		5,05,000

#### Preference Shareholders Account

	Rs		Rs
Realisation Account	1,00,000	10% Preference Share Capital Account	3,00,000
11% Preference Shares in Rana (2013) Ltd. Account	2,00,000		
	3,00,000		3,00,000

#### Rana (2013) Ltd. Journal Entries

Date	Particulars	Dr. Rs	Cr. Rs
(i)	Business Purchase Account	Dr. 3,50,000	
	To Liquidators of Rana Ltd.		3,50,000
	(Acquisition of Rana Ltd. business for a purchase consideration of Rs3,50,000)		
(ii)	Patents Account	Dr. 50,000	
	Freehold Premises Account	Dr. 2,88,000	
	Stock-in-trade Account	Dr. 1,60,000	
	Debtors Account	Dr. 1,90,000	
	Furniture Account	Dr. 22,500	

	Investments Account	Dr.	90,000	
	Bank Account	Dr.	10,000	
	To 12% Debentures in Rana Ltd.			2,00,000
	To Accrued Interest on Debentures			24,000
	To Unsecured Loan			36,000
	To Creditors			1,19,000
	To Provision for Doubtful Debts			19,000
	To Business Purchase Account			3,50,000
	To Capital Reserve (Balancing figure)			62,500
	Acquisition of the business of Rana Ltd.)			
(iii)	Capital Reserve Account	Dr.	50,000	
	To Patents Account			50,000
	(Utilization of capital reserve to write off patents)			
(iv)	Liquidators of Rana Ltd.	Dr.	3,50,000	
	To Equity Share Capital Account			1,50,000
	To 11% Preference Share Capital Account			2,00,000
	(Payment of consideration other than cash)			
(v)	Share First and Final Call Account	Dr.	1,00,000	
	To Equity Share Capital Account			1,00,000
	(Making of first and final call of Rs 4 on 25,000 Equity shares for making them fully paid)			
(vi)	Bank Account	Dr.	1,00,000	
	To Share First and Final Call Account			1,00,000
	(Receipt of first and final call)			
(vii)	12% Debentures Account	Dr.	2,00,000	
	Accrued Interest on Debentures Account	Dr.	24,000	
	To Equity Share Capital Account			2,24,000
	(Allotment of 24,000 equity shares of j 10 each fully paid)			

(viii)	Creditors Account	Dr.	1,19,000	
	To Bank Account			84,000
	To Equity Share Capital Account			35,000
	(Payment to creditors by allotment of equity shares and cash)			
(ix)	Preliminary Expenses Account	Dr.	5,000	
	To Bank Account			5,000
	(Payment for preliminary expenses)			
(x)	Capital Reserve Account	Dr.	5,000	
	To Preliminary Expenses Account			5,000
	(Writing off the preliminary expenses to capital reserve)			

**Rana (2013) Ltd.**

**Balance Sheet As At 1 April 2013**

Particulars	Note	Rs
<b>I. EQUITY AND LIABILITIES</b>		
<b>1. Shareholders' Funds</b>		
(a) Share capital	1	7,09,000
(b) Reserves and surplus	2	7,500
<b>Sub</b>		<b>7,16,500</b>
<b>Total</b>		
<b>2. Non-current Liabilities</b>		
Unsecured Loans		36,000
<b>Total Equity and Liabilities</b>		<b>7,52,500</b>
<b>II. ASSETS</b>		
<b>Non-current Asset</b>		
(a) Fixed Assets	3	3,10,500
(i) Tangible Asset		90,000
		<b>4,00,500</b>

<b>(ii) Non-Current Investments</b>		
<b>2. Current Assets</b>	4	
(a) Inventories		1,60,000
(b) Trade Receivables		1,71,000
(c) Cash and cash equivalents		21,000
		<b>3,52,000</b>
<b>Total</b>	<b>Sub</b>	<b>7,52,500</b>
<b>Assets</b>	<b>Total</b>	

### Notes to Accounts

	Particulars	Rs	Rs
<b>1. Share-capital</b>			
	<b>Preference share capital</b>		
	Issued, subscribed and fully paid up:		
	2,000, 11% Preference shares of Rs 10 each		2,00,000
	<b>(Issued for consideration other than cash)</b>		
	<b>Equity share Capital</b>		
	Issued, subscribed and fully paid up:		
	50,900 equity shares of Rs 10 each		5,09,000
	<b>(Issued for consideration other than cash)</b>		
			<b>7,09,000</b>
<b>2 Reserves and Surplus</b>			
	Capital Reserve		62,500
	Less: Patents written off		(50,000)
			12,500
	<b>Less: Preliminary expense written off</b>		5,000
			<b>7,500</b>

<b>3</b>	<b>Tangible Assets</b>		
	(i) Freehold Premises	2,40,000	
	Add: Appreciation (20%)	48,000	2,88,000
	(ii) Furniture	30,000	
	Less: Depreciation	7,500	22,500
			3,10,500
<b>4</b>	<b>Inventories</b>		2,50,000
	Stock of Goods		90,000
	Less: Loss on Revaluation before reconstruction		
			1,60,000
<b>5</b>	<b>Trade Receivables (Debtors)</b>		1,90,000
	Less: Provision for Doubtful debts		19,000
			1,71,000
<b>6</b>	<b>Cash and Cash Equivalents</b>		10,000
	Cash at Bank b/d		1,00,000
	Add: Issue of share capital		1,10,000
			84,000
	Less: Creditors		26,000
			5,000
	Less: Preliminary Expenses		21,000

#### 4.14 Summary:

Corporate restructuring in the form of amalgamations have become very popular in the economic environment of the world. Amalgamations gained momentum in the Indian economy following economic liberation in 1991. When two or more companies having similar nature of business merge their businesses in order to form a new company, such a merging is known as amalgamation of companies. In other words, two or more existing companies will liquidate themselves and a new company will be formed to take over the business of these companies. According to AS-14 for the purpose of accounting, the amalgamation of companies is divided into two categories i.e., amalgamation in the nature of merger and amalgamation in the nature of purchase. After the amalgamation of two or more companies, the prevailing competition among themselves is eliminated. Amalgamation of companies

reduces the expenditure, cost and price of the products of the bigger companies, smaller businessmen therefore, cannot last for long when confronted by the bigger players. There are two main methods of accounting for amalgamations: the pooling of interests method; and the purchase method.

#### 4.15 Glossary:

##### 1. Amalgamation

An amalgamation takes place where two or more companies carrying on business of a like nature combine together and form a new company.

**2. Absorption:** When an existing Company purchases another existing Company, it is known as absorption.

**3. External Reconstruction:** In external reconstruction, a brand new company is formed to take over the business of only one existing company (a sick or loss making).

**4. Internal Reconstruction:** In internal reconstruction there is neither liquidation nor formation of a new Company to take over any exiting business. The exiting Company continues in its legal entity form and is only reorganised internally.

**5. Purchase Consideration:** The purchase consideration is the price which is paid by the transferee Company to the transferor Company for the amalgamation of business. As per AS-14, "Consideration for amalgamation means the aggregate of shares and other securities issued and the payment made in the form of cash or other assets by the transferee Company to the shareholders of the transferor Company".

#### 4.16 Answers: self assessment:

1. True
2. True
3. False
4. False
5. Pooling
6. Shareholder's Account
7. Transferor
8. Amalgamation
9. Realisation Account
10. Purchase Consideration
11. Agreed

#### 4.17 Terminal Questions:

1. Define Amalgamation, Absorption and Reconstruction.

2. Define Purchase Consideration.
3. Describe the different methods of Purchase Consideration.

**4.18 Suggested Reading:**

1. J.R. Monga, Corporate Accounting, Mayur Paperbacks, New Delhi.
2. Naseem Ahmed, Corporate Accounting, Atlantic Publishers, New Delhi.
3. R.L. Gupta Advanced Financial Accounting, S. Chand and Co., New Delhi.



**Lesson- 5****COMPANY LIQUIDATION ACCOUNTS****STRUCTURE:**

- 5.0 Learning Objectives
- 5.1 Introduction
- 5.2 Meaning of Liquidation
- 5.3 Modes of Winding up
- 5.4 Consequences of winding up
- 5.5 Statement of Affairs
- 5.6 Summary
- 5.7 Glossary
- 5.8 Answers: Self Assessment
- 5.9 Terminal Questions
- 5.10 Suggested Readings
- 5.0 **LEARNING OBJECTIVES**

After studying the lesson, you should be able to understand:

1. What is Liquidation?
2. What are the different modes of winding up.
3. Statement of affairs and lists to be annexed.
4. Accounting Treatment in case of liquidation.

**5.1 INTRODUCTION**

A company is an artificial person. It is created by law, and, therefore, the law alone can dissolve it. On dissolution, the company's name shall be struck off by the Registrar from the register of companies and he shall also get the fact published in the official gazette.

**5.2 MEANING OF LIQUIDATION**

Liquidation or winding up of a company is a process by which dissolution of a company is brought about and properly administered for the benefit of its creditors and members. An administrator called liquidator is appointed and he takes over the control of the company, collects its assets, pays its debts and finally distributes the surplus among its members in accordance with their rights. Thus, liquidation or winding up ultimately leads to dissolution of a company. In between winding up and dissolution, the legal entity of the company remains and it can be used in a court of law.

**5.3 MODES OF WINDING UP**

A company may be wound up in any of the following three ways :

- (1) Compulsory winding up
- (2) Voluntary winding up

- (3) Winding up under the supervision of the court.

### **5.3.1 COMPULSORY WINDING UP**

Winding up of a company by an order of the court is known as compulsory winding up. According to Section 433 of the Companies Act, the court may order for the compulsory winding up of a company in the following circumstances :

- (i) If the company passes a special resolution for winding up.
- (ii) If the company commits a default in holding the statutory meeting.
- (iii) If the company fails to commence the business within a year of its incorporation or suspends business for a year.
- (iv) if the number of members of the company falls below 7 in case of a public company and 2 in case of a private company.
- (v) If the company is unable to pay its debts. It may be noted that a company cannot be declared as an insolvent under Insolvency laws for its inability to pay its debts. It can simply be wound-up in such a case.
- (vi) If the court is of the opinion that it is just and equitable that the company should be wound up. The petition for winding up to the court can be made by the company itself, any of its creditors, a contributory, the Registrar or any person authorized by the central Government to make such a petition.

### **5.3.2 VOLUNTARY WINDING UP**

A winding up without any intervention of the court is termed as voluntary winding up. According to Section 489 of the Companies Act, a company may be wound-up voluntarily :

- (i) By passing an ordinary resolution in the general meeting :
  - (a) When the period for which the company was constituted, has expired or
  - (b) When the event on the happening of which depended the termination of the existence of the company has happened.
- (ii) By passing a special resolution to wind up voluntarily for any reason whatsoever. Voluntary winding up is of two kinds :
  - (a) Members' voluntary winding up, and
  - (b) Creditors' voluntary winding up.

Member voluntary winding up requires the filing of a statutory declaration of solvency by at least two of the majority of the directors, whichever is more, of the company with the Registrar. The question of creditors' voluntary winding up will arise in a case where the company is not in a position to pay its liabilities in full. In such a case declaration of solvency shall not be made and filed with the Registrar.

### **5.3.3 WINDING UP UNDER THE SUPERVISION OF THE COURT**

According to Section 522 of the Companies Act at any time, after a company has passed a resolution for voluntary winding up the court may make an order that the voluntary winding up shall continue subject to the supervision of the court.

Such an order is passed by the court on the application of any creditor or contributory or liquidator or the company itself, under the following circumstances:

- (i) The liquidator under voluntary winding up is prejudiced or is negligent in collecting the assets of the company, or
- (ii) The resolution for winding up was obtained by fraud.

#### 5.4 CONSEQUENCES OF WINDING UP

The following are the consequences which generally follow a company's winding up decision.

- (i) An official designated as liquidator will take over the administration of the company. In case of compulsory winding up the official liquidator attached to High Court, functions as liquidator of the company. In case of voluntary winding up such an official is appointed by the members or the creditors depending upon members' or creditors' voluntary winding up
- (ii) The power of the Board of Directors will terminate and will now vest with the liquidator.
- (iii) The winding up order or resolution of voluntary winding up shall operate as a notice of discharge to all members of the company. The members of the company will be termed as contributories on the commencement of company's winding up. The liquidator shall prepare a list of all such contributories who may be made liable to contribute towards the company on account of deficiency in the assets of the company. In case there is a surplus in the assets, the liquidator shall prepare a list of those members, who are entitled to share the surplus. The term contributory includes members of both the above categories.
- (iv) The liquidator will realize the assets of the company and distribute the proceeds among various claimants in the following order (a) Legal charge, (b) Liquidator's remuneration, (c) Cost of expenses of winding up. (d) Workmen's dues and claims of the secured creditors as mentioned in section 529A (e) Preferential creditors, (f) Creditors secured by floating charge and (g) Unsecured creditors. In case some surplus is still left, it will be distributed among the contributories as follows :
  - (a) **Preferential shareholders.** These shareholders are entitled to the return of their capital in priority to any return of capital to the equity shareholders. In the absence of any provisions in the company's articles any arrears of preference dividend will be paid only after returning their capital to the equity shareholders. It may also be noted that right to claim arrears is available only to the holders of cumulative preference shares. Preference shares are always taken as cumulative unless otherwise stated. In any case, any dividend declared but unpaid has to be paid in priority to even return of capital to the preference shareholders.
  - (b) **Equity shareholders.** Any amount left after paying to preference shareholders will be used for returning their capital to the equity shareholders. In case any surplus is still left, such surplus will also go to the equity shareholders. However, if the preference shares are participating, they will be entitled to share such surplus with the equity shareholders in the ratio as given in the company's articles.

##### 5.5.1 SECURED CREDITORS

A secured creditor may adopt any of the following options :

- (i) He may rely on the security and ignore the company's liquidation.

- (ii) He may value the security and prove for the balance of his debt in the company's liquidation.
- (iii) He may give up his security and prove for the whole amount in company's liquidation.

### **5.5.2 INTEREST ON DEBT**

The date up to which interest will be payable by the company on loans, debentures, etc., depends on the fact whether the company is solvent or insolvent. In case the company is solvent (i.e. when the available assets are sufficient to pay liabilities up to the commencement of winding up), interest will be paid up to the date of actual payment. In case the company is insolvent, the interest will be payable only up to the date of commencement of company's winding up.

### **5.5.3 DUES OF WORKERS (SECTION 529)**

Section 529 provides for application of insolvency rules in winding up of insolvent companies. In order to protect the interests of the workers, this section has been suitably amended by the Companies (Amendment) Act, 1985. As a result of this amendment, the legitimate dues of the workers will rank pari passu with secured creditors in the event of closure of the company and above even the dues to government.

The following provisions for the section are relevant for our purpose:

- (i) The security of every secured creditor shall be deemed to be subject to a pari passu charge in favour of the workmen to the extent of workmen's portion therein. In case a secured creditor instead of relinquishing his security and proving his debt, opts to realize his security, there will be the following consequences :
  - (a) The liquidator shall be entitled to represent the workmen and enforce such charge;
  - (b) Any amount realized by the liquidator byway of enforcement of such charge shall be applied rateably for the discharge of workmen's dues; and
  - (c) So much of the debts dues to such secured creditor as could not be realized by him by virtue of the foregoing provisions of this proviso or the amount of the workmen's portion in his security, whichever is less shall rank pari passu with the workmen's dues for the purpose of Section 529A.
  - (d) The secured creditor shall be liable to pay his portion of expenses incurred by the liquidator.
- (ii) For the above purpose, the portion of expenses incurred by the liquidator for the preservation of security which a secured creditor shall be liable to pay shall be the whole of the expenses less an amount which bears to such expenses the same proportion as the workmen's portion in relation to the security bears to the value of the security.  
 For example, if the total expense incurred by the liquidator amount to Rs. 5,000 value of the security is Rs. 50,000, the amount of secured creditor is Rs. 80,000 and the workmen's dues arc Rs. 20,000. The secured creditors will have to pay Rs. 40,000 (i.e., Rs. 50,000 less 1/5 of Rs. 50,000) to the liquidator.
- (iii) Certain new terms, "Workmen", "workmen's dues" and "workmen's portion" have been introduced by the Amendment Act. These terms have the following meanings for the purposes of Section 529, 529A and 532.

- (a) "Workmen" in relation to a company, means the employees of the company, being workmen within the meaning of the Industrial Disputes Act, 1947.
- (b) "Workmen's dues", in relation to a company means the aggregate of the following sums due from the company to its workmen, namely :
  - (1) All wages or salary including wages payable for time or piece work and salary earned wholly or in part by way of commission of any workman, in respect of services rendered to the company had any compensation payable to any workman under any of the provisions of the Industrial Disputes Act, 1947. (2) All accrued holiday remuneration becoming payable, to any workman, or in the case of his death to any other person in his right, on the termination of his employment before, or by the effect of the winding up order or resolution;
  - (3) Unless the company is being wound up voluntarily merely for the purposes of reconstruction or of amalgamation with another company, or unless the company has, at the commencement of the winding up, under such a contract with insurers as is mentioned in Section 14 of the Workmen's Compensation Act, 1923, rights capable of being transferred to and vested in the workmen, all amounts due in respect of any compensation or liability for compensation under the said Act in respect of death or disablement of any workmen of the company.
  - (4) All sums due to any workman from a provident fund, a pension fund, a gratuity fund or any other fund for the welfare of the workmen, maintained by the company;
- (c) "Workmen's portion", in relation to the security of any secured creditor of a company, means the amount which bears to the value of the security the same proportion as the amount of the workmen's dues; and
  - (1) The amount of workmen's dues; and
  - (2) The amount of the debts due to the secured creditors.

**Example :** The value of the security of a secured creditor of a company is Rs. 1,00,000. The total amount of the workmen's dues is Rs. 1,00,000. The amount of the debts due from the company to its secured creditor is Rs. 3,00,000. The aggregate of the amount of workmen's dues and of the amounts of debts due to secured creditors is Rs. 4,00,000. The workmen's portion of the security is therefore one fourth of the value of the security, that is Rs. 25,000

#### **5.5.4 OVERRIDING PREFERENTIAL PAYMENT (SECTION 529A)**

The Companies (Amendment) Act 1985 introduced a new Section 529A. The section gives priority in payment to workmen's dues and debts due to secured creditors to the extent they could not be paid because of the former ranking *pari passu* with the latter. The section provides as follows:

- (i) Notwithstanding anything contained in any other provisions of this Act or any other law for the time being in force in the winding up of a company. (a) workmen's dues; and (b) debts due to secured creditors to the extent such debts rank under clause (c) of the provision to sub-section (1) of Section 529 *pari passu* with such dues, shall paid in priority to all other debts.

- (ii) The debts payable under clause (a) and clause (b) of sub-section (1) shall be paid in full, unless the assets are insufficient to meet them, in which case they shall abate in equal proportions.

**Example :** The following details have been extracted from the books of a company at the time of the liquidation:

Secured creditors (with assets charged in their favour Rs. 2,00,000)	Rs. 3,00,000
Workmen's dues	1,00,000
Preferential creditors (excluding workmen's dues)	50,000
Unsecured creditors	2,00,00
<b>Other assets</b>	<b>2,50,000</b>

The assets available will be used as follows:

- Assets charged in favour of secured creditors worth Rs. 2,00,000 will be shared by Secured Creditors and workers in the ratio of 3 : 1

	<b>Rs</b>
Share of secured creditors 2, 00,000 x3/4	1,50,000
Share of workers 2, 00,000 x1/4	50,000
2. Over-riding preferential payments amount to:	
(i) Secured creditors to the extent of their security being used for workmen's dues	50,000
(ii) Balance of workmen's dues (1, 00,000-50,000)	50,000
3. Other Assets will be used as follows:	
(i) Over-riding preferential payments	1, 00,000
(ii) Preferential creditors	50,000
(iii) Unsecured creditors	1, 00,000
(Total 1, 00,000 + 2, 00,000)	2, 50,000

### **5.5.5 PREFERENTIAL CREDITORS PAYMENTS (SECTION 530)**

Section 530 of the Companies Act deals with certain preferential payments which have to be paid in priority to all other debts. As a result of the Companies (Amendment) Act, 1985 workmen's dues priority to over the preferential payments as stated in Section 530. As a matter of fact, the companies Act now makes a distinction between the terms, "Officer", "employee" and "workman" for the purposes of preferential payments. The officer's due have got no priority in payment. Workmen's dues ran pari passu with the secured creditors and are to be paid in priority to the dues payable to an employee. It has been made clear by an amendment in Section 530 that the expression "employee" does not include a "workman." As a result the compensation payable to workman under the provisions of Chapter 5A of the Industrial Disputes Act, 1947 and compensation payable to workman for death or disablement

under the Workmen's Compensation Act rank *pari passu* with the secured creditors and have been included in the workmen's dues.

Subject to the provisions of Section 529A discussed above, the following are the preferential creditors which will be paid in priority to other creditors in the event of companies' winding up. (i) All revenues, taxes, cases and rates due from the company to the Central or State government or to a local authority which have become due and payable within twelve months before the date of the appointment of provisional liquidator, or otherwise the date of winding up order in case of compulsory winding up and the date of the passing of the resolution for winding up in the case of voluntary winding up. The term due and payable means presently payable. In case of income tax, it is only when the final order of assessment is passed and the demand notice is issued that it can be said that Income tax for that assessment year has become due in the sense of "becomes presently payable." It is only then it becomes of debt due and payable to the Government. The same principle applies to sales tax or other taxes also.

- (ii) All wages or salaries (including commission earned) or any employee<sup>1</sup> in respect of services rendered to the company and due for a period not exceeding four months within the said twelve months before the relevant date subject to such limit as may be specified by Central Government in the official Gazette in respect of each claimant.<sup>2</sup>
- (iii) All accrued holiday remuneration becoming payable to the employee or in case of his death, to any other person in his right, on termination of his employment before, or by the effect of the winding up.
- (iv) Unless the company is being wound up voluntarily merely for the purpose of reconstruction, or of amalgamation with another company, all amounts due in respect of contribution payable during the said twelve months under the Employees' State Insurance Act, 1948 or any other law for the time being in force.
- (v) Unless the company is being wound up voluntarily for reconstruction and amalgamation, or where it has taken out a workmen's compensation insurance policy, all compensation due under Workmen's Compensation Act, 1923 in respect of death or disablement of any employee of the company.
- (vi) All sums due to any employee from a provident fund, a pension fund a gratuity fund, or any other fund for the welfare of the employees maintained by the company.
- (vii) The expenses of any investigation held in pursuance of Section 235 or 237 in so far as they are payable by the company.

All the above preferential debts shall rank equally among themselves and in case of deficiency of assets, they shall abate in proportion to their total amounts. They shall enjoy priority or preference even over those creditors who are secured by a floating charge on the assets.

## **5.6 STATEMENT OF AFFAIRS**

According to Section 454 of the Companies Act, the directors of the company have to submit a statement of affairs of the company within 21 days of passing of the winding up order or appointment of provisional liquidator, as the case may be. The statement should be submitted to the liquidator and should contain the following particulars:

- (i) The assets of the company, stating separately the cash balance in hand, at the bank and negotiable instruments, if any, held by the company;
- (ii) Company's debts and liabilities;
- (iii) The names, residences and occupations of its creditors, stating separately the amount of secured, and unsecured debts, and in case of secured debts, particulars of securities given, whether by the company or an officer thereof, their value and the dates on which they were given.
- (iv) The debts to the company and the names, residences, and occupations of persons from whom they are due and the amount likely to be realized on account thereof;
- (v) Such further or other information as may be prescribed or as the official liquidator may require. The statement is required to be made in the prescribed form and duly verified by an affidavit and signed by a Director and the Manager, Secretary, or other chief officer of the company, as given below:

**FORM NO. 57**  
**(See Rule 127)**

**In the high Court at .....(or) in the District Court of.....**

Original Jurisdiction.

In the matter of Companies Act, 1956

In the matter of .....Ltd

Company Petition No.....of 19

**Statement of Affairs under section 454**

Statement of affairs of the above named company as on the .....day of .....19, 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..... 19, 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 .....this.....day of ..... 19, 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 dependents are stated, and to initial any crossing cut 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.....19.....being 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 realizable values and liabilities expected to rank:

<b>Assets not specifically pledged (as per list 'A')</b>				<b>Estimated realizable value (Rs.)</b>
Balance at bank	-----	-----	-----	-----
Cash in hand	-----	-----	-----	-----
	-			
Marketable Securities	-----	-----	-----	-----
			---	
Bills receivable	-----	-----	-----	-----
	---		---	
Trade debtors	-----	-----	-----	-----
	--	-	-	--
Loans and advances	-----	-----	-----	-----
	---	---	---	---
Unpaid calls	-----	-----	-----	-----
	----	---	----	--
Stock-in-trade	-----	-----	-----	-----
	----	-	----	----
Work-in-progress	-----	-----	-----	-----
	----		----	---
Freehold property	-----	-----	-----	-----
	----	--	----	----
land and buildings	-----	-----	-----	-----
	----	--	----	---
Leasehold property	-----	-----	-----	-----
	----	--	----	---
Plant & machinery	-----	-----	-----	-----

	---		---	----
Furniture, fittings, utensils, etc	-----	-----	-----	-----
Investments other than marketable securities	-----	--	-----	-----
Livestock	-----	--	-----	--
Other property, etc	-----	--	---	-----
-----	-----	-----	-----	-----
-----	-----	-----	-----	-----

Assets	(a)	(b)	(c)	(d)
Specifically Pledged (as per list 'B')	Estimated Realizable Value Rs.	Due to Secured Creditors Rs.	Deficiency ranking as unsecured Rs	Surplus credited to last column Rs
Freehold property	-----	-----	-----	-----
-----	---		-----	

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  
 Gross realizable value of assets

Specifically pledged	-----	-----	-----	Rs.----
Other assets	-----	-----	-----	Rs. ----
Gross assets	-----	-----	-----	Rs. ----
				Rs.

Estimated total assets available for preferential creditors debenture holders secured by a floating charge and unsecured creditors (brought forward) .....

All assets specifically mortgaged, pledged or otherwise given as security should be included under this head. In the case of goods given as security, those in possession of the company and those in possession should be separately set out.

**(e) Liabilities**

**Gross** (To be deducted from surplus or added to deficiency as the case may be)

**Liabilities**

**Rs.**

Secured creditors (as per list 'B') to the extent to which claims 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')	.....	
Estimate balance of assets available for Debenture holders secured by a floating charges and unsecured creditors*	.....	
Debenture holders secured by a floating charge (as per list 'D')	.....	
Estimate surplus/deficiency as regards debenture-holders	.....	
Unsecured Creditors (as per list E):	.....	
Estimated unsecured balance of claims of creditors partly secured on specific assets, brought from preceding pages (c)		
Trade Account		
Bills payable		
Outstanding expenses		-----
Contingent liabilities (state nature)		-----
	-----	
Estimated surplus/deficiency as regards between creditors (being difference between Gross assets brought from proceeding page (d) and Gross liabilities as per column (e)	.....	
<b>Issued and called-up capital :</b>	.....	
Preference share of .....each		
Rs.....called-up (as (per list 'p)		.... ..
Equity shares of .....each Rs.....called-up (as per list 'G')	-----	-----
	-----	

**Estimated surplus/deficiency as regards****Rs.**

Members (as per list 'H').

**\*The figures must be read subject to the following notes :**

1. (f) There is not unpaid capital liable to be called up or.

(g) The nominal amount of unpaid capital liable to be called up is Rs. .... Estimated to produce Rs. .... Which is/is not charged in favour of Debenture holder (Strike out (f) (g) ]

2. The estimates are subject to cost of the winding up and to any surplus or deficiency on trading pending realization of the assets.

The details of the particulars to be given in the statement of affairs can be summarized as follows:

**List A.** This consists of all "free" assets, i.e., assets not specifically pledged in favour of any credit or. Assets against which there is a floating charge will also be included in this list. Calls in arrears will also come in this category to the extent they are realizable. However, uncalled capital should not be included in this list.

**List B.** This consists of assets pledged specifically in favour of certain creditors. And excess of the realizable value of the assets over the amount due should be shown separately as given in the prescribed form of the statement of affairs. In case of deficiency, the amount of such deficiency has to be included in list E, i.e. unsecured creditors. For example, building worth Rs. 20,000 has been mortgaged in favour of bank for a loan of Rs. 30,000, the bank is unsecured to the extent of Rs. 10,000 and, therefore, this amount will be included in List E of unsecured creditors.

**List C.** This consists of preferential creditors, i.e. creditors, who are unsecured but are entitled to priority in payment over creditors having a floating charge and other unsecured creditors. A list of preferential creditors has already been given earlier in the chapter.

**List D.** This consists of those creditors, who have floating charge over the assets of the company. Usually in this list, debenture-holders are included since they are generally presumed to have a floating charge over the assets of the company. Trade creditors, bills payable, liability for bills discounted (to the extent of possible loss on account of dishonor of the bills), creditors on open account etc. come in this category.

**List E.** This consists of holders of the preference share capital of the company. They are to be taken at a value which is left after unrealizable calls in arrears.

**List F.** This consists of holders of the equity share capital of the company. The amount due to them is to be arrived after deducting from the called up share capital, any unrealizable amount of calls in arrears.

**List H.** This explain the reasons for the surplus or the deficiency as shown by the statement of affairs. Earlier this list used to be in the form of ledger account. Of course, it is still termed as a "Deficiency or Surplus Account" but it is shown in the form of a statement. The period covered by this account must commence on a date not less than three years before the date of winding

up order (or the order appointing Provisional Liquidator, or the date directed by the official liquidator), or, if the company has not been incorporated, for the whole of that period, the date of formation of the company, unless the Official Liquidator otherwise agrees.

The prescribed form is given below:

**List H. Deficiency or Surplus Account**

<b>Items contributing to Deficiency (or reducing surplus)</b>	<b>Rs.</b>
1. Excess (if any) of capital and liabilities over assets on the..... 19.....as shown by balance sheet (copy annexed)*	-----
2. Net dividends and bonuses declared during the period from ..... 19.....to the date of the statement.	-----
3. Net trading losses (after charging items shown in note below) for the same period. ....	-----
4. Losses other than trading losses written off or for which provision has been made in the books during the same period (given particulars or annex schedule) .....	-----
5. Estimated losses now written off for which provision has been made for the purposes of preparing the statement (given particulars or annex schedule). ....	-----
6. Other items contributing to deficiency or reducing* surplus .....	-----
<b>Items reducing Deficiency (or contributing to surplus) :</b>	
7. Excess (If any) of assets over capital and liabilities on the .....19.....as shown in the balance sheet *(copy annexed). ....	-----
8. Net trading profit (after charging items shown in note below) for the period ..... from the ..... 19.....to the date of statement.	-----
9. Profits and income other than trading profits during the same period (give particulars or annex schedule). ....	-----
10. Other items reducing deficiency or contributing to surplus: Deficiency/surplus (as shown by the statement of affairs)	-----
<b>Less : Exceptional or non-recurring receipts: .....</b>	
Balance, being other trading profit or loss.	-----
Net trading profit or loss as shown in deficiency or surplus A/c above .....	-----

**Signature:**

**Date .....19....**

\*Only one items will appear.

Note as to Net Trading Profits and Losses:

Particulars are to be inserted here (so far as applicable) of the items mentioned below, which are to be taken into account in arriving at the amount of net trading profits or losses shown in this account:

Provisions for depreciation, renewals or diminution in value of fixed assets.

Charges for Indian income tax and other Indian taxation on profits.

Interest on debentures and other fixed loans, payments to directors made by the company and required by law to be disclosed in the accounts.

The following points should be kept in mind while preparing a statement of affairs and a deficiency or surplus account.

- (i) Any likely expenditure on liquidation should be ignored. A note may simply be given stating that Deficiency or Surplus as shown by this statement of affairs is subject to the cost of liquidation.
- (ii) Personal guarantee given by any party including the guarantees given by the, directors for loans raised by the company, should be ignored while preparing the statement of affairs.
- (iii) Any unrecorded asset or liability should be shown both in the statement of affairs and the deficiency or surplus account to give dual effect. For example, if out of bills discovered for Rs. 20,000, bills of Rs. 6,000 are likely to be dishonored, this amount of Rs.6.000 should be included in the statement of affairs in the list of unsecured creditors and in the deficiency or surplus account as an item increasing deficiency or reducing surplus.
- (iv) If at any stage, in the statement of affairs the deduction to be made is more than the "amount available, deficiency will appear; otherwise there will be a surplus, In case of deficiency at any stage, items after this stage will be added to find out the total deficiency.
- (v) In case the company in liquidation has stopped maintaining proper books of account after a certain date (as given in the question) a trial balance should be prepared with the available information. The items should be taken at their book values. Any difference in the trial balance is the profit or loss made by the company during the period the company did not maintain proper books of account.

### Self assessment

Fill in the blanks:

1. .... of a company is the process whereby its life is ended and its property administered for the benefit of its creditors and members.
2. In the case of liquidation of a company, all the ..... of the company are realised and amount is collected from unpaid calls on the shares.
3. A limited company can be liquidated by any of..... ways.
4. A creditors for ` 5,000 holding a charge on the machinery of the book value ` 7,000 (market value ` 4,500) will be called.....
5. Deficiency/Surplus Account is prepared as per.....

6. List 'B' includes all the past members who ceased to be members (except by death) within ..... of the winding up of the company.
7. The court may order the ..... to first pay off the debt due by him to the company and then claim the amount due to him.

**ILLUSTRATION:**

A winding up order has been issued against M Ltd.

The following information is obtained with regard to the assets and liabilities as on 30 June, 1996.

	<b>Rs</b>
Freehold premises (book value Rs. 4,50,000) valued at	3,75,000
First mortgage of freehold premises	3,00,000
Second mortgage of freehold premises	1,12,500
8% debentures carrying a floating charge on the undertaking interest due 1st April, and paid on due dates	1,50,000
Managing Director's emoluments (6 months)	22,500
Staff salary unpaid (one month)	16,050
Trade debtors-Good	31,500
Doubtful (estimated to realize 50 per cent)	12,900
Bad	72,750
Plant and Machinery (book value Rs 2,47,500) estimated to realize	1,74,000
Bank overdraft-unsecured	58,125
Cash in hand	825
Stock (at cost Rs. 50,850) estimated to realize	33,900
Issued Capital:	
Equity shares of Rs. 10 each fully called-up	1,50,000
Calls in arrears, Rs. 3,000 estimated to realize Unsecured creditors	2,96,250
Contingent liability in respect of a claim for damages	
Rs. 37,500—estimated to be settled for Income-tax liability	18,000
For 30 June, 1994	5,250
For 30 June, 1995	1,275
For 30 June, 1996	2,700

The Reserves of the company on 1 Sept., 1995 amounted to Rs. 7,500

you are required to prepare:

- (i) Statement of Affairs, and (ii) Deficiency Account.

**Solution:**

Particulars					(inRs.) Estimated Realizable Values
Assets not specifically pledged, as per List A					
Cash in hand					825
Trade debtors					37,950
Unpaid calls					1,500
Stock					33,900
Plant and machinery					1,74,000
Assets specifically pledged as per List B					
	Estimated realizable value	Due to secured creditors	Deficiency ranking as unsecured	Surplus	
Freehold premises	3,75,000	3,00,000			
Second mortgage on above		1,12,500	37,500		
Estimated total assets available for Preferential creditors, Debenture-holders secured by a floating charge and other creditors (carried forward)					2,48,175 -----
Summary of gross assets Rs.					
Assets specifically pledged		3,75,000			
Other assets		2,48,175			
		-----			
		6,23,175			
Estimated total assets available for preferential creditors, debenture-holders secured by a floating charge and unsecured creditors brought forward					2,48,175 -----

Gross Liabilities Rs.	Liabilities to be deducted from surplus or added to deficiency as the case may be)	
3,75,000	Secured creditors as per List B to the extent claims are covered, by assets specifically pledged	
20,025	Preferential creditors as per list C	<u>20,025</u>
	Estimated balance of assets available for debenture holders having a floating charge and unsecured creditors	2,28,150
1,53,000	Debenture holders secured by floating charge as per list D	<u>1,53,000</u>
	Estimate surplus as regards debenture holders	75,150
	Unsecured creditors as per List E.	
	Estimated unsecured-balance of claims of partly secured creditors	37,500
37,500	Trade	creditors
2,96,250	2,96,250	
27,750	Outstanding expenses and taxes	
58,125	27,750	
<u>18,000</u>	Bank overdraft	<u>4,37,625</u>
9,85,650	58,125	
	Contingent liability for claim for damages	18,000
	-	-----
	Estimated deficiency as regards creditors, being the excess off gross liabilities over gross assets	3,62,475
	Issued and called-up capital:	
	Preference share capital as per List P.	<u>1,48,500</u>
	15,000 equity shares of Rs. 10 each fully called-up less calls in arrear, Rs. 1,500 as per List G	5,10,975
	Estimated deficiency as regards contributories as per list H	

\*The figures must be read subject to the following

1. There is no unpaid capital liable to be called up
2. The estimates are subject to cost of the winding up and to any surplus or deficiency on trading, pending realization of assets.

**List H-Deficiency Account**

<b>A. Items contributing to Deficiency</b>	<b>Rs.</b>
1. Excess of capital and liabilities over assets on 1 September, 1995	
2. Dividends and bonuses declared	
3. Net trading losses after charging depreciation taxation, interest on debentures etc	2,55,825
4. Losses other than trading losses	
5. Estimated losses now written off	
Freehold premises	75,000
Trade debtors	79,200
Plant and machinery	73,500
Stock	16,950
Claim for damages	18,000
	2,62,650
6. Any other item	5,18,475
<b>B. Items reducing Deficiency</b>	
7. Excess of assets over capital and liabilities as on 1 September, 1995	7,500
8. Net trading profit	----
9. Profit and incomes other than trading profit	----
10. Other items Deficiency-as explained in the statement of affairs	----
Deficiency as explained in the statement of affairs	5,10,975

**Working Notes:****BALANCE SHEET****as at 30 June, 1996**

<b>Liabilities</b>	<b>Rs.</b>	<b>Assets</b>	<b>Rs.</b>
Capital (net	1,47,000	Freehold premises	4,50,000
Reserve	7,500	Plant and machinery	2,47,500
1st Mortgage	3,00,000	Sundry debtors	1,17,150
2nd Mortgage	1,12,500	Stock:	50,850
8 percent Debentures Interest for 3 months	1,50,000	Cash	825
	3,000	Profit and loss A/c (Balancing figure)	2,55,825
Sundry creditors (including managerial remuneration and salaries)			
Bank overdraft	3,34,800		
	58,125		

Provision for taxation	9,225		
	<b>11,22,150</b>		<b>11,22,150</b>

(ii) Preferential Creditors :		<b>Rs.</b>
Income Tax :	1994-1995	1,275
	1995-1996	2,700
		16,050
		<hr/>
	Staff salary	<u>20,025</u>

- (iv) Managing Directors emoluments have not been categorized as preferential creditors since he is an officer and not an employee of the company.

### 5.7 Summary:

Liquidation means putting an end to the life of the company. The assets of the liquidated company are administered for the benefit of the members and creditors. A company can be compulsory wound up by the National Company Law Tribunal. The various circumstances under which a company can be compulsorily wound up like- Inability of the company to pay its debt; Reduction in number of membership; if the company does not commence its business within a year from its incorporation or suspends its business for a whole year, etc. Voluntary winding up are of two types – Members' voluntary winding up and Creditors' voluntary winding up. Contributory means a person who is liable to contribute to the assets of the company in the event of its being wound up and includes holders of shares which are fully paid. Liquidator is the person who is appointed to administer the process of liquidation of a company. Preferential payments mean the payments to be made in preference to all other debts according to the provisions of the Companies Act.

### 5.8 Glossary:

1. **Liquidation:** Liquidation or winding up of a company is a process by which dissolution of a company is brought about.
2. **Compulsory winding up:** Winding up of a company by an order of the court is known as compulsory winding up.
3. **Voluntary winding up :**A winding up without any intervention of the court is termed as voluntary winding up.
4. **Contributory:** A contributory means a person liable to contribute to the assets of the company in the event of its being wound up and includes holders of shares which are fully paid.
5. **Liquidator:** A liquidator is a person who is entrusted the duty of winding up of a company. He is appointed to administer and to take control of the company.

### 5.9 Answers: self assessment

1. Liquidation
2. Assets

3. Three
4. Partly Secured
5. List 'H'
6. One Year
7. Contributory

**5.10 Terminal Questions:**

1. What do you mean by liquidation of a Company?
2. Describe the different modes of winding up.
3. Explain the various lists to be attached to the statement of Affairs.

**5.11 Suggested Readings**

Arulanandam, M.A. and Raman, K.S., Advanced Accountancy, Himalaya Publishing House, New Delhi.

M.C. Shukla and T.S. Srewal, Advanced Accountancy, Sultan Chand & Co. New Delhi.

R.L. Gupta, Advanced Financial Accounting, S. Chand & Co. New Delhi.

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**Lesson- 6****ACCOUNTING FOR HOLDING AND SUBSIDIARY COMPANIES****STRUCTURE:**

- 6.0 Learning Objectives
- 6.1 Introduction
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- 6.0 **LEARNING OBJECTIVES**

After studying the lesson, you should be able to understand:

1. The meaning of holding and Subsidiary Company.
2. Advantages and disadvantages of holding company.
3. Legal Definition and Requirements.
4. Accounting treatment in Consolidated Balance Sheets of Holding and Subsidiary Company.

**6.1 INTRODUCTION**

Companies are those that are able to nominate the majority of the directors of some other companies; such other companies are known as subsidiary companies. The holding company usually holds the majority of the paid up equity capital. A company may itself be a holding company and at the same time be subsidiary of another company. A company may be formed and then it may proceed to float the other company inviting other to join but holding the majority of share in these companies. Such a holding company is known as “parent” company. When existing companies, wishing to avoid competition float a .company which then proceeds to acquire the majority of shares in the existing companies, the name given to the holding company is “off spring” company.

**6.2 ADVANTAGES OF HOLDING COMPANY:**

The advantages of holding companies are as under:

- (1) Subsidiary companies maintain their separate identity and as such they maintain their goodwill.

- (2) The public may not be aware of the existence of combination among the various companies and, therefore, the fruits of monopoly or near monopoly may be enjoyed without resentment in the minds of the people. This however, is clearly a disadvantage from the social point of view, because, if there is monopoly the public is ought to know.
- (3) The person, controlling the holding company need to invest a comparatively small amount in order to control the subsidiary companies. If for example A, holding company, has two subsidiaries B and C and if Band C in turn have three subsidiaries each, the person who have the majority of shares in A will be able to control eight other companies. Had these companies been amalgamated, a much large amount would have been required in order to control the concern. This again is a disadvantage from the social point of view, because it may lead to irresponsibility.
- (4) By maintaining the separate identity of various companies, it would be possible to carry forward losses for Income tax purposes.
- (5) Each subsidiary company has to prepare its own accounts and therefore, the financial position and profitability of each undertaking is known.
- (6) Should it be found desirable that the content of the holding company should be given up, it can be easily arranged; all that is required is that the shares in the subsidiary companies should be disposed off in the market.

### 6.3 DISADVANTAGES OF THE HOLDING:

The disadvantages of holding companies are the following:

- (1) There is a possibility of fraudulent manipulation of accounts, specially if the accounts of various companies are made up to different dates.
- (2) Inter company transactions are often enter at fanciful or unduly low prices in order to suit those who control the holding companies.
- (3) There is the danger of the oppression of minority share holders.
- (4) There may by accounting difficulties in appraising the financial position of companies due to inter company transactions carried on at too high or too low prices.
- (5) The shareholders in the holding company may not be aware of the true financial position of the subsidiary companies.
- (6) Similarly, the creditors and outside shareholders in-the subsidiary companies may not also be aware of the true financial position.
- (7) The subsidiary companies may be forced to appoint persons of the choosing of holding companies as directors or other officers at unduly high remuneration.

Whatever the advantages and disadvantage, the holding company has come to stay and the law, now wisely tries to regulate its working. The law has defined a holding company and a subsidiary company. Private companies subsidiary to a public company do not enjoy the privilege given to private companies. Also the law compels the holding company to give information about the subsidiary companies.

#### 6.4 LEGAL DEFINITION AND REQUIREMENTS:

Section 4 of the Companies act, 1956 defines a subsidiary company, A company is subsidiary of another if and only if

- (a) that other company controls the compositions or its Board of directors; or
- (b) That other
  - (i) Where the first mention company is an existing company in respect of which the holders of preference share issued before ' the commencement of this holder of equity shares, exercised or controls more than half of total voting power of such company.
  - (ii) What the first mentioned company is any other company, holder of more than half in nominal value of its equity share capital; or
- (c) The company is subsidiary of any company which is that other company's subsidiary.

#### Illustration :

Company B is subsidiary of company A and company C is subsidiary of company A. If Company D is subsidiary of company C, company D will also be subsidiary of company B and consequently also of company A.

In case if a company is incorporated in a foreign country, the laws of that country will determine whether a company is a holding or a subsidiary company.

The substance of the above definition is that a company is a holding company if (1) It is able to appoint or dismiss the majority of directors of another company without consulting any one but such a power exercised by it in a fiduciary capacity (i.e. in its capacity as a trustee) or by virtue of debenture held by it or by virtue of a loan given by it (if its ordinary business is to lead money) will not make a company holding company. (2) It holds the majority of voting power or equity snares in another company unless the shares are held in a fiduciary capacity or, if it is a ending company, by way of security for a long granted; and (3) A company is a subsidiary of one of its subsidiaries. Shares held or power to appoint majority of directors on behalf of a company by nominee really belongs to a company.

#### Accounts:

Section 121 and 214 of the Companies Act govern the presentation of accounts of subsidiary companies by the holding companies. It should be remembered that the various, sections relating to the preparation of the Profit and Loss Account and the balance sheet apply to the holding as well as subsidiary companies.

Under Section 212, the following must be attached to the balance sheet of a holding company:

- (a) a copy of the recent balance sheet of the subsidiary company (or companies);
- (b) a. copy of the recent profit and Loss Account of a subsidiary (or Subsidiaries);
- (c) a copy of the recent report of the board of directors of the subsidiary;
- (d) a copy of the recent report of the auditors of the subsidiary (or subsidiaries);

#### A statement showing:

- (1) The extent of the holding company's interest in the subsidiary (or subsidiaries) at the end of the financial year of the subsidiary (or subsidiaries);

- (ii) The profits (after deduction of losses) of the subsidiary (or subsidiaries) so far as they concern the holding company separately for the current financial year and separately for profits already dealt with in the books of the holding company and not so dealt with. (The term 'Profits') means profits of a revenue nature and earned after the date of the acquisition of the shares by the holding company.
- (f) Where the financial year of the subsidiary company does not coincide with the financial year of the holding company, a statement showing the following :
  - (i) Whether and to what extent there has been a change in the holding company's interest in the subsidiary company since the close of the subsidiary company :
  - (ii) Details of any material changes which have occurred between the end of the financial year of the holding company in respect of :

The subsidiary's Fixed assets;

its investments;

the money lent by it;

and the money's borrowed by it for any purpose other than that of meeting current liabilities,

- (g) if for any reason the Board of directors of the holding company is unable to obtain information on the subject of revenue or capital profits (subject of statement (e above) a reporting writing to that effect.)

Under the same section the interval between the close of the financial year of the subsidiary company and that of the holding company cannot be more than six months for the purpose of the section. This means that the information to be attached to the balance sheet of a holding company in respect of a subsidiary company in respect of the subsidiary companies, companies cannot be more than 6 months old. Under section 212 the Central Government has the power to declare that the financial year of a subsidiary shall end with that of holding company. The power will be exercised either at the request or with the consent of the Board of Directors of the company whose financial year is to be extended. This will naturally postpone the preparation of the final account and the holding of the general meeting and submission of the various returns.

**Section 212 is reproduced below:**

- (1) There shall be attached to the balance sheet of a holding company having a subsidiary or subsidiaries at the end of the financial year as at which the holding company's balance sheet is made out, the following documents in respect of such subsidiary of each subsidiary as the case may be:—
  - (a) A copy of the balance sheet of the subsidiary
  - (b) A copy of its Profits and Loss Account
  - (c) A copy of the report of its Board of Director
  - (d) A copy of the report of its auditors
  - (e) A statement of the holding company's interest in the subsidiary as specified in sub section (3)
  - (f) The statement referred to in sub-section (5) if any and

- (g) The report referred to in sub-section (6), if any,
- (2) (a) The balance sheet referred to in clause (a) of subsection (1) shall be made out in accordance with requirements of this act
- (i) as at the end of financial year of the subsidiary, where such financial year coincides with the financial year of the holding company.
  - (ii) as at the end of the financial year of the subsidiary last before, that of the holding company.
- (b). The Profit and Loss Account and the reports of the board of directors and the auditors, referred to in clauses (b), (c) and (d) of sub-section (f), shall be made out, in accordance, with the requirements of this act, for the financial year of the subsidiary referred to in class (a).
- (c) Where the financial year of the subsidiary does not coincide with that of the holding company, the financial year afore-said of the subsidiary shall not end on a day which precedes the day on which the holding company's financial year ends by more than 6 months,
- (d) Where the financial year of a subsidiary is short in duration that of its holding company references to the financial year of the subsidiary the duration of which, in the aggregate, is not less than the duration of the holding company's year.
- (3) The statement referred to in clause (e) of subsection (i) shall specify:—
- (a) The extent of the holding's company interest in the subsidiary at the end of the financial year or of the last of the financial years of the subsidiary referred to in sub-section financial (2).
  - (b) The net aggregate amount, so far as it concerns member of the holding company and is not dealt with in the company's accounts of the subsidiary profits after deducting its losses or vice-versa:— (i) for the financial year or years of the subsidiary aforesaid and (ii) for the previous financial years of the subsidiary since it become the holding company's subsidiary so far as those profits are dealt, with or provision is made for those losses, in as company's account.
- (4) Clause (b) and (c) of sub-section (3) shall apply only to Profit and Losses of the subsidiary which may properly be treated in the .holding companies account as revenue profit and losses, and the profit and losses attributable to any shares in a subsidiary for the time being held by the holding company or any other of its subsidiaries shall not (for that or any other purpose) be treated as aforesaid so far as they are profits or losses for the period before the date on or as from which the shares where acquired by the company or any of its subsidiaries except that they may in a proper case be so treated where:
- (a) The company is itself the subsidiary of another body corporate; and
  - (b) The shares were acquired from that body corporate or a subsidiary of it and for the purpose of determining whether any profits or loses for the said period, the profit or loss, for any financial year of the subsidiary may, of it is not practicable to apportion it with reasonable accuracy by the reference to the facts, be treated as occurring from day to day during that year and be apportioned accordingly.

- (5) Where the financial year or year of subsidiary referred to in sub-section (5) do not coincide with the financial year of the holding company a statement containing information on the following matters shall also be attached to the balance sheet of the holding company.
- (a) Whether there has been any, and if so, what change in the holding company's interest in the subsidiary between the end of financial year of the last of the financial years of the subsidiary and the end of the subsidiary and the end of the holding company's financial years.
  - (b) Detail of any material changes which have occurred between the end of financial year of the last of the financial years of the subsidiary and the end of the holding company's Financial Year in respect of;
    - (i) The subsidiary's Fixed Assets.
    - (ii) Its investments:
    - (iii) The money lent by it;
    - (iv) The money borrowed by it for any purpose other than of meeting current liabilities.
- (6) If, for any reason, the board of director of the holding company is unable to obtain information on any of the matters required to be specified by sub-section (4) a report in writing to that effect shall be attached to the balance sheet of the holding company.
- (7) The documents referred to in clause (e), (f) and (g) sub-section (l) shall be signed by the person by whom the balance share of the holding company is required to be signed.
- (8) The Central Government may on the application or with the consent of the board of directors of company, direct that in relation to any subsidiary, provision of this section shall not apply, or shall apply only to such extent as may be specified in the direction.
- (9) If any such person as is referred to in subsection (6), of section 209 fail to take all reasonable steps to comply with the provisions of this section, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months or with fine which may extend to one thousand rupees, or with both.
- (10) If any person, not being a person referred to in sub-section (6) of section 209, having been charged by the managing case may be with the duty of seeing that provision of this section are complied with, makes default in doing so, he shall in respect of each offence, be punishable with imprisonment for a term which may extend to 6 months, or with, fine which may extend to one thousand rupees or both. Provided that no person shall be sentenced to imprisonment for any such offence unless it was committed wilfully.

### **6.5 CONSOLIDATED BALANCE SHEET:**

As a supplement to the Legal Balance Sheet the finding company may publish a consolidated balance sheet in which the assets and liabilities of all the subsidiary companies are assimilated just like a head office incorporating the assets and liabilities of its branches. Such a balance sheet would serve to reflect the holding company's position to greater details than any other method.

In view of the fact that the main object of the holding company system is to exercise control over its Subsidiaries, it is highly essential that those in management should have placed before them, at

periodical interval, consolidated statement should have placed before them, reflecting the true working results as also the financial position of the combine as a whole and a consolidated balance sheet serves a very useful purpose in this direction. Besides, questions are now often asked in many almost all the examinations in Advance Accounting calling upon the student to prepare consolidated balance sheet for information supplied them and it is hoped, therefore, that the following hints together with the practical illustrations fully worked out will help them in understanding the few peculiar points arising in the preparation of such statements.

## 6.6 CONSOLIDATION OF FINANCIAL STATEMENTS

In India, holding companies are not legally required to publish consolidated or group accounts though it is a legal obligation under the companies Act of England. However, it is appropriate to group or combine the accounts so that the shareholders get a clear insight about their interest both in the holding company and its subsidiaries.

## 6.7 FORMS AND CONTENTS OF CONSOLIDATED BALANCE SHEET

Companies Act 1956 does not require preparation and presentation of a Consolidated Balance Sheet. Since directors are the agents and trustees of the shareholders, they are accountable to disclose as to how their funds have been invested. Hence a clear picture of various assets including investments be presented before the shareholders. Therefore, a consolidated Balance Sheet is prepared which is in conformity with the schedule VI of Companies Act, 1956.

### CONSOLIDATED BALANCE SHEET

(A Format)

As on .....

Liabilities	Rs.	Rs.
<b>Share Capital (of H. Ltd. only)</b>		.....
<b>Reserve &amp; Surplus:</b>		
Revenue Reserves of H Ltd.	.....	
Add Share in Revenue Reserves of S Ltd.	.....	.....
Capital Reserve of H Ltd.	.....	
Less Goodwill, if any, as per Contra	.....	
Profit & Loss Account of H Ltd.	.....	
Add Share in Revenue (post-acquisition) profits of S Ltd.	..... .....	
Less Holding Company's share in unrealized profits	.....	.....
<b>Secured Loans:</b>		
Secured Loans of H Ltd.	.....	
Add Secured Loans of S Ltd.	.....	.....

	Unsecured Loans of H Ltd.	.....	
Add	Unsecured Loans of S Ltd.	.....	
Less	Mutual Owings (Inter-company Loans)	.....	.....
<b>Current liabilities &amp; Provisions :</b>			
	Of H Ltd. ....	.....	
	Of S Ltd. ....	.....	
Less	Inter Company liabilities	.....	.....
<b>Minority Interest</b>			
<b>Assets</b>			
<b>Fixed Assets</b>			
	Cost of Control (Goodwill)		
	Goodwill of H Ltd. as per Balance Sheet	.....	
	Goodwill of S Ltd. as per Balance Sheet	.....	
Less	Capital Reserve as per Contra	.....	.....
<b>Other Fixed Assets (Net)</b>			
	of H Ltd. ....	.....	
	of S Ltd.	.....	
<b>Investments</b>			
	of H Ltd. except in subsidiary	.....	
	of S Ltd.	.....	
<b>Current Assets, Loans &amp; Advances:</b>			
	of H Ltd.	.....	
	of S Ltd.	.....	
Less	Inter Company debts		
Less	Share of Unrealized profit	.....	
<b>Miscellaneous Expenditure:</b>			
	Items such as P & L A/c	.....	

Preliminary Expenses of Holding Company only	.....	
<b>H Ltd. = Holding Co./ S Ltd. = Subsidiary</b>		.....

### I. Wholly Owned subsidiary and Cancellation of Investment Account

The main objective of consolidated Balance Sheet is to present and provide financial information about the group (Which Consists of holding and its subsidiaries. The economic activities of the group are shown as the activities of a single economic entity. While consolidating assets and liabilities of the group, the common items which are the assets for one company and liabilities for other company, are eliminated.

In case of cent-percent holding or wholly owned subsidiary company, the entire share capital (issued) is acquired by the holding company. If S Ltd. has issued capital of Rs. 10,00,000 in shares of Rs. 10 each, then H Ltd. has acquired all 1,00,000 shares of Rs. 10 each. If shares are acquired at par then the Cost of investment will be Rs. 10,00,000. While consolidating the Share Capital of S Ltd. (of Rs. 10,00,000) and Investments of H Ltd. costing Rs. 10,00,000 will be eliminated.

#### BALANCE SHEETS OF H LTD. & S LTD. As on 31st March, 2005

Liabilities	H Ltd.	S Ltd	Assets	H Ltd.	S Ltd
	'000	'000		'000	'000
Equity Shares Capital	2500	1000	Sundry Assets	2000	1200
Shares of Rs. 10 each	500	200	Investments in		
S. Liabilities			1,00,000 shares of S Ltd	1000	
	3000	1200		3000	1200

Prepare Consolidated Balance Sheet.

#### Solution :

In this problem, the entire issued Capital of S Ltd. is acquired by H Ltd. at par. Thus, while preparing a consolidated Balance Sheet the investment of holding company in equity shares of subsidiary Company is replaced by the assets and liabilities of the subsidiary. It is to be noted that the holding company's interest in the subsidiary company's net assets is 100%. In other words all assets and liabilities of Subsidiary company have become the assets and liabilities of holding company. The financial position of the group can better be understood by eliminating the issued share capital of S Ltd. and Investments in shares of S Ltd. This has been shown below by means of a consolidated Balance Sheet.

**CONSOLIDATED BALANCE SHEET**

as on .....

Liabilities		Assets	Rs. 000
Equity Share Capital Shares of Rs. 10 each	2500	S Assets	
S. Liabilities		H Ltd	2000
H Ltd 500		S Ltd	1200
S Ltd 200	700		
	3200		3200

**II. MINORITY INTEREST:**

When a subsidiary company is not wholly owned by a holding company, then the shares are held by other (outsiders) who are in minority from voting-power point of view, Such outsiders (shareholders) interest in the subsidiary company is known as "Minority Interest". For example H Ltd. acquires only 8,000 shares in S Ltd. out of total 10,000 shares issued. Thus H Ltd. is holding only 80% of shares in S Ltd. while remaining 20% shares are held by outsiders. Thus the share of minority shareholders in the net assets is restricted to 20% and that of holding company to 80%.

Minority interest represents amount payable to outsiders by virtue of their holdings which is equal to their net value of their holding. These minority shares holders are entitled to proportionate share in accumulated profits or losses. It is calculated as under:

Minority Interest =	Paid up value of equity shares held by outsiders
Add	Proportionate share in pre-acquisition profits & reserves.
Add	Proportionate share in post-acquisition profits & reserve.
Less	Proportionate share in pre/ post acquisition losses (Such as Debit balance of P& L A/c, Discount on Issue of Debentures Shares and Preliminary Expenses)

However, if any change in the value of assets is agreed upon, then the impact of such revaluation should be incorporated in the minority interest also. The share of minority shareholders so computed is shown on the liabilities side of Balance Sheet under the heading "Minority Interest".

**Illustration**

From the following information prepare a consolidated balance sheet of H. Ltd. and its subsidiary S. Ltd.:

Equity and Liabilities	H. Ltd. Rs	S. Ltd Rs	Assets	H. Ltd. Rs	S. Ltd Rs
Share Capital in			Sundry Assets	8,00,000	5,40,000

shares of Rs 10 each	10,00,000	5,00,000	Investments in the		
Other Liabilities of S Ltd.	2,00,000	40,000	shares 40,000		
			shares@ Rs10 each	4,00,000	---
	<u>12,00,000</u>	<u>5,40,000</u>		<u>12,00,000</u>	<u>5,40,000</u>

### Solution

In this case H. Ltd. owns only 80% of total issued capital of Rs 5,00,000 of S. Ltd. and Rs 1,00,000 share capital is held by the outsiders or minority share holders. It is again presumed that H. Ltd. has bought shares in S. Ltd. at par and the two companies do not trade with each other. The outside shareholders have 20% or 1/5 share in the net assets which must be shown in the liabilities side on consolidation under the heading minority interest. The consolidated balance sheet would thus appear as under:

### Consolidated Balance Sheet of H. Ltd And Its Subsidiary S. Ltd. As on.....

	Particulars	Note	Rs
<b>I.</b>	<b>EQUITY AND LIABILITIES</b>		
	<b>1. Share holders' Funds</b>		
	Share Capital	1	10,00,000
	<b>2. Minority Interest</b>	2	<u>1,00,000</u>
	3. Other Liabilities	3	<u>2,40,000</u>
	<b>Total Equity and Liabilities</b>		<b><u>13,40,000</u></b>
<b>II.</b>	<b>ASSETS</b>		
	Sundry Assets	4	13,40,000
	<b>Total Assets</b>		<b><u>13,40,000</u></b>

### Notes to Accounts

Particulars	Rs	Rs
<b>1. Share capital (H. Ltd)</b>		
<b>Issued, subscribed and Fully Paid</b>		
<b>1,00,000 Equity shares of Rs10 each (H. Ltd.)</b>		10,00,000
<b>2. Minority Interest</b>		
1/5 share in the share capital of S. Ltd		1,00,000
<b>3. Other Liabilities</b>		
H. Ltd		2,00,000
S. Ltd		40,000
		-----
		2,40,000
<b>4. Other Assets</b>		
H. Ltd		8,00,000
S. Ltd.		5,40,000
		-----
		13,40,000

### NOTES

1/5 Minority interest which is equal to 1/5 share in the share capital means.

1/5 share in the net assets of company calculated as under:

1/5 share in the assets of S. Ltd.	1, 08,000	
Less: 1/5 share in other liabilities of S. Ltd.	8,000	
	-----	
	1, 00,000	
	-----	

Even in a partly owned subsidiary company, the share capital of subsidiary company is never added to the share capital of the holding company. Instead, it should be split (divided) into two parts as explained below:

- (a) share of minority or outsiders should be included in what is technically called, Minority Interest Account, and be shown as a separate liability;
- (b) share of the holding company should be deducted from the investment in the shares of subsidiary company made by holding company;

- (c) as stated above, the total minority interest is equal to the proportionate share of outsiders in the share capital, reserves and profits of the subsidiary company reduced by proportionate share in the accumulated losses. In this illustration, since there are no accumulated profits (or losses), the minority interest in net assets is exactly equal to the share capital held by outsiders.

### III. Cost of Acquiring Control (or Good will)

Cost of control represents excess of “cost of investment in shares of subsidiary” over the “intrinsic value” of shares acquired. Intrinsic value is equal to net assets value of shares. It rarely happen in practices that the holding company would acquire the shares in the subsidiary company at the par or nominal value. The shares may be purchased at a premium or at a discount. If the holding company purchases the shares at a price above the face or nominal value (paid up), the excess price paid represents, ‘cost of control or Good will” on consolidation

### IV. Pre-Acquisition and Post-Acquisition Profits

Profits earned by the subsidiary company before the date of acquisition of shares by the holding company are known as pre-acquisition profits. Profits earned by the subsidiary company after the date of acquisition of shares by the holding company are treated as post acquisition or revenue profits. Such revenue profits are ignored while calculating cost of control or capital reserve. The balances in the surplus and reserves accounts of the holding company are reproduced separately in the consolidated Balance Sheet.

### V. Pre-acquisition Losses

These are treated as capital losses in so far the share of holding company in such losses is concerned. It increases the cost of acquiring control (or goodwill) or decreases the capital reserve in the consolidated balance sheet. These losses are in the form of debit balance of profit & loss A/c, Preliminary expenses, or discount on issue of shares or debentures, on the date of acquisition of shares.

### VI. Post-acquisition Losses

The loss incurred by a subsidiary company during the post-acquisition period does not affect calculation of goodwill or Capital Reserve, because such losses are treated as revenue losses. Holding company’s share of loss is adjusted against the Profit & Loss Account in the Consolidated Balance Sheet while share of loss of minority shareholders is debited to Minority Interest A/c.

### Illustration

The extracts of balance sheets of H. Ltd., and its subsidiary S; Ltd., as on 31 March 2013, were as follows:

<b>Equity and Liabilities</b>	<b>H. Ltd. Rs</b>	<b>S. Ltd Rs</b>	<b>Assets</b>	<b>H. Ltd. Rs</b>	<b>S. Ltd Rs</b>
Share Capital (shares of Rs 1 each)	10,000	6,000	Sundry Assets	16,000	10,000
General Reserve	4,000	-----	Investment shares in S Ltd.	4,000	-----
	4,000	1,800			

Surplus	2,000	2,200			
Creditors	20,000	10,000		20,000	10,000

The shares were purchased by H. Ltd. in S. Ltd. on 30 September 2012.

On 1 April 2012 the profit and loss statement of S. Ltd. showed a loss of Rs. 3,000 which was written off from out of the profits earned during the year. Profits are earned uniformly over the year 2012-13. Prepare a consolidated balance sheet of H. Ltd. and S. Ltd. as on 31 March 2013 giving all workings.

**Solution:**

	Rs
<b>(1) H. Ltd.'s Share in Pre-acquisition Loss</b>	
Total Pre-acquisition Loss	3,000
H. Ltd.'s share 2/3 of Rs. 3,000	2,000
<b>Pre-acquisition loss of Rs.2,000 is a capital loss for H. Ltd. and it would be either added to the cost of control or deducted' from the capital reserve.</b>	
<b>(2) H. Ltd.'s Share in Post-acquisition Profits</b>	1,800
Surplus in the Profit and Loss Statement	3,000
<b>Add:</b> Pre-acquisition losses written off	<u>4,800</u>
<b>Total Profits for 2012-13</b>	
Profit between 1 October 2012 to 31 March 2013	2,400
1/2 of Rs.4,800	1,600
H. Ltd. share 2/3 of Rs.2,400	
<b>(3) H. Ltd. Share of Capital Profits</b>	2,400
Pre-acquisition profits i.e., from 1.04.2012 to 30.09.2012 : 1/2 of Rs.4,800	1,600
H. Ltd.'s share 2/3 of Rs. 2,400	
<b>The Pre-acquisition profit of? 1,600 would be used either to reduce the goodwill or increase the capital reserve</b>	
<b>(4) Cost of Control or Goodwill</b>	4,000
Investment in the shares of S. Ltd.	<u>4,000</u>
<b>Less:</b> Paid up value of the shares held	-----
Cost of control or Goodwill	2,000
<b>Add:</b> Pre-acquisition loss (1)	(1600)

<b>Less:</b> Capital Reserve (3)	400
Goodwill	

**Consolidated Balance Sheet of H: Ltd.  
And Its Subsidiary S. Ltd. As On 1 April 2013**

	Particulars	Note	Rs
<b>I.</b>	<b>EQUITY AND LIABILITIES</b>		
	<b>1. Share holders funds</b>		
	(a) Share Capital (H. Ltd).	1	10,000
	(b) Reserves and Surplus	2	9,600
			19,600
	<b>Sub</b>	3	2,600
	<b>Total 2. Minority Interest</b>		
		4	4,200
	<b>3. Current Liabilities</b>		
	Trade Payables		26,400
	<b>Total Equity and</b>		
<b>II.</b>	<b>Liabilities</b>		
		5	26,000
		6	400
	<b>ASSETS</b>		26,400
	<b>1. Non-Current Assets</b>		
	<b>(a) Fixed Assets</b>		
	(i) Tangible		
	(ii) Intangible		
	<b>Total</b>		
	<b>Assets</b>		

## Notes to Accounts

Particulars	Rs	Rs
<b>1. Share capital (H. Ltd.)</b>		
<b>Issued, subscribed and Fully Paid up</b>		
10,000 Equity shares of Rs.1 each		10,000
		4,000
<b>2. Reserves and Surplus</b>	4,000	
(i) General Reserve (H. Ltd.)	1,600	5,600
(ii) Surplus (H. Ltd.)		9,600
Share in S. Ltd. (see working note)		2,000
		600
<b>3. Minority Interest</b>		2,600
Equity share capital		
<b>Add</b> : share in Profit 1/3 of Rs,1,800		
		2,000
		2,200
<b>4. Trade Payables</b>		4,200
Sundry Creditors for Goods :		
H. Ltd.		16,000
S. Ltd.		10,000
		26,000
<b>5. Tangible Fixed Assets</b>		
Sundry Fixed Assets :		
H. Ltd		2,000
S Ltd		1,600
		400
<b>6. Intangible Fixed Assets</b>		
Goodwill on consolidation		
<b>Less</b> : Capital Reserve		

## **VII. Elimination of Common Transactions**

When the consolidated balance sheet is prepared, it must be ensured that inter-company balance are eliminated by offsetting liabilities in one company's balance sheet against the corresponding assets in the other company's balance sheet. The following instances may be noted carefully:

- (a) Loans advanced by one company to other company.
- (b) Goods shown on credit by Holding Company to subsidiary and vice-versa.
- (c) Bills of exchange given by one company and received by another or vice-versa.

## **VIII. Unrealized Profit**

Accounting treatment for unrealized profit raised only when:-

- (a) Goods have been sold at a profit by one constituent company to another of the same group.
- (b) Goods (all or portion of it) remain unsold with the purchasing company on the date of consolidation.

If one company hold stocks which have been purchased from the other, price charged must be cost plus profit. But as the goods have not been sold to a company within the group, it cannot be said that profit has been realized because transaction has not taken place with any outside entity. Any such unrealized profit is therefore deducted from the value of the stock of one company and the same profit deducted from the profit and loss statement of the other company.

## **IX. Contingent Liabilities:**

Contingent liabilities are those liabilities which may or may not arise. The payment of such liabilities depends upon the occurrence of certain events.

- (a) Liability for Bills discounted.
- (b) Liabilities under guarantee.
- (c) Arrears of dividend on cumulative preference shares.
- (d) Liability for call on partly paid up shares held.
- (e) Claims against the company not acknowledged.

If the contingent liability is in respect of a transaction between the company in the group and outside third party, it will appear as a 'note' to the Consolidated Balance Sheet. But if the contingent liability is in respect of a transaction between holding and subsidiary companies, it will disappear from the foot note of individual company's balance sheet and appear as an actual liability in the consolidated balance sheet.

## **X. Bonus Shares**

Shares allotted by a company to its existing shareholders free of cost on pro-rata basis out of its accumulated profits are known as "Bonus shares". The treatment of bonus shares would depend upon the source utilized for issuing bonus shares.

- (a) Issue of bonus shares out of pre-acquisition profits.
- (b) Issue of bonus shares out of post-acquisition profits.

## **XI. Revaluation of Assets & Liabilities**

At the time of acquisition of shares of the subsidiary company, holding company may revalue the assets and liabilities to know its true value.

### **(I) Accounting Treatment on Revaluation of Assets**

- (a) Any increase in the value of assets is in the nature of capital profit.
- (b) Any reduction in the value of assets is a :
  - (i) Capital Loss if revaluation is done before or at the time of acquisition of control by holding company and it will increase the cost of control (or goodwill) or reduce the amount of capital reserve.
  - (ii) Revenue loss if the revaluation is done in the post-acquisition period.
- (c) For appreciation in the value of assets, depreciation charge would be increased proportionately and would be deducted from revenue profits of subsidiary company.
- (d) For decrease in the value of assets, depreciation charge would be decreased proportionately and added to the revenue profits of subsidiary.
  - (iii) Accounting Treatment in case of revaluation of liabilities.

Any change in the value of liability is either a capital loss or capital profit and as such adjusted accordingly.

## **XII. Preference shares in Subsidiary Company**

Preference shares are treated as cumulative unless otherwise state. If a subsidiary company has issued preference shares there may be two situations:

- (a) Preference shares are held by outsiders.

These are included in Minority interest. The amount included consists of paid up value of these shares hold by outsiders plus dividend accrued thereon up to the date of consideration.

- (b) Preference shares are held by the Holding Company

The paid up value of such preference shares is adjusted in the cost of control account in the same manner as in case of equity shares.

## **XIII. Debentures in Subsidiary Company**

Debentures of the holding company will appear in the consolidated balance sheet separately just like share capital. Debentures in subsidiary company are to be shown as non-current liability in the consolidated balance Sheet. If a part of debentures of a subsidiary is held by holding company as investments and part by outsider, the amount of debentures held by the holding company should be reduced to the extent of investments and only the amount of debentures held by outsiders would appear as a separate item in the consolidated balance sheet.

## **XIV. Dividend**

While preparing Consolidated Balance Sheet the accounting treatment of dividend depends upon the circumstances and the sources out of which the dividend has been paid or proposed to be paid by subsidiary company.

- (a) **Unclaimed Dividend:** Usually it appears on the liabilities side of Balance Sheet of the subsidiary company. If it belongs to minority shareholders, it should be added back to "Minority Interest". In case it belongs to Holding Company it should be cancelled by corresponding unclaimed dividend appearing on the assets side of the balance sheet.
- (b) **Proposed Dividend:** Accounting treatment of proposed dividend depends upon the nature of profits out of which this dividend has been provided. Usually, it is provided out of current year's (Post-acquisition) profit.

### There may be two situations

- (i) **Proposed dividend appearing in the Balance Sheet:** The amount of proposed dividend in the balance sheet of subsidiary company must be added with current year's profits of the subsidiary company. After that, cost of control and minority interest would be calculated. Finally, share in the proposed dividend will be deducted from minority interest and the same will be shown as a separate item in the consolidated balance sheet under current liabilities: Short Term Provision.
- (ii) **Proposed dividend does not appear in the Balance Sheet:** It will have no effect on the subsidiary Company's current year's profit.

### (c) Payment of Dividend

Whenever subsidiary company pays dividend to its shareholders including its parent company the accounting treatment again depends on the nature of profits. If the dividend so paid relate to revenue (Post-acquisition) profit then the same should be credited to Profit & Loss A/c of holding company. If dividend so paid is out of pre-acquisition (capital profit) it should be adjusted against cost of control A/c. Under no situation it is credited to profit & Loss A/c of the holding company.

- (d) Interim Dividend paid by Subsidiary company during the accounting year must be added to the balance sheet of the current year's profits of the subsidiary. Holding company's share of the same must be deducted from the consolidated profit. Minority's interest of the same will be deducted from minority's interest. Interim dividend will not be shown anywhere in the consolidated balance sheet.

### XV. Miscellaneous Expenditure:

These items in the balance sheet of subsidiary company are in the nature of capital losses and hence must be taken into consideration while calculating the cost of control and minority interest. These items include preliminary expenses, discount on issue of shares and debentures, underwriting commission, etc. the proportionate share of holding company in preliminary expenses etc. would be added to the cost or deducted from the capital reserve, as the case may be. Similarly, the proportionate share of the minority interest in such losses must be deducted from the minority interest itself. Thus in the consolidated balance sheet, these capital losses of the subsidiary company shall never appear as separate items. These must be eliminated.

### Self - Assessment

Fill in the blanks:

1. \_\_\_\_\_ refers to the date on which the relationship of holding company and subsidiary company comes into existence.

2. \_\_\_\_\_ refers to the period beginning with the date of acquisition of majority shares by the holding company and ending with the date on which the current accounting year ends.
3. Investment in subsidiary is replaced by \_\_\_\_\_ of the subsidiary company.
4. \_\_\_\_\_ is the residual interest in the assets of an enterprise after deducting all its liabilities.
5. Final dividend refers to that portion of \_\_\_\_\_ which has been declared by the Members at Annual General Meeting.

**Illustration:**

The following is a summary of the balance in the books of Black Ltd., and Bird Ltd., as on 31 March” 2013:

Credited	Black Ltd Rs,	Bird Ltd. Rs
Fully paid Equity Shares of Rs. 1 each	3,00,000	1,80,000
General Reserves	50,000	40,000
Surplus	98,500	44,400
Provision for Depreciation on Fixed Assets	60,000	30,000
6% Debentures (20 Debentures of Rs 1,000 each)	-----	20,000
Proposed Dividend	30,000	18,000
Debenture Interest accrued	-----	1200
Creditors	87,000	29,800
	6,25,500	3,63,400
<b>Debits</b>		
Fixed Assets at cost	2,50,000	2,20,000
1,35,000 Equity Shares in Bird Ltd. at cost	2,25,000	-----
6%, Debentures of Bird Ltd.	5,000	-----
Current Assets	1,45,500	1,43,400
	6,25,500	3,63,400

You ascertain the following:

- (a) Black Ltd. acquired the shares in Bird Ltd. on 31 March, 2012
- (b) The general reserve of Bird Ltd was the same on 31 March, 2012. The balance of the profit and loss statement of Bird Ltd. is made up as follows:

Balance on 31 March, 2012	28,000
Net Profit, year ended 31 march, 1998	34,400
	-----
	62, 400
<b>Less:</b> Provision for proposed dividends	18,000
	-----
	<b>44,400</b>

- (c) The stock-in-trade of Bird Ltd. on 31 March, 2012 included j 16,000 in respect of goods purchased from Black Ltd. These goods had been sold by Black Ltd. to Bird Ltd. at such a price as to give Black Ltd. a profit of 20% on invoice price.

You are required to prepare a consolidated balance sheet of Black Ltd. and its subsidiary company, Bird Ltd. as on 31 March, 2012 Ignore taxation. Workings are to be shown.

### Solution

#### WORKING NOTES

(i)	<b>Share of Black Ltd. in Capital Profit</b>	
	General reserves, April 1, 2012	40,000
	Surplus April 1, 2012	28,000
		<b>68,000</b>
(ii)	Black Ltd's share $\frac{3}{4}$	51,000
	<b>Current Year's Surplus</b>	
	Surplus as per balance sheet	44,400
	<b>Add:</b> Proposed dividend	<b>18,000</b>
		<b>62,400</b>
	<b>Less:</b> Opening Surplus	28,000
		<b>34,400</b>
		<b>25,800</b>
(iii)	<b>Minority Interest</b>	
	Face value of shares held	45,000
	<b>Add:</b> $\frac{1}{4}$ of j 40,000 (general reserves)	10,000
	<b>Add:</b> $\frac{1}{4}$ of j 62,400 (Surplus + proposed dividend)	15,600

			70,600
	<b>Less: Proposed dividend to be shown separately (1/4 off 18,000)</b>		<b>4,500</b>
			<b>66,100</b>
	<b>Cost of Control/Capital Reserve</b>		
	Cost of investments in Bird Ltd		
	<b>Less : Face value of shares held</b>	1,26,000	2,25,000
	Capital profits 3/4 (i)	51,00	
		-----	
	<b>Goodwill</b>		1,86,000
	<b>Unrealized profit on Stock</b>		39,100
	20/100 x 16,000 = 3,200		
(iv)			

**Consolidated Balance Sheet of Black Ltd.  
And Its Subsidiary Bird Ltd. As On 31 March 2013**

	Particulars	Note	Rs,
I.	<b>EQUITY AND LIABILITIES</b>		
	<b>1. Shareholders' Funds</b>		
	(a) Share Capital	1	3,00,000
	(b) Reserves and Surplus	2	1,71,000
	<b>Sub</b>		<b>4,71,000</b>
	<b>Total</b>		<b>66,100</b>
	<b>2. Minority Interest</b>	3	
	<b>3. Non-Current Liabilities</b>		<b>15,000</b>
	Long-term Borrowings (unsecured)	4	
	<b>4. Current Liabilities</b>		<b>1,16,800</b>
	(a) Trade Payables	5	900
		6	

II.	(b) Other Current Liabilities	7	34,500
	(c) Short-term Provisions		<u>152,200</u>
	<b>Sub Total</b>		<u>7,04,400</u>
	<b>Total Equity and Liabilities</b>		
	<b>ASSETS</b>		
	<b>1. Non-Current Asset</b>		
	(a) Fixed Assets	8	3,80,000
	(i) Tangible Assets	9	39,000
	(ii) Intangible Assets		<u>4,19,000</u>
	<b>Sub Total</b>		2,85,400
	<b>2. Current Assets</b>	10	<u>7,04,400</u>
	<b>Total</b>		
<b>Assets</b>			

### Notes to Accounts

	Particulars	Note	Rs
<b>1.</b>	<b>Share capital (Black Ltd.)</b> 3,00,000 Equity shares of j 1 each		<u>3,00,000</u>
<b>2.</b>	<b>Reserves and Surplus</b>		
	(i) General Reserves (Block Ltd)		50,000
	(ii) Surplus	98,500	
	<b>Add : Share in Bird Ltd</b>	<u>25,800</u>	
		1,24,300	
	<b>Less : Unrealized Profit on stock</b>	<u>3200</u>	1,21,100
			<u>1,71,000</u>
<b>3</b>	<b>Minority Interest</b> Face value of shares held		45,000
			10,000

	<b>Add</b> : 1/4 of Rs.40,000 ( <b>General Reserves</b> )	15,600
	1/4 of Rs. 6,24,000 ( <b>Surplus + Proposed dividend</b> )	<b>70,600</b>
	<b>Less</b> : Proposed dividend to be shown separately (1/4) of 18,000)	<b>4,500</b>
		<b>66,100</b>
<b>4.</b>	<b>Long-term Borrowings</b>	
	(Unsecured ) 6% Debentures	20,000
	<b>Less</b> : Held by Bird Ltd	5,000
		<b>15,000</b>
<b>5.</b>	<b>Trade Payable</b>	
	Sundry Creditors for Goods	
	Black Ltd.	87,000
	Bird. Ltd.	29,800
		<b>1,16,800</b>
<b>6.</b>	<b>Other Current Liabilities</b>	
	Debentures Interest Accrued	1,200
	<b>Less</b> Inter-Company debts	300
		<b>900</b>
<b>7.</b>	<b>Short term Provisions</b>	
	Proposed Dividend	30,000
	Black Ltd.	4,500
	Bird. Ltd.	<b>34,500</b>
		<b>4,70,000</b>

<b>8.</b>	<b>Tangible Assets</b>		90,000
	Gross Block		<u>3,80,000</u>
	<b>Less :</b> Provision for Depreciation		
<b>9.</b>	<b>Intangible Assets</b>		2,25,000
	<b>Goodwill on consolidation:</b>		<u>1,86,000</u>
	Cost of Investments	1,35,000	<u>39,000</u>
	<b>Less :</b> Face Value of shares	<u>51,000</u>	
	Capital Profits		2,88,900
<b>10.</b>	<b>Current Assets</b>		<u>300</u>
	<b>Gross</b>		2,88,600
	<b>Less:</b> Debentures Interest		<u>3,200</u>
			2,85,400
	<b>Less:</b> Unrealized Profit on stock		

### 6.8 Summary:

A holding company is one which controls one or more companies either by means of holding shares in that company or companies or by having powers to appoint—directly or indirectly—the whole, or a majority, of the Board of Directors of those companies. A company controlled by a holding company is known as a subsidiary company. Practically, it is a part and parcel of the combination movement in business and is operated for the purpose of controlling companies engaged in a similar line of business. Section 129 of the Companies Act, 2013 ('the Act') provides that the financial statements of the Company shall give true and fair view of state of affairs of the Company, comply with applicable accounting standards and shall be made as per Schedule III of the Act. The consolidated financial statements are prepared to ascertain the financial performance and financial position of the group as a whole and appropriate value of a holding company.

### 6.9 Glossary:

- Minority Interest:** When a subsidiary company is not wholly owned by a holding company, then the shares are held by other (outsiders) who are in minority from voting-power point of view, Such outsiders (shareholders) interest in the subsidiary company is known as Minority Interest.

2. **Pre-acquisition profits:** Profits earned by the subsidiary company before the date of acquisition of shares by the holding company are known as pre-acquisition profits.
3. **Post acquisition profits:** Profits earned by the subsidiary company after the date of acquisition of shares by the holding company are treated as post acquisition or revenue profits.
4. **Bonus shares:** Shares allotted by a company to its existing shareholders free of cost on pro-rata basis out of its accumulated profits are known as Bonus shares.

#### 6.10 **Answers: Self Assessment:**

1. Date of acquisition
2. Post-acquisition period
3. Assets and liabilities
4. Equity
5. Proposed Dividend

#### 6.11 **Terminal Questions:**

1. Define holding and subsidiary company.
2. Write a note on consolidation procedure.
3. What are the advantages of consolidation of financial statements of holding company and subsidiary company?
4. Write a note on Accounting Standard - 21 'Consolidated Financial Statements'.
5. Write short notes on
  - (i) Minority Interest
  - (ii) Cost of Control
  - (iii) Unrealized Profit
  - (iv) Revaluation of Assets
  - (v) Pre and Post acquisition of Profit.

#### 6.12 **SUGGESTED READINGS**

Goyal, Bhushan Kumar, Fundamentals of Corporate Accounting, International Book House Pvt. Ltd., New Delhi 2013.

Tulsian, P .C. and Tulsian, Bharat, Corporate Accounting, S Chand and Company Ltd., Ram Nagar, New Delhi, 2019.

Monga, J.R., Fundamentals of Corporate Accounting, Mayur Paperbacks, New Delhi, 2013.

Goel, D.K. and Goel, Shelly, Corporate Accounting, Arya Publications, New Delhi, 2015.

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**Lesson-7****ROYALTY ACCOUNTS****Structure**

- 7.0 Learning Objectives
- 7.1 Introduction
- 7.2 Types of Royalty
- 7.3 Minimum Rent
- 7.4 Short Workings
- 7.5 Recoupment of Short Working
- 7.6 Accounting Entries in the books of the Lessee
- 7.7 Accounting Entries in the books of Lesser or Land Lord
- 7.8 Sub-Lease
- 7.9 Summary
- 7.10 Glossary
- 7.11 Answers: Self Assessment
- 7.12 Terminal Questions
- 7.13 Suggested Readings
- 7.0 **LEARNING OBJECTIVES**

After studying the lesson, you should be able to

1. Know the meaning of Royalty and its types.
2. Understand Minimum Rent, short working etc.
3. Understand the Accounting Entries in the books of Lessee and Lessor or Land Lord.
4. Know the concept of sub-lease.

**7.1 INTRODUCTION**

Royalty is an amount payable for utilizing the benefit of certain rights vested with some other person over the time in his hand, the author of books possesses right over his book. Royalty is a periodical payment based on output or sale for the use of a certain assets or right. The person who makes payment to the owner of the asset in exchange for the right to use his asset is known as lessee and the owner of the asset to whom payment is made is known as Lessor or Land Lord.

**7.2 TYPES OF ROYALTY**

There are many types of royalties but following types of royalties are very popular:

- (i) Mining royalties.
- (ii) Brick-making royalties.
- (iii) Oils-wells royalties.

- (iv) Patent royalties.
- (v) Copy right royalties.

Some royalties are usually payable on the basis of production whereas the other type of royalties are payable on the basis of sales. The Lessee making the payment of royalty treats it as ordinary business expenditure and debits Royalty Account. Thus, Royalty Account is a nominal Account and is closed at the end of every accounting year by transferring it to the Profit and Loss Account.

### 7.3 MINIMUM RENT

Minimum Rent is the amount that is guaranteed by the Lessee to the Lessor for a particular period for usages of property whether any benefit is derived or not. It is the amount provided to the Lessor in assurance of a moderate and certain regular income. The amount of minimum rent is predefined and is disclosed usually in the Royalty Agreement signed by the Lessor and Lessee. The fixation of such rent is in the interest of the Landlord because it guarantees him the receipt of the minimum amount in case of low output or sales. Minimum Rent is also known as Dead Rent, or fixed rent or Contract Rent.

### 7.4 SHORT WORKINGS

Short working is the amount excess of minimum rent over actual royalty for a particular period. In other words, whenever minimum rent is more than the actual royalty; the difference is called short working.

**For Example :-** M/s Sood printed a book on Finance at a minimum rent of Rs. 20,000 per annum, royalty being payable @ Rs. 7.50 per copy sold and the number of copies sold in the first year is 2000 and in the second year is 4000. In this case, M/s Sood will have to pay Rs. 20,000 (i.e. minimum rent) to the authors in the first year even though the royalty worked out to be Rs. 15,000 for 2000 copies @ 7.50 per copy sold. In the second year Rs. 30,000 for 4000 copies @ 7.50 per copy sold will be paid to the authors even though minimum rent is Rs. 20,000. In this example, there is a short working of Rs. 5000, i.e. Rs. 20,000 minimum rent Rs. 15,000 actual royalty in the first year. There is no short working in the second year because actual royalty of Rs. 30,000 is more than the minimum rent of Rs. 20,000.

### 7.5 RECOUPMENT OF SHORT WORKING

The process of adjusting the short working of a certain period against the surplus of subsequent period is called "Recoupment of Short Working". Usually in the first few years of the royalty agreement, the work does not gather the required momentum because of the time taken in the preparation for starting the production or pushing up the sales. So short workings arising in the first few years may not be due to inefficiency of the lessee. The right of recoupment of short workings can be:

- (a) Restricted (i.e. fixed) to a certain period, or
- (b) Unrestricted (i.e. floating).

The question of short working or its recoupment does not arise if the royalty agreement does not contain a clause of minimum rent.

### 7.6 ACCOUNTING ENTRIES IN THE BOOKS OF THE LESSEE

(1) When Royalties are less than the minimum rent and short workings are recoverable in subsequent years.

**Entries without opening Minimum Rent Account.**

- (a) Royalties Account Dr. (With actual amount of royalties earned)  
 Short Working Account Dr. (With the difference)  
     To Landlord (with the Minimum Rent)
- (b) Landlord Dr. (With the amount of Minimum rent paid)  
     To Bank
- (c) Profit and Loss or Production Account Dr. (With the actual amount of  
     To Royalties Account royalties transferred)

The debit balance of the Short Working Account will be carried forward and shown as an asset in the Balance sheet till it is recoupable.

**Entries with opening Minimum Rent Account**

- Minimum Rent Account Dr.  
     To Land Lord  
 (Being minimum rent payable to the landlord)
- Royalties Account Dr.  
 Short Working Account Dr.  
     To Minimum Rent Account

(Being actual amount of royalties earned and excess amount payable to the landlord debited to short working account to make the payment of minimum rent)

- Landlord Account Dr.  
     To Bank Account  
 (Being the amount of minimum rent paid)

- Profit and Loss or Production Account Dr.  
     To Royalties Account  
 (Being the actual amount of royalties transferred)

(2) When Royalties exceed the minimum Rent and Short working are recouped.

- (a) Royalties Account Dr.  
     To Landlord  
 (Being the amount of royalties earned by the Landlord)
- (b) Land Lord Dr. (With actual royalties earned)  
     To Short Working A/c (With the account which can be recouped)  
     To Bank Account (With the amount paid)

- (c) Profit and Loss or  
 Production Account Dr.  
     To Royalties Account  
 (Being actual royalties earned transferred to the Profit and Loss Account)

**Entries (a) and (b) can also be shown as follows:**

- (a) Royalties Account Dr. (With actual royalties earned)  
     To Short Working Account (With the amount which can be recouped)  
     To Land Lord (With the difference)

- (b) Land Lord Account Dr.  
     To Bank Account  
 (Being amount paid to the landlord)

The debit balance (if any) in the short working account which is no longer recoupable should be written off to Profit and Loss Account:-

- Profit and Loss Account Dr.  
     To Short working Account  
 (Being Transfer of irrecoverable short working)

**Illustration:**

The Bihar Coal Company Ltd. are lessee of a mine on a royalty of 50 paise per ton of coal raised, with a dead rent of Rs. 30,000 per annum, and power to recoup short workings during the First five years of the lease.

The output for the first three years was as follows:

1st year 15,000 tons ; 2nd year 50,000 tons; 3rd year 75,000 tons.

Draft the necessary journal entries in the books of the company giving effect to the above. You are also required to write up the 'Minimum Rent Account, Royalties Account, Short workings Account, Landlord's Account and Profit and Loss Account.

**Solution:**

**ANALYTICAL TABLE**

Year	Output	Royalties@ 50 paise per ton	Short- workings	Surplus	Recoupment	Payment
	Tons	Rs	Rs	Rs	Rs	Rs
1.	15,000	7,500	22,500	-----	-----	30,000

			(30,000-7,500)			
2.	50,000	25,000	5,000 (30,000-25,000)	-----	-----	30,000
3.	75,000	37,500	-----	7,500	7,500 (37,500-30,000)	30,000

### JOURNAL ENTRIES

		Dr.	Cr.
1st Year	Minimum Rent Account ... To Landlord's Account (Being minimum rent payable to the landlord)	Dr. 30,000	30,000
	Royalties Account ... Dr. Short workings Account .. To Minimum Rent Account (Being royalties on 15,000 tons @ 50 paise per ton and Rs. 22,500 treated as short workings to make up the minimum amount of Rs. 30,000)	7,500 22,500 Dr. 30,000	30,000
	Landlord's Account ... To Bank (Being the payment of minimum rent)	Dr. 30,000	30,000
	Profit and Loss Account ... To Royalties Account (Being transfer of royalties to Profit and Loss A/c)	Dr. 7,500 30,000	7,500
2 <sup>nd</sup> Year	Minimum Rent Account ... To Landlord's Account (Being minimum rent payable to the landlord)	Dr. 25,000	30,000
	Royalties Account ...	25,000	

3 <sup>rd</sup> Year	Dr. Short working Account ... To Minimum Rent Account	Dr. 5,000	30,000
	(Being royalties on 50,000 tons @ 50 paise per ton and Rs. 5,000 treated as Short workings to make up the minimum amount of Rs. 30,000)	30,000	
	Landlord's Account.. To Bank Account (Being the payment of minimum rent)	Dr. 25,000	30,000
	Profit and Loss Account ... To Royalties Account (Being transfer of royalties to Profit and Loss A/c)	Dr. 37,500	25,000
	Royalties Account ... Dr. To Landlord's Account (Being royalties due on 75,000 tons @ 50 paise per ton)	37,500	37,500
	Landlord's Account .. To Bank Account To Short workings Account (Being the minimum rent of Rs. 30,000 paid to the landlord and Rs. 7,500 Short working recouped)	Dr. 37,500	30,000 7,500
	Profit and Loss Account ... To Royalties Account (Being transfer of royalties to Profit and Loss A/c)	Dr. 37,500	37,500

#### MINIMUM RENT ACCOUNT

		Rs			Rs
1st Year	To Landlord's A/c	30,000	1st Year	By Royalties A/c	7,500
		<u>30,000</u>		By Short workings A/c	22,500
					<u>30,000</u>

2 <sup>nd</sup> Year	To Landlord's A/c	30,000		By Royalties A/c	25,000
		<u>30,000</u>		By Short workings A/c	5,000
					<u>30,000</u>

### ROYALTIES ACCOUNT

		Rs			Rs
1 <sup>st</sup> Year	To Minimum Rent Account	<u>7,500</u>	1 <sup>st</sup> Year	By Profit and Loss A/c	<u>7,500</u>
2 <sup>nd</sup> Year	To Minimum Rent Account	<u>25,000</u>	2 <sup>nd</sup> Year	By Profit and Loss A/c	<u>25,000</u>
3 <sup>rd</sup> Year	To Landlord's A/c	<u>37,500</u>	3 <sup>rd</sup> Year	By Profit and Loss A/c	<u>37,500</u>

### SHORTWORKINGS ACCOUNT

		Rs			Rs
1 <sup>st</sup> Year	To Minimum Rent Account	<u>22,500</u>	1 <sup>st</sup> Year	By Balance c/d	<u>22,500</u>
2 <sup>nd</sup> Year	To Balance b/d	22,500	2 <sup>nd</sup> Year	By Balance c/d	<u>27,500</u>
	To Minimum Rent Account	5,000			<u>27,500</u>
		<u>27,500</u>			
3 <sup>rd</sup> Year	To balance b/d	<u>27,500</u>	3 <sup>rd</sup> Year	By Landlord's A/c	7,500
		27,500		By Balance c/d	<u>20,000</u>
		<u>27,500</u>			<u>27,500</u>
4 <sup>th</sup> Year	To Balance b/d	20,000			

Short workings can still be carried forward because period of recovery is first five years of the lease.





2. Minimum Rent is the amount that is guaranteed by the lessee to the \_\_\_\_\_ for a particular period for usages of property whether any benefit is derived or not.
3. The person who makes payment to the owner of the asset in exchange for the right to use his asset is known as\_\_\_\_\_.
4. \_\_\_\_\_ is also known as Dead Rent, or fixed rent or Contract Rent.
5. The owner of the asset to whom payment is made is known as\_\_\_\_\_.
6. Short working is the amount excess of minimum rent over \_\_\_\_\_ for a particular period.
7. The process of adjusting the short working of a certain period against the surplus of subsequent period is called “\_\_\_\_\_”.

### ILLUSTRATION

A company leased a colliery from the Swatantra Coal Ltd. on 1st January, 1981 at a minimum rent of Rs. 40,000 merging into a royalty of Re. 1 per ton with power to recoup short workings over the first three years of the lease. The output of the colliery for first four years was 18,000 tons, 32,000 tons, 48,000 tons and 38,000 tons respectively.

Pass the necessary journal entries for each of the four years in the books of Swatantra Coal Ltd.

### Solution

#### ANALYTICAL TABLE

Year	Output	Royalties@ Re.1 per ton	Short- workings	Surplus	Recoupment	Short- working not Recouped	Payment
	Tons	Rs	Rs	Rs	Rs	Rs	Rs
1981	18,000	18,000	22,000	-----	-----	-----	40,000
1982	32,000	32,000	8,000	-----	-----	-----	40,000
1983	48,000	48,000	-----	8,000	8,000	22,000	40,000
1984	38,000	38,000	2,000	-----	-----	2,000	40,000

### JOURNAL ENTRIES

	Particulars		Dr.	Cr.
<b>1981</b>	Lessee's Account ...	Dr	40,000	
Dec. 31	To Royalties Receivable Account			18,000
	To Short workings Suspense Account			22,000
	(Being the minimum amount due from lessee-royalties on 18,000 tons @ Re. 1 per ton and Rs. 22,000 treated as short workings to make up the minimum amount of Rs. 40,000)			
-----				
Dec. 31	Bank Account.	Dr.	40,000	
	To Lessee's Account			40,000
	(Being the amount of minimum rent received from Lessee)			
Dec. 31	Royalties Receivable A/c	Dr.	18,000	
	To Profit and Loss Account			18,000
	(Being the amount of royalties receivable transferred to Profit and Loss Account)			
-----				
1982	Lessee's Account ...	Dr.	40,000	
Dec. 31	To Royalties Receivable Account			32,000
	To Short working Suspense Account			8,000
	(Being the minimum amount due from lessee royalties on 32,000 tons @ Rs. 1 per ton and Rs. 8,000 treated as short working to make up the minimum amount of Rs. 40,000)			
-----				
Dec. 31	Bank Account ...	Dr.	40,000	
	To Lessee's A/c			40,000
	(Being the amount of minimum rent received from Lessee)			
-----				
Dec. 31	Royalties Receivable A/c ...	Dr.	32,000	
	To Profit and Loss A/c			32,000
	(Being the amount of royalties received transferred to Profit and Loss Account)			
-----				
	Lessee's Account ...	Dr.		

1983	To Royalties Receivable Account			
Dec. 31	(Being royalties earned @Re.1 per ton on 48,000 tons)		48,000	
	-----			48,000
Dec. 31	Bank Account ...	Dr.		
	Short workings Suspense Account.	Dr.		
	To Lessee's Account		40,000	
	(Being the amount of minimum tent received and short workings recouped)		8,000	
	-----			48,000
Dec. 31	Royalties Receivable Account ...	Dr.		
	Short-workings Suspense Account ...	Dr.		
	To Profit and Loss Account		48,000	
	(Being the transfer of royalties receivable and the balance in the Short workings Suspense A/c which is now irrecoverable)		22,000	
	-----			70,000
1984	Lessee's Account ...	Dr.		
Dec. 31	To Royalties Receivable Account			
	To Short workings Suspense Account		40,000	
	(Being minimum amount due from lessee—royalties on 38,000 tons @ Re. 1 per ton and Rs. 2,000 treated as Short workings to make up the minimum amount of Rs. 40,000)			38,000
	-----			2,000
Dec. 31	Bank A/c	Dr.		
	To Lessee's Account			
	(Being minimum amount received from lessee)		40,000	
	-----			40,000
Dec. 31	Royalties Receivable Account ...	Dr		
	Short workings Suspense Account ...	Dr		
	To Profit and Loss Account			
	(Being transfer of royalties receivable and irrecoverable Short workings to Profit and Loss Account)		38,000	
			2,000	
				40,000

**Note:** In case of sub-lease Production or Sales by the sub-lessee will be considered to be production or sales under the original lease and royalties payable to the original landlord will be calculated on the basis of total production or sales of both the lessee and the sub-lessee.

### 7.9 Summary:

Royalty is a periodical payment based on output or sale for the use of a certain assets or right. There are many types of royalties like: Mining royalties, Brick-making royalties, Oils-wells royalties, Patent royalties, Copy right royalties etc.

### 7.10 Glossary:

1. **Lessee:** The person who makes payment to the owner of the asset in exchange for the right to use his asset is known as lessee.
2. **Lessor:** The owner of the asset to whom payment is made is known as Lessor or Land Lord.
3. **Minimum Rent:** Minimum Rent is the amount that is guaranteed by the Lessee to the Lessor for a particular period for usages of property whether any benefit is derived or not. Minimum Rent is also known as Dead Rent, or fixed rent or Contract Rent.
4. **Recoupment of Short Working:** The process of adjusting the short working of a certain period against the surplus of subsequent period is called "Recoupment of Short Working."

### 7.11 Answers: Self Assessment:

1. Periodical payment
2. Lessor
3. Lessee
4. Minimum Rent
5. Lessor or Land Lord
6. Actual royalty
7. Recoupment of Short Working

### 7.12 Terminal Questions:

- (1) Write short notes on
  - (a) Minimum Rent
  - (b) Sub-Lease
  - (c) Royalties Receivable
- (2) What do you mean by royalty? Pass necessary journal entries in the books of lessee and lessor from imaginary figures.

### 7.13 Suggested Readings:

- (1) Shukla & Grewal : Advanced Accounts.
- (2) S.P. Jain & K.L. Narang : Advanced Accounting.
- (3) R.L. Gupta : Advanced Accounting.
- (4) S.N. Maheshwari : Advanced Accountancy.

**Lesson-8****INSURANCE COMPANIES ACCOUNTS****STRUCTURE**

- 8.0 Learning Objectives
- 8.1 Introduction
- 8.2 Types of Insurance
- 8.3 Books Maintained by Insurance Companies
- 8.4 Annual Accounts of Life Insurance Business
- 8.5 Determination of Profits in Life Insurance Business
- 8.6 Accounts of General Insurance Companies
- 8.7 Summary
- 8.8 Glossary
- 8.9 Answers: Self Assessment
- 8.10 Terminal Questions
- 8.11 Suggested Readings.
- 8.0 **LEARNING OBJECTIVES**

After studying the lesson, you should be able to:-

1. Understand the meaning and types of Insurance business.
2. Know the books of accounts maintained for insurance business.
3. Explain certain terms associated with insurance business.
4. Prepare final accounts of Life Insurance business.
5. Prepare final accounts of general insurance business.

**8.1 INTRODUCTION**

Today, only one business, which affects all walks of life, is insurance business. That's why insurance industry occupies a very important place among financial services operative in the world. Owing to growing complexity of life, trade and commerce, individuals as well as business firms are turning to insurance to manage various risks. The term insurance can be defined in financial as well as in legal terms. The financial definition deals with the funding or financial arrangement of the losses whereas the legal definition deals with provisions relating to legally enforceable contract. Insurance is a financial arrangement, which redistributes the costs of unexpected losses among the members of the pool. The pool is a collection of people facing common risks. All members contribute a fixed amount towards a pool called premium. In exchange for the premium payment, the person gets an assurance that a certain sum of money is to be paid to him on the happening of the event insured against. The assurance is that his loss will be made good. Thus, insurance involves the transfer of loss exposures to an insurance pool and the redistribution of losses among the members of the pool. Insurance can be defined as a contract between two parties by which one party undertakes to make good or indemnify

any financial loss suffered by other party, in consideration of a sum of money, on the happening of a specified event e.g. fire, accident or death. We call the party agreeing to pay for the losses the insurer. We call the party whose loss makes the 'insurer' pay the claim the insured. We call the payment insured pays to the insurer the premium. We call the insurance contract a policy. In the end we can sum up that insurance is a transfer of risk from the individual to the group and there is a sharing (pooling) of losses on some equitable basis such that fortuitous losses can be indemnified (paid).

The insurance has the following characteristics, which are observed in case of life, marine, fire and general insurance.

Sharing of risk - Insurance is a device to share the financial losses which might be falling on an individual or his family on the happening of a specified event. The event may be death in case of life insurance, fire in fire insurance etc. If insured the loss arising from these events will be shared by all insured in the form of premium.

- (1) Co-operative device
- (2) Value of risk
- (4) Payment at contingency
- (5) Amount of payment
- (6) Large number of insured persons
- (7) Insurance is not a gambling

## 8.2 TYPES OF INSURANCE

The insurance can be broadly divided into two types:

- (1) Life Insurance,
- (2) General Insurance,

### **Life Insurance**

Life Insurance is different from other insurance in the sense that the subject matter of insurance is life of human being. The insurer will pay the fixed amount of insurance at the death or at the expiry of certain period. At present, life insurance enjoys maximum scope because each and every person requires the insurance. This insurance provides protection to the family at the premature death or gives adequate amount at the old age when earning capacities are reduced.

### **General Insurance**

The general insurance includes property insurance, liability insurance and other forms of insurance. Fire and marine insurance comes under property insurance. Liability insurance includes motor, theft, fidelity and machine insurances to a certain extent. The strictest form of liability insurance is fidelity insurance whereby the insurer compensates the loss to the insured when he is under the liability of payment to the third party. The life insurance contract is a contingent contract and the claim becomes payable when the contingency occurs, that is, death or the completion of the stipulated period. General insurance, on the other hand, is a contract of indemnity and the claim is payable on the happening of an event insured and there must be a loss consequent to the event. The purpose of general insurance is to compensate the actual loss suffered by the insured due to the event insured and not to allow him to make any profit out of it.

### 8.3 BOOKS MAINTAINED BY INSURANCE COMPANIES

Under the Insurance Act 1938 it is obligatory on the part of all insurance companies including the general insurance companies to maintain the following books which may be called 'statutory books'

1. **The Registrar of Policies:** - This book contains the following particulars in respect of each policy issued:
  - (a) The Name and address of the policy holder.
  - (b) The date when the policy was affected.
  - (c) A record of any assignment of the policy.
2. **The Register of Claims:** This book should contain the following particulars in respect of each claim:
  - (a) The date of claim
  - (b) The name and address of the claimant
  - (c) The date on which the claim was discharged.
  - (d) In the case of a claim which is rejected, the date of rejection and the ground for rejection.
3. **The register of licensed insurance agents—**This book should contain the following particulars in respect of each agent:
  - (a) Name and address of every insurance agent appointed
  - (b) The date of appointment
  - (c) The date on which appointment ceased, if any.

In addition to the statutory books mentioned above, insurance companies also maintain the following subsidiary books for recording the transactions:

- (i) Proposal register
- (ii) New premium cash book
- (iii) Renewal premium cash book
- (iv) Agency and branch cash book.
- (v) Petty cash book
- (vi) Claims cash book
- (vii) General cash book
- (viii) Agency credit journal
- (ix) Agency debit journal
- (x) Lapsed and cancelled policies book
- (xi) Chief journal
- (xii) Commission book
- (xiii) Agency ledger
- (xiv) Policy loan ledger

(xv) General loan ledger

(xvi) Investment ledger

#### 8.4 ANNUAL ACCOUNTS OF INSURANCE BUSINESS

Annual accounts of a Life Insurance business are completed by preparing a Revenue Account and a Balance Sheet.

##### Revenue Account

The Revenue Account of a life insurance business is prepared in accordance with Form D of the Insurance Act, 1938, a specimen of which is given below:

#### FORM D

##### Form of Revenue Account Applicable to Life Insurance Business

##### Revenue Account of for the year ended 19... in respect of Life Insurance Business

	<i>Business within India</i>	<i>Business out of India</i>	<i>Total</i>		<i>Business within India</i>	<i>Business out of India</i>	<i>Total</i>
1	2	3	4	5	6	7	8
1. Claims under policies (including provision for claims due or intimated) <b>Less:</b> Re-insurances: By death By maturity 2. Annuities less reinsurance. 3. Surrenders including surrenders of bonus less reinsurances. 4. Bonuses in cash less reinsurances. 5. Bonuses in reduction of	<i>Rs</i>	<i>Rs</i>	<i>Rs</i>	1. Balance of Life Assurance Fund at the beginning of the year. 2. Premium less reinsurances. First year's premium. Renewal of premiums. Single premiums. 3. Consideration for annuities granted less reinsurances. 4. Interest, dividends and rent. <b>Less:</b> Income tax thereon. 5. Registration fees. 6. Other income to	<i>Rs</i>	<i>Rs</i>	<i>Rs</i>

<p>premiums, less reinsurances</p> <p>6. Expenses of Management</p> <p>(i) (a) Commission to Insurance agent less that on reinsurances.</p> <p>(b) Allowances and commission other than c o m m i s s i o n included in subitem (a) preceding</p> <p>(ii) Salaries, etc., other than to agents and those contained in item No.</p> <p>(iii) T r a v e l i n g expenses</p> <p>(iv) Directors' fees</p> <p>(v) Auditors' fee</p> <p>(vi) Medical fees</p> <p>(vii) Legal charges</p> <p>(viii) Advertisements</p> <p>(ix) Printing and Stationery</p> <p>(x) Other expenses of M a n a g e m e n t (accounts to be specified)</p> <p>(xi) Rents for offices belonging to and</p>				<p>be specified.</p>			
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occupied by the insurer. (xiii) Rents of other offices occupied by the insurer) 7. Bad Debits 8. Taxes. 9. Other expenditure to be specified. 10. Balance of Life Assurance Fund at the end of the year.							
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### Credit Side Items

1. **Life Assurance Fund:** This is the opening balance available in the Life Assurance Fund carried forward from the previous year and the same is shown on the credit side of the Revenue Account.
2. **Premium:** Premium includes the premium received or yet to be received for the relevant year less any minimum paid or to be paid on reinsurance plus the bonus in reduction of premium.
3. **Considerations for annuities granted:** Any lump sum payment received in lieu of granting will be shown as income in the credit side of the revenue Account.
4. **Interest, dividend and rent:** If there is any income by way of interest, dividend or rent of the insurance company, the net income (after deduction of tax) will be shown on the outer column of the credit side of the revenue Account. Any accrued and outstanding interest, dividend, etc., is also taken into account.
5. **Registration fees:** This is an income to the insurance company and the same is shown on the Revenue Account.
6. **Other incomes:** Any other income other than the incomes mentioned above will be appearing under this category.

### Debit Side Items

1. **Claims:** Any amount payable by the insurance company to the insured, or his nominee, on the policy is called a claim. The claim in life insurance business may arise due to two factors — by death or on maturity of the policy. While calculating the liability for claims, claims accepted and claims intimated but accepted will be taken into account and from which any reinsurance recoveries will be deducted.

2. **Annuity:** This is an annual payment which a life insurance company agrees to pay to the insured till his death for a lump sum received in the beginning. Annuity is considered as an expense and shown on the debit side of the Revenue Account.
3. **Surrender value:** If the insured is unable to pay further premiums, he can discontinue the payment and on the date of his discontinuation, the cash value of the policy, known as the surrender value, is ascertained and the same is paid to the insured if he opts for it and is debited to the Revenue Account.
4. **Bonus in cash:** The insurance company may pay the bonus in cash for the holder of a 'with profit policy.' The bonus paid in cash will be shown on the debit side of the Revenue Account.
5. **Bonus paid in reduction of premiums:** The insurance company may deduct the bonus payable from the premium amount due from the insured instead of paying the bonus in cash. This is known as bonus paid in reduction of premium. The item will appear on both the sides of the Revenue Account as expenditure (debit side) and on the credit side it will be added to the premium to find out the net premium.
6. **Expenses of management:** The expenses covered under this head will include administration establishment charges, etc., and will be shown on the debit side of the Revenue Account separately or in the form of an attached schedule or working note.
7. **Bad debts, taxes and other expenditure:** Expenses classified under these heads are shown separately on the debit side of the Revenue Account.
8. **Life Assurance Fund:** This is the excess of the items 1 to 6 on the credit side of the Revenue Account over items 1 to 9 of the debit side of the Revenue Account. It is the closing balance in the Life Assurance Fund.

## Balance Sheet

The Balance Sheets of all types of insurance business are to be prepared in accordance with Form A, a specimen of which is given below :

**FORM A**  
**Form of Balance Sheet**  
**Balance Sheet... 19...**

<i>Liabilities</i> 1	<i>Rs.</i> 2	<i>Assets</i> 3	<i>Rs.</i> 4
<b>1. Shareholders capital (with details)</b> <b>2. Reserve or Contingency A/cs</b> (i) Investment Reserve Account (ii) Profit and Loss Appropriation A/c		<b>1 . Loans:</b> (i) On mortgages of property (ii) On security of municipal and other public rates (iii) On stocks and shares	

<p><b>3. Balances of Funds and Accounts</b></p> <p>(i) Life Insurance Funds —  (a) Business in India  (6) Business outside India</p> <p>(ii) Fire Insurance Business Account</p> <p>(iii) Marine Insurance Business A/c</p> <p>(iv) Miscellaneous Insurance Business Account</p> <p>(v) Other accounts, if any to be specified</p> <p>(vi) Pension or Superannuation A/c</p> <p>(vii) Debentures stock</p> <p><b>4. Loans and advances</b></p> <p>(i) Bills payable</p> <p>(ii) Estimated liability in respect of outstanding claims whether due or intimated</p> <p>(iii) Annuities due and unpaid</p> <p>(iv) Outstanding dividends</p> <p>(v) Amounts due to other persons or bodies carrying on insurance business</p> <p>(vi) Sundry creditors including outstanding expenses &amp; taxes</p> <p>(vii) Other liabilities</p> <p>(viii) Contingent liabilities (to be specified)</p>	<p>(iv) On insurer's policies within their surrender value</p> <p>(v) On personal security</p> <p>(vi) To subsidiary companies</p> <p>(vii) Reversions and life interest purchased</p> <p><b>2. Investments</b></p> <p>(i) Deposit with the Reserve Bank of India</p> <p>(ii) Government securities</p> <p>(iii) Municipal securities</p> <p>(iv) Bonds, debentures, stocks and other securities whereon interest is guaranteed by the Govt.</p> <p>(v) Railway securities</p> <p>(vi) Securities of incorporated companies</p> <p>(vii) Holdings in subsidiary companies</p> <p>(viii) House property</p> <p>(ix) Freehold and leasehold ground rents and rent charges</p> <p>3. Agent's balances</p> <p>4. Outstanding premiums</p> <p>5. Interest, dividends and rents outstanding</p> <p>6. Interest, dividends and rates accounting but not due</p> <p>7. Amounts due from other persons or bodies carrying on insurance business</p> <p>8. Sundry debtors</p>	
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		9. Bills receivable	
		10. Cash	
		(i) At bankers on Deposit A/c	
		(ii) At bankers on Current A/c	
		and in hand	
		(iii) At call and short notice	
		11. Other accounts (to be specified)	
	<b>Total</b>		<b>Total</b>

### ILLUSTRATION

A life insurance company disclosed a fund of Rs. 20,00,000 and the Balance Sheet total Rs. 45,00,000 on 31<sup>st</sup> December, 1989 before taking the following into consideration :

(a) A claim of Rs. 10,000 was intimated and admitted but not paid during the year; (b) A claim of Rs. 6,000 outstanding in the books for 8 years is written back ; (c) Interest on securities accrued Rs. 800, but not received during the year, (d) Rent of the own building occupied Rs. 2,000 ; (e) Premium of Rs. 600 is payable under reinsurance ; (f) Reinsurance recoveries Rs. 26,000; (g) Bonus utilized in reduction of premium Rs. 10,000, and (h) Agent's commission to be paid Rs. 8,000.

Pass the necessary journal entries for the above omission, recomputed the fund and show the Balance Sheet total after making the above adjustments.

### SOLUTION

#### JOURNAL ENTRIES

		Rs	Rs
(a)	Claims A/c <span style="float: right;">Dr.</span>	10,000	
	To Outstanding Claims A/c		10,000
	(Being the adjustment in respect of claims intimated and admitted, but not paid during the year)		
		6,000	
(b)	Outstanding Claims A/c <span style="float: right;">Dr.</span>		6,000
	To Claims A/c		
	(Being claims outstanding written back)	800	
(c)	Accrued Interest A/c <span style="float: right;">Dr</span>		800

	To Interest A/c (Being the interest on securities brought into account)		
		2,000	
(d)	Rent A/c Dr.		2,000
	To Rent of the Own Building A/c (Being rent of the own building occupied)	600	
(e)			600
	Premium (Reinsurance) A/c Dr.		
	To Outstanding Premium A/c (Being premium payable under re-insurance)	26,000	
(f)			26,000
	Outstanding Debtors A/c Dr.		
	To Claims A/c 26,000 (Being claims receivable under re-insurance)	10,000	
(g)			10,000
	Bonus in Reduction of Premium A/c Dr.		
	To Premium A/c (Being bonus utilized in reduction of premium)	8,000	
(h)			8,000
	Commission A/c Dr.		
	To Outstanding Commission A/c (Being commission due to agent not yet paid)		

### STATEMENT SHOWING THE RECOMPUTATION OF FUND

	Rs	Rs
Fund shown by Insurance Revenue A/c		20,00,000
<b>Add:</b> Interest accrued on securities	800	
Claims Outstanding 6,000	6,000	
Re-insurance recoveries 26,000	26,000	
Rent of the own building	2,000	
	<u>34,800</u>	
<b>Less :</b> Premium payable under re-insurance	600	
	<u>600</u>	
		<u>34,200</u>
		20,34,200

<b>Less :</b> Claims intimated but not admitted		
Agents Commission	10,000	
Rent of the own building	8,000	
	2,000	
		20,000
Correct fund on 31-12-1989		20,14,200

### 8.5 DETERMINATION OF PROFIT IN LIFE INSURANCE BUSINESS.

A life policy is generally taken for a number of years. The premium received for such long term contracts cannot be treated as income for ascertaining the profit for that year. For example, under a contract of annuity only one premium as initial payment is received whereas the annuitant is required to be paid annuity till he dies. In case of life insurance, the claim must arise either on death or on expiry of the period of the policy. That the future premium may or may not be received depends on the existence of the insured. Thus on a particular date a liability of the corporation is to be calculated as the premiums to be received in future will generally be less than the amount payable as claims. There is a gap between claims which are expected to arise and premiums which are expected to be received. This gap is known as net liability. Thus it becomes desirable to create a reserve equal to its net liability in order to ascertain the profit made by the corporation. The Life Insurance Corporation of India makes the valuation of its liability every alternate year in order to ascertain its profit. This is done by 'a person known as actuary i.e. mathematician well versed in the intricacies of life insurance. The process by which net - liability is ascertained by an actuary, is known as actuarial valuation. This is; necessary to determine the profit in case of life insurance business.

#### PROCEDURE FOR ASCERTAINING PROFIT OR LOSS

Net liability is compared with life assurance fund on a particular date in order to calculate the surplus or deficiency. This comparison is made by preparing a Valuation Balance Sheet, a specimen form of which is given as follows:

#### VALUATION BALANCE SHEET

**As on .....19.....**

	Rs		Rs
To Net liability as per actuary's valuation		By life Assurance Fund as per Balance Sheet	
To Surplus		By Deficiency	

Only surplus (and not deficiency) will be shown in the Balance Sheet. With profit policyholders have a. Right to participate in the profits of the insurance business to the extent of 95% of true profit. For calculation of true profit, surplus as disclosed by Valuation Balance Sheet must be adjusted by:

- (i) Adding interim bonus (if any) as it is really advance payment of bonus,
- (ii) Deducting any expenses still to be incurred.

Out of 95% of true profit, interim bonus already paid should be deducted, to calculate the amount due to the policyholders.

## 8.6 Accounts of General Insurance Companies

Given below are the points to be kept in mind while preparing the final accounts of general insurance companies:

1. **General insurance companies may be doing more than one business** — fire, marine, accident, consequential loss, etc. For each category of business, a separate Revenue Account is to be prepared in the prescribed Form F.
2. **Reinsurance:** Reinsurance means transfer of the part of the risk by the insurer to another insurer.

Suppose a ship has been insured for Rs. 10,00,000 by an insurer. If he feels that the risk is too heavy to be borne by him individually, he can transfer a part of this risk to another insurer. This is known as *Reinsurance Ceded* for the first insurer and *Reinsurance Accepted* for the reinsure. In such a case, the original insurer gives a proportionate share of the premium collected by him to the second insurer and this premium on reinsurance ceded is deducted from the premium income of the original insurer to find out his net premium. The premium on reinsurance accepted is an income for the reinsure and is added to his premium on direct business to find out his net premium. Commission received on reinsurance ceded will be income for the first insurer and is credited in the Revenue Account. Any Commission on reinsurance accepted will be an expenditure and is debited to the Revenue Account.

3. **Bonus in Reduction of Premium:** General Insurance Companies allow a rebate on the premium payable by the insured while renewing the policy related to a particular asset in the subsequent year. This rebate is known as 'No claim Bonus' or 'Bonus in reduction of premium.' Bonus in Reduction of Premium is treated as expenditure and is transferred to the side of the concerned revenue account.
4. **Reserve for unexpired risk:** In general insurance whole premium for the period collected in advance at the time of contracting the agreement. Claims may arise on any day during the life time of the policy. Hence at the end of every accounting year there will be a number of policies for which no claim might have been received but these policies may be valid during the next accounting year also. In such cases, a provision has to be made for the unexpired portion of the risk in the policies by debiting the Revenue Account and crediting the Provision for Unexpired Risk Account at the end of the current year. The provision for unexpired risk at the end is shown in the Balance Sheet and closed and transferred to the Revenue Account in the beginning of the next year.

The executive committee of the General Insurance Council has stipulated that the provision for unexpired risk should be 100% of the net premium in the case of marine insurance and 50% of the net premium in the case of other businesses.

Besides the usual provision for the unexpired risk, the company can have an additional reserve for the unexpired risk if it so desires. The accounting treatment is the same as adopted for the usual provision.

### Accounting treatment of provision for unexpired risks

- (a) In the first instance if provision for unexpired risk is given as adjustment — it will appear on the debit side of the revenue account and be shown on the liability side of the Balance Sheet.
  - (b) In the subsequent period it appears in the Trial Balance and is given as adjustment. The amount appearing in the trial balance (opening balance) is transferred to the credit side of the Revenue Account and the provision given in the adjustment will be treated as shown in (a).
5. A combined Profit and Loss Account and the Profit and Loss Appropriation Account is prepared at the end of the period in the prescribed forms B and C respectively.
  6. A combined Balance Sheet is prepared for all categories of business put together in accordance with Form A given.
  7. Commission on policies effected through insurance agents cannot exceed 5% of the premium in respect of fire and marine policies and 10% in case of miscellaneous businesses. In case of policies effected through a principal agent, the maximum limits are 20% for fire and marine policies and 15% in case of miscellaneous insurance, less any commission payable to an agent in respect of the policy concerned.

### FORM F

Form of Revenue Account applicable to fire insurance business, marine insurance business and miscellaneous insurance business

Revenue Account... for the year ended 19 ... in respect of... business.

	Rs		Rs
Claims under policies less reinsurance paid during the year (a)		Balance of Account at the beginning of the year;	
Total estimated liability in respect of outstanding claims at the end of the year, whether due or intimated (d)		Reserve for unexpired risks.	
Total.		Additional Reserve, if any	
<b>Less:</b> Outstanding at the end of previous year (b)		* Premiums less reinsurance (d)	
<b>Commission :-</b>		Interest dividends and rents	
Commission on direct business		<b>Less:</b> Income tax thereon	
		Commission on reinsurances ceded	
		* Other incomes to be specified (e)	
		Loss Transferred to Profit and Loss Account	

<p>Commission on reinsurance accepted</p> <p>*Expenses of management (c) Bad debts</p> <p>*United Kingdom, Indian Dominion and Foreign taxes</p> <p>*Other expenditure (to be specified)</p> <p>Profit transferred to Profit and Loss Account</p> <p>Balance of Account at the end of year as shown in the Balance Sheet</p> <p>Reserve for unexpired risks being.. . per cent of premium income of the year</p> <p>Additional reserve, if any</p> <p style="text-align: right;"><b>Total</b></p>	<p>_____</p> <p>_____</p>	<p>Transferred from Appropriation Account</p> <p style="text-align: right;"><b>Total</b></p>	<p>_____</p> <p>_____</p>
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**Notes:**

- (a) This heading must include all expenses directly incurred in settling claims.
- (b) If in any year the claims actually paid and those still unpaid at the end of that year in respect of the previous year or years are in excess of the amount included in the previous year's Revenue Account as provision for outstanding claims, the amount of such excess must be shown in the Revenue Account.
- (c) If any sum has been deducted from this item and entered on the assets side of the Balance Sheet, the amount deducted must be shown separately.
- (d) Where the accounts furnished under the provisions of the Section II of the insurance Act, 1938, separate figures for claims paid to claimants in India and claimants outside India and for premiums derived from business effected outside India must be given.
- (e) All the amount received by insurer directly or indirectly, whether from the head office or from any other source outside India shall also be shown separately in the Revenue Account except such sums as properly ascertained to the Capital Account.

Where the account is furnished under the provision of Clause (b) of Sub-section (2) of Section 16 of the Insurance Act, 1938, by an insurer to whom that section applies, separate figures for business within India and business outside India must be given against the items marked with asterisk Against all other items the total amount for the business as a whole may be given.

### FORM B

#### Form of Profit and Loss Account

#### Profit and Loss Account of.. for the year ended 19...

	Rs		Rs
Indian central taxes on the insurer's profit not applicable to any particular fund or account.		Interest, dividend and rent not applicable to any particular fund or account.	
Expenses of management not applicable to any particular fund or account.		<b>Less:</b> Income tax thereon	
Loss on realization of investment not charged to reserves or any particular fund or account.		Profit on realization of investment not credited to reserves or any particular fund or account.	
Depreciation of investments not charged to reserves or any particular fund or account.		Appreciation of investment not credited to reserves or any particular fund or account.	
Loss transferred from Revenue Account (details to be given).		Profit transferred from Reserves Account (details to be given).	
Other expenditure (to be specified).		Transfer fees.	
Balance for the year carried to Appropriation Account.		Other incomes to be specified.	
		Balance being loss for the year carried to Appropriation Account.	
<b>Total</b>	_____	<b>Total</b>	_____

### FORM C

#### Profit and Loss Appropriation

#### Account for the year ended 19 ...

	Rs		Rs
Balance being loss brought forward		Balance brought forward from last	

<p>from last year.</p> <p>Balance being loss for the year brought from Profit and Loss Account as in Form B.</p> <p>Dividends paid during the year on account of the current year (to be specified and if free of tax to be so stated).</p> <p>Transfer to any particular funds for account (details to be given).</p> <p>Balance at end of the year as shown in the Balance Sheet.</p> <p><b>Total</b></p>	<hr/>	<p>year Rs...</p> <p><b>Less:</b> Dividends since paid in respect of last year (to be specified and if free of tax to be so stated)</p> <p>Balance for the year brought from Profit and Loss Account as in Form B.</p> <p>Balance being loss at end of the year as shown in the Balance Sheet.</p> <p><b>Total</b></p>	<hr/>
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**Self Assessment:**

**Fill in the blanks:**

1. Insurance is a transfer of \_\_\_\_\_ from the individual to the group and there is a sharing (pooling) of losses on some equitable basis such that fortuitous losses can be indemnified (paid).
2. The life insurance contract is a \_\_\_\_\_ and the claim becomes payable when the contingency occurs, that is, death or the completion of the stipulated period.
3. General insurance, on the other hand, is a \_\_\_\_\_ and the claim is payable on the happening of an event insured and there must be a loss consequent to the event.
4. A \_\_\_\_\_ is a sum paid to the life office to assure the benefit specified by the policy.
5. Pension policies involve paying \_\_\_\_\_ or single premiums to create a stream of income (starting at retirement), usually also with the option of paying a capital sum.
6. The amount of \_\_\_\_\_ that is paid to the policyholder depends the type of policy written, and in particular whether it is without or with profit.
7. Commissions are paid to brokers or \_\_\_\_\_ ('intermediaries') as an incentive to sell policies and maintain and expand the life company's business.
8. There are two types of commission: \_\_\_\_\_ commission on new policies and \_\_\_\_\_ commissions for subsequent periods
9. The asset for the \_\_\_\_\_ would be written off to the technical account over an appropriate period.

10. \_\_\_\_\_ means transfer of the part of the risk by the insurer to another insurer.

### Illustration

The following is the Trial Balance of the Zenith Insurance Co. Ltd. as on March 31, 1998

	Debit Rs	Credit Rs
<b>Expenses of Management:</b>		
Fire	38,600	
Marine	17,200	
<b>Claims paid:</b>		
Fire	56,000	
Marine	53,700	
<b>Commission:</b>		
Fire	34,800	
Marine	24,700	
Income tax on interest	2,900	
Directors' fees and travelling expenses	5,800	
Depreciation on furniture	400	
Contribution to Staff Provident Fund	1,500	
Securities deposited with Reserve Bank of India	12,59,100	
Cooperative land mortgage bank debentures	2,93,500	
Interest accrued	3,600	
State Government loans	1,52,000	
National Savings Certificates	90,000	
Shares in companies	40,000	
<b>Premium outstanding:</b>		
Fire	70,400	
Marine	59,600	
Sundry debtors	19,300	
Fixed deposit (staff security)	7,200	
Fixed deposit (Employees Provident Fund Investments)	7,000	
Cash and bank balances	65,400	
Furniture less depreciation	3,200	
Library books	1,000	

<b>Reserve for unexpired risks:</b>		
Marine		1,22,000
Fire		65,100
<b>Premiums less reinsurance:</b>		
Fire		1,65,300
Marine		1,11,800
<b>Additional Reserves:</b>		
Fire		71,400
Marine		7,501
<b>Claims outstanding at the commencement :</b>		
Fire		1,900
Marine		100
Interest on investments		25,700
Miscellaneous receipt		100
Share Capital — 1,40,000 shares of Rs. 10 each		14,00,000
General reserve		1,27,800
Staff Security Deposit		7,200
Staff Provident Fund		7,000
Sundry creditors		1,60,000
Contingency Reserve		20,000
Investment fluctuation reserve		14,000
	<b>23,06,900</b>	<b>23,06,900</b>

- (1) Estimated Liability in respect of claims outstanding at the close of the year was as follows :  
Fire Rs. 2,600, Marine Rs. 9,400.
- (2) You are requested to make the following provisions :
  - (a) Rs. 10,000 for survey expenses for marine insurance claims.
  - (b) Rs. 20,000 for provisions for taxation.
- (3) Provide in case of fire insurance for additional reserve for unexpired risks at 10% of the net premium in addition to the opening balance.
- (4) In respect of fire insurance, a reinsurance premium paid Rs. 30,000 a claim of Rs. 10,000 covered by reinsurance, and commission at 5% on reinsurance ceded; have still to be accounted for.

- (5) Market value of the investment Rs. 18,25,500.
- (6) Reserve for unexpired risks should be 50% of the premiums less reinsurances in the case of fire insurance and 100% of the premiums less reinsurances in marine insurance.

Prepare the Revenue Accounts and Profit and Loss Account for the year ended March 31, 1998 and the Balance Sheet as on that date.

**Solution:**

**Zenith Insurance Company**

**Fire Insurance Revenue Account for the year ended March 31, 1998**

	Rs		Rs
Claim under policies less reinsurance, paid during the year		Balance of the account at the beginning of the year:	
46,000		Reserve for unexpired risk	65,100
Estimated liability for claims outstanding at the end of the year whether due or intimated	2,600	Additional reserve	71,400
	_____		1,36,500
48,600		Premium less reinsurance (1,65,300 - 30,000)	1,35,300
outstanding claims at the commencement of the year	46,700	Commission on reinsurance ceded	1,500
1,900			
	34,800		
	38,600		
Commission on direct business and on reinsurance accepted	620		
Expenses of management			
Profit transferred to Profit and Loss A/c			
Balance of the Account at the end of the year as shown in the Balance Sheet:	1,52,580		
Reserve for unexpired risks			
67,650	_____		_____
	2,73,300		2,73,300

Additional reserve (71,400+13430)      84,930			
_____			

**Marine Insurance Revenue Account for the year ended March 31, 1998**

	Rs		Rs
Claims under policies less reinsurance, paid during the year		Balance of the account at the beginning of the year	
53,700		Reserve for unexpired risk	1,22,000
Estimated liability in respect of outstanding claims at the end of the year whether due or intimated	9,400	Additional reserve	7,500
_____			1,29,500
63,100		Premium less reinsurance	1,11,800
<b>Less:</b> Outstanding at commencement of the year	63,000		
100	10,000		
_____			
Provision for survey expenses	24,700		
Commission on direct business and on reinsurance accepted	17,200		
Expenses of management	7,100		
Profit transferred to P & L A/c			
Balance of the Account at the end of the year as shown in	1,19,300		
<b>Balance Sheet:</b>			
Reserve for unexpired risk	<u>2,41,300</u>		<u>2,41,300</u>
1,1,800			

Additional reserve	7,500		
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**Profit and Loss Account for the year ending March 31, 1998**

Provision for taxation	20,000	Interest, dividends and rent not applicable to any particular fund or account, less tax (25,700-2,900)	22,800
Directors fees and travelling expenses	5,800	Profit from fire insurance 620	7,720
Contribution to Staff Provident Fund	1,500	Profit from marine insurance 7,100	100
Depreciation on furniture	400	Misc. Receipts	
Balance being profit carried to Balance Sheet	2,920		
	<u>30,620</u>		<u>30,620</u>

**Balance Sheet of Zenith Insurance Company as on March 31,1998**

	Rs		Rs
Share Capital:		Loans	Nil
Authorized: Shares of Rs. 10 each Issued, Subscribed & called-up: 1,40,000 shares of Rs. 10 each	14,00,000	Investments (at cost: Market value Rs. 18,025,000)	
Reserve & contingency accounts:		Deposit with Reserve	
General reserve	1,27,800	Bank of India 12,59,100	
Investment fluctuation fund	14,000	National Savings Certificates 90,000	
Contingency reserve	20,000	State Government Securities 1,52,000	
Profit & Loss A/c	2,920	Co-op, land mortgage bank debentures	
	<u>1,64,720</u>	2,93,500	
Balance of Funds & Accounts:		Shares of joint stock companies	18,34,600
Fire insurance	1,52,580	40,000	nil
		Agents' balances	

Marine insurance 1,19,300	2,71,880	Outstanding premiums:	1,30,000
-----		Fire	
Current and other liabilities:		70,400	
Staff Security Deposit      7,200		Marine	59,600
Staff Provident Fund      7,000		-----	
Due to other insurers 30,000		Interest, rent A dividends accruing but not due	
Estimated liability in respect of outstanding claims whether due or intimated:		3,600	
Fire      2,600		Amount due from other insurers      (10,000 + 1,500)	
Marine <u>9,400</u> 12,000		11,500	
Sundry creditors 1,60,000	2,46,200	Sundry debtors 19,300	1,14,000
Outstanding		Fixed deposits:	
Survey expenses 10,000		Staff Securities      7,200	
Provision for taxation <u>20,000</u>		Provident Fund	4,200
	<u>20,82,800</u>	Investments <u>7,000</u>	
		14,200	
		Cash and Bank	
		balance	
		<u>65,400</u>	<u>20,82,800</u>
		Other accounts:	
		Furniture less	
		Depreciation	
		3,200	
		Library books	<u>1,000</u>

### 8.7 Summary:

Insurance industry occupies a very important place among financial services operative in the world. Owing to growing complexity of life, trade and commerce, individuals as well as business firms are turning to insurance to manage various risks. At present, life insurance enjoys maximum scope because each and every person requires the insurance. General insurance is a contract of indemnity and the claim is payable on the happening of an event insured and there must be a loss consequent to the event. The purpose of general insurance is to compensate the actual loss suffered by the insured due to the event insured and not to allow him to make any profit out of it.

**8.8 Glossary:**

1. **Reinsurance:** Reinsurance means transfer of the part of the risk by the insurer to another insurer.
2. **Bonus paid in reduction of premiums:** The insurance company may deduct the bonus payable from the premium amount due from the insured instead of paying the bonus in cash. This rebate is known as 'No claim Bonus' or 'Bonus in reduction of premium.'
3. **Commission:** Commissions are paid to brokers or agents ('intermediaries') as an incentive to sell policies and maintain and expand the life company's business.
4. **Premium:** A premium is a sum paid to the life office to assure the benefit specified by the policy.
5. **Annuity:** An annuity policy provides for payments to be made at regular intervals, starting at a specified date, and usually continuing until the death of the policyholder.

**8.9 Answers: self assessment**

1. Risk
2. Contingent contract
3. Contract of indemnity
4. Premium
5. Regular
6. Claim
7. Agents
8. Initial; renewal
9. Commission
10. Reinsurance

**8.10 Terminal Questions:**

1. Point out the difference between Life Insurance and General Insurance.
2. What statutory books are required to be maintained by Insurance Companies?
3. What important points should be kept in mind in preparing the final accounts of general Insurance Companies?

**8.11 SUGGESTED READINGS**

M.A. Arulanandam, K.S. Raman, Advanced Accountancy, Himalaya Publishing House, Mumbai.  
 S.P. Jain & K.L. Narang Advanced Accountancy, Kalyani Publishers, New Delhi.  
 R.L. Gupta Advanced Accountancy, Sultan Chand & Sons.

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## ASSIGNMENTS

**Note:** Attempt any four Assignments from the following. Assignments are compulsory.

1. What do you mean by forfeiture of shares? How are shares forfeited? Pass journal entries regarding forfeiture and reissue of shares.
2. What is a debenture and its redemption? Describe various methods of redemption of debentures.
3. Give Vertical form of Balance sheet with imaginary figures and explain main item therein.
4. How is a consolidated Balance Sheet prepared? Explain.
5. Define Insurance. What statutory books are maintained by insurance companies?
6. Define Amalgamation, Absorption and Reconstruction. What are the different methods of Purchase consideration?
7. Point out the difference between Life Insurance and General Insurance. What statutory books are required to be maintained by Insurance Companies?
8. What do you mean by royalty? Pass necessary journal entries in the books of lessee and lessor from imaginary figures.