Directorate of Distance Education

UNIVERSITY OF JAMMU
JAMMU

SELF LEARNING MATERIAL

OF

ADVANCED ACCOUNTING

For the Examination to be held in 2019 onwards

COURSE NO : M. COM - C 211	**UNIT : I - IV**
M. COM - II SEMESTER	**LESSON NO. : 1 - 20**

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ADVANCED ACCOUNTING (M. COM)

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UNIVERSITY OF JAMMU
M.COM. SECOND SEMESTER
ADVANCED ACCOUNTING

Course No : M.Com-C 211 | **Maximum Marks: 100**
Time : 3 Hours | **External : 80**
Internal : 20

Syllabus for the examinations to be held in May 2020 onwards.

OBJECTIVE : To provide students with an insight into accounting for human resource, consolidation of financial statements, accounting for changes in financial position and reasons for mergers and acquisitions.

UNIT–I : FINANCING FOR EXPANSION (MERGERS AND ACQUISITIONS) **PAGE NO. 7-91**

Meaning and forms of expansion; Forms of combination ; Economics/Reasons of merger, Types of mergers; Legal and procedural aspects of mergers; Valuation of firms; Forms of financing a merger; Capital structure after merger and consolidations; Financial problems of merger and consolidations; Mergers in India; Accounting for amalgamations AS-14; SEBI (Substantial acquisition of shares and takeovers) Regulations, 1997; Computation of share exchange ratio, Pre-merger EPS and Post-merger EPS.

UNIT-II : ACCOUNTS OF GOVERNMENT COMPANIES AND STATUTORY CORPORATIONS **92-189**

Accounts of government companies; Preparation and presentation of the final accounts; Forms and contents of statement of profit and loss account; Forms and contents of statement of balance sheet; Accounts of statutory corporations; Specimen of directions issued by the Comptroller and Auditor-General-System of accounts and book-keeping, internal control, manufacturing and production accounts, statement of profit and loss account and balance sheet.

UNIT-III : CONSOLIDATED FINANCIAL STATEMENTS **190-274**

Meaning, objectives, merits and demerits of Holding Companies; Rationale for Holding Companies; Advanced treatment of dividends, bonus shares, fictitions assets, unrealized profit, contingent liabilities and revaluation of assets; Treatment of goodwill already appearing in the books of Subsidiary Companies; Elimination of common transactions; Holding Companies having more than one subsidiary; Sale and purchase of shares in subsidiary company; Preparation of consolidated balance sheet.

UNIT-IV : VALUATION OF RATE OF RETURN ON CAPITAL EMPLOYED AND LEASE EVALUATION **275-340**

Meaning of return on capital employed; Valuation of return on capital employed by net assets approach and liabilities approach method; Computation of profit for return on capital employed; Precautions to be taken while using return on capital employed; Significance of return on capital employed; Limitations of return on capital employed; Lease evaluation-meaning of leasing and types of leasing arrangements; Difference between financial lease and operating lease; Financial evaluation of lease from the point of view of lessee and lessor.

BOOKS RECOMMENDED

1. Accounting Standards by D.S. Rawat, IV Edition, Taxman Publication.
2. Corporate Accounting by S.N. Maheshwari and SK Maheshwari 4th edition, Vikas Publishing House.
3. Higher Accounting by S.P. Jain & K.L. Narang, Kalyani Publishers.
4. Advanced Accounting by Ashok Sehgal and Deepak Sehgal, Taxman Publications.
5. Advanced Accounts by R.L. Gupta, Sultan Chand & Sons, New Delhi.
6. Advanced Accounts by Shukla, Grewal & Gupta S. Chand Publishers.
7. Introduction to Financial Accounting by Horngren, Sundens, Elliot, Pearson Education Publishers.
8. Financial Accounting by PC Tulsian, Tata McGraw Hill Publications.
9. Fundamentals of Financial Accounting by Welsch and Anthony, Richard D Irwin Inc.

NOTE FOR PAPER SETTING

The paper consists of two sections. Each section will cover the whole of the syllabus without repeating the question in the entire paper.

Section A : It will consist of eight short answer questions, selecting two from each unit. A candidate has to attempt any six. Answer to each question shall be within 200 words. Each question carries four marks and total weightage to this section shall be 24 marks.

Section B : It will consist of six essay type questions with answer to each question within 800 words. One question atleast shall be from each unit and the candidate has to attempt any four. Each question will carry 14 marks and total weightage shall be 56 marks.

MODEL QUESTION PAPER

ADVANCED ACCOUNTING

Time : 3 Hours **M. Marks : 80**

SECTION - A

Attempt any six questions. Each question carries four marks. Answer to each question should be within 200 words.

1. How redemption of preference shares can be made ?
2. Discuss the procedure for the redemption of debenture.
3. What do you mean by cross-holding ?
4. Differentiate between fund flow statement and income statement.
5. State the objectives of fund flow statement.
6. Discuss in brief the merits and demerits of holding company.
7. Discuss the financial problems of mergers and consolidations.
8. Discuss in brief the forms of financing mergers.

SECTION - B

Attempt any four questions. Each question carries 14 marks. Answer to each question should be within 800 words.

1. The King Kong Ltd.'s Balance sheet shows the following balance on 31-3-12. 30,000 equity shares of Rs. 10 each fully paid; 18,000 10% Redeemable Preference shares of Rs. 10 each fully paid; 4000, 15% Redeemable Preference shares of Rs. 10 each, Rs. 8 paid up. General Reserve Rs. 12,000; Securities Premium Rs. 15,000; Profit Loss Account Rs. 80,000 and Capital Reserve Rs. 20,000.

   Preference shares are redeemed on 1-4-12 at a premium of Rs. 2 per share. For redemption, 4000 equity shares of Rs. 10 each are issued at 10% premium.

A bonus issue of equity share was made at par, two shares being issued for every five held on that date. Show the journal entries to record the above transactions.

2. The following are the Balance Sheets of Arun Ltd., Brown Ltd. and Crown Ltd. as at 31.12.2011 :

Liabilities :	Arun Ltd.	Brown Ltd.	Crown Ltd.
	Rs.	Rs.	Rs.
Share Capital (Shares of Rs. 100 each)	6,00,000	4,00,000	2,40,000
Reserves	80,000	40,000	30,000
Profit and Loss Account	2,00,000	1,20,000	1,00,000
Sundry Creditors	80,000	1,00,000	60,000
Arun Ltd.	--	40,000	32,000
Total	9,60,000	7,00,000	4,62,000
Assets	Arun Ltd.	Brown Ltd.	Crown Ltd.
	Rs.	Rs.	Rs.
Goodwill	80,000	60,000	40,000
Fixed Assets	2,80,000	2,00,000	1,82,000
Shares in :			
Brown Ltd. (3,000 Shares)		3,60,000	
Crown Ltd. (400 Shares)			60,000
Crown Ltd. (1,400 Shares)--		2,08,000	
Due from : Brown Ltd.		48,000	
Crown Ltd.			32,000
Current Assets	1,00,000	2,32,000	1,82,000
Total	9,60,000	7,00,000	4,62,000

(i) All shares were acquired on 1.7.2011.

(ii) On 1.1.2011 the balances to the various accounts were as under :

Reserves	40,000	40,000	20,000
Profit and Loss account	20,000 (Dr.)	20,000	12,000

(iii) During 2011, Profits accured evenly.

(iv) In August, 2011, each company paid interim dividend of 10%. Arun Ltd. and Brown Ltd. have credited their profit and loss account with the dividends received.

(v) During 2011, Crown Ltd. sold an equipment costing Rs. 40,000 to Brown Ltd. For Rs. 48,000 and Brown Ltd. in turn sold the same to Arun Ltd. for Rs. 52,000.

Prepare the consolidated Balance Sheet as at 31.12.2011 of Arun Ltd. and its subsidiaries.

3. The Balance Sheets of X Ltd. as on Dec. 31, 2004 and Dec. 31, 2005 were as follows:

	2004	2005		2004	2005
Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
				80,000	1,20,000
	5,00,000	70,000		5,00,000	8,00,000
	1,00,000	1,60,000		1,00,000	75,000
	1,53,000	1,90,000		1,50,000	1,60,000
Bills Payable	40,000	50,000	Cash	20,000	20,000
Outstanding Expenses	7,000	5,000			
	8,50,000	**11,75,000**		**8,50,000**	**11,75,000**

Additional information :

(i) Rs. 50,000 depreciation has been charged to plant & machinery during the year 2005.

(ii) A piece of machinery costing Rs. 12,000 (Depreciation provided thereon Rs. 7,000) was sold to 60% profit on book value. Prepare fund flow statement.

(iii) Discuss merger and consolidation of business concerns. Why are merger and consolidation necessary ?

(iv) Discuss various important regulations as provided in SEBI regulation, 1997.

(v) "A fund flow statement is a better substitute for an income statement". Discuss.

4. Explain the SEBI Regulations, 1997 in detail.

5. Discuss the sale and purchase of shares of subsidiary company.

6. What do you mean by return on capital employed ? Discuss in detail.

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FINANCING FOR EXPANSION (MERGERS & ACQUISITIONS)

M.Com II Sem.	**Advanced Accounting**	**Unit-I**
M.Com – C 211		**Lesson No. 1**

STRUCTURE:

1.1 Introduction

1.2 Objectives

1.3 Meaning and Forms of Expansion

1.4 Forms of Combination

1.5 Economics/ Reasons of Mergers

1.6 Summary

1.7 Glossary

1.8 Self Assessment Questions

1.9 Lesson End Exercise

1.10 Suggested Readings

1.1 INTRODUCTION

Growth is always essential for the existence of a business concern. A concern is bound to die if it does not try to expand its activities. There may be a number of reasons which are responsible for the expansion of business concerns. Predominant reasons for expansion are economic but there may be some other reasons too.

1.2 OBJECTIVES

After going through this lesson, you should be able to understand the meaning and forms of expansion, forms of combination, and reasons of merger.

1.3 MEANING AND FORMS OF EXPANSION

The expansion of a concern may be in the form of enlargement of its activities or acquisition of ownership and control of other concerns. Thus, expansion maybe; (i) internal expansion, and (ii) external expansion.

Internal Expansion

Internal expansion results from the gradual increase in the activities of the concern. The concern may expand its present production capacity by adding more machines or by replacing old machines with new machines with higher productive capacity. The internal expansion can also be undertaken by taking up the production of more units or by entering new fields on the production and marketing sides. Internal expansion may be financed by the issue of more share capital, generating funds from old profits or by issuing long term securities. The net result of internal expansion is the increase in business activities and broadening the present capital structure.

External Expansion

External expansion refers to 'business combination' where two or more concerns combine and expand their business activities. The ownership and control of the combining concerns may be undertaken by a single agency.

Business combination is a method of economic organisation by which a common control of greater or lesser completeness, is exercised over a number of firms which either are operating in competition or independently. This control may either be temporary or permanent, for all or only for some purposes. This control over the combining firm can be exercised by a number of methods which in turn give rise to various forms of combinations. In the words of **Haney**, "To combine is to become one of the parts of a whole, and combination is merely a union of persons to make a whole or group for the persuasion of some common prupose." From this definition it is clear that combination may be of varying degrees and is always for the achievement of common objectives. Combination is coming together of persons or organisations and the main motivation behind such assembly is to secure maximization of profits by eliminating competition.

In the process of combination, two or more units engaged in similar business or indifferent related process or sages of the same business join with a view to carry on their activities or shape their policies on common or co—ordinated basis for mutual benefit or maximum profits. The combination maybe among competing units or units engaged in different processes. After combination, the constituent firms pursue some common objectives or goals.

Following are the reasons for expansion:

1. **Existence :** The existence of the concern depends upon its ability to expand. In a competitive world only the fittest survives. The firm needs to control its costs and improve its efficiency so that ii may be achieved if the activities of the firm are expanded. So, expansion is essential for the existence of the firm otherwise it may result into failure and may be out of business.

2. **Advantages of Large Scale Business :** A large scale business enjoys a number of economies in production, finance, marketing and management. AU these economies enable a firm to keep its costs under control and have an upper hand over its competitors. A large scale concern can also withstand the cyclical changes in the demands of their products.

3. **Use for Higher Profits :** Every businessman aspires to earn more and more profits. The volume of profits can be increased by the expansion of business activities. Undoubtedly, profit is the main motive behind all types of expansions. The incurring of higher costs at the time of expansion may not be associated with higher profits. If a new concern is purchased at a higher price without considering economic aspects, it will not be wise expansion plan. One should be very careful while planning expansion scheme and economic factors should be the motivating forces to enable a concern to increase its profits.

4. **Monopolistic Ambitions :** One of the important factors behind business expansion s the monopolistic ambitions of business leaders. They try to control more and more concerns in the. same line so that they may be able to dictate their terms. So expansions also result out of monopolistic ambitions.

5. **Better Management :** A bigger business concern can afford to use the services of experts.

Various managerial functions can be efficiently managed by those persons who are qualified for such jobs. On the other hand, a smaller concern is generally managed by the owners themselves and they may not be experts in all departments of the business.

6. **Natural Urge :** The expansion is also a way of life. As everybody wants to go higher and higher in his private life and this is applicable to a business concern too. Every businessman wants to expand its activities in a natural way. It not only gives him more profits but also gives him satisfaction.

1.4 FORMS OF COMBINATION

There is some disagreement on the precise meaning of various terms relating to the forms of business combinations, viz; merger, amalgamation, absorption, consolidation, acquisition, takeover, etc. Sometimes, these terms are used interchangeably, in broader sense even when there are legal distinctions between the kinds of combinations. We have discussed these terms in the following pages keeping in mind the relevent legal framework in India.

(a) Merger or Amalgamation

A merger is a combination of two or more companies into one company. It may be in the form of one or more companies being merged into an existing company or a new company or may be formed to merge two or more existing companies. The Income Tax Act, 1961 of India uses the term 'amalgamation' for merger.

According to Section 2 (IA) of the Income Tax Act, 1961, the term amalgamation means the merger. One or more companies merge with another company or merger of two or more companies to form one company in such a manner that:

(i) all the property of the amalgamating company or companies immediately before the amalgamation becomes the property of the amalgamated company by virtue of the amalgamation.

(ii) all the liabilities of the amalgamating company or companies immediately before the amalgamation become the liabilities of the amalgamated company by virtue of the amalgamation.

(iii) Shareholders holding not less than nine—tenths in value of the shares in the amalgamating company or companies (other than shares already held therein immediately before the amalgamation by or by a nominee for, the amalgamated company by virtue of the amalgamation.

According to the Companies Act, 1956, the term amalgamation includes 'absorption'. In S.S Somayajula v. Hop Prudhommee and Co. Ltd., the learned Judge refers to amalgamation as "a state of things under which either two companies are joined so as to form a third entity or one is absorbed into or blended with another." Thus, merger or amalgamation may take any of the two forms:

(i) merger or amalgamation through absorption.

(ii) merger or amalgamation through consolidation.

(i) Absorption : A combination of two or more companies into an existing company is known as 'absorption.' In a merger through absorption all companies except onego into liquidation and lose their separate indentities. Suppose, there are two companies, A Ltd. and B Ltd, Company B Ltd. is merged into A Ltd.leaving its assets and liabilities to the acquiring company A Ltd; and company B Ltd. is liquidated. It is a case of absorption. An example of this type of merger in India is the absorption of Reliance Polyproplene Ltd. (RPPL) by Reliance Industries Ltd. As a result of the absorption, the RPPL was liquidated and its shareholders were offered 20 shares of RR. for every 100 shares of RPPL held by them.

(ii) Consolidation : A consolidation is a combination of two or more companies into a new company. In this form of merger, all the existing companies, which combine, go into liquidation and form a new company with a different entity. The entity of consolidaitng corporations is lost and their assets and liabilities are take over by the new corporation or company. The assets of old concerns are sold to the new concern and their management and control also passes into the hands of the new concern. Suppose, there are two companies called A Ltd. and B. Ltd ; and they merge together to form a mew company called AB Ltd. or C Ltd; it is a case of consolidation.

The term ‘consolidation’ is also, sometimes used as ‘amalgamation.’ However, a merger through absorption may be distinguished from a merger through consolidation. One concern acquires the business of I another concern without forming a new company in the case of an absorpion whereas a new concern is formed by the union of two or more concerns in case of consolidation. Consolidation, generally, takes place between ‘ two equal—size concerns and the size of concerns considerably differs in case of a merger through absorption.

Generally a small concern is merged with a big concern. Though both the terms are used interchangeably. The methods and problems of financing mergers through absorption and consolidations are also similar.’

(b) Acquisition and Take-Over : An essential feature of merger through absorption as well as consolidation is the combination of the companies. The acquiring company takes over the ownership of one or more other companies and combine their operations. However, an acquisition does not involve combination of companies. It is simply an act of acquiring conrol over management of other companies. The control over management of another company can be acquired through either a ‘friendly take—over’ or through ‘forced’ or ‘unwilling acquisition’. When a company takes—over the control of another company through mutual agreement, it is called acquisition or friendly take—over. On the other hand, if the control is acquired through unwilling acquisition, i.e., when the take—over is opposed by the ‘target’ company it is known as hostile take —over.

(c) Holding Companies : The other form of partial consolidation is a holding company which generally arises Out of lust for power. A holding company is a form, of business organisation which is created for the purpose of combining industrial unit is by owning a controlling amount of their share capital. Legally, a holding company is one which holds directly or through a nominee, a majority of the voting shares in the subsidiary Company or possesses the power to nominate the majority of the directors. A holding company may have a number of subsidiary companies or subsidiary company may be a holding company of another company or Companies. The subsidiary of a subsidiary company is also a subsidiary company of the holding company, although a subsidiary company has a separte legal entity but for all practical purposes subsidiaries are under the effective control of a holding company.

1.5 ECONOMICS/ REASONS OF MERGERS

A number of mergers, takeovers and consolidation have taken place in our country in the recent times. Barely two months after Procter and Gamble India Ltd. and Godrej Soaps announced their strategic alliance. The Rs,2087 crore Hindustan Lever Ltd. announced that it will takeover the loss—making Tata Oil Mills (TOMCO) ending the latter's 76 year existence with a merger. The Rs.3700 crore RPG Enterprises has sold the typewriter maker, Remington Rand, to a Calcutta based business man. But, then , what are the motives or reasons for such mergers and acquisitions . One of the major reason cited for such mergers, is the liberalisation of the Indian economy. Liberalisation is forcing companies to enter new businesses, exit from others, and consolidate in some simultaneously. The following are the other important reasons for mergers or amalgamations:

1. **Economies of Scale :** An amalgamated company will have more resources at its command than the individual companies. This will help in increasing the scale of operations and the economies of large scale will be availed. These economies will occur because of more intensive utihsation of production facilities distribution network, research and development facilities, etc. These economies will be available in horizontal mergers (companies dealing in same line of products) where scope of more intensive use of resources is greater.

   The economies will occur only up to a certain point of operations known as optimal point. It is a point where average costs are minimum. When production increases from this point, the cost per unit will go up. The optimal point of production is shown with the help of a diagram also.

2. **Operating Economies :** A number of operating economies will be available with the merger of two or more companies Duplicating facilities in accounting purchasing marketing etc will be eliminated Operating inefficiencies of small concerns will be controlled by the superior management emerging from the amalgamation.

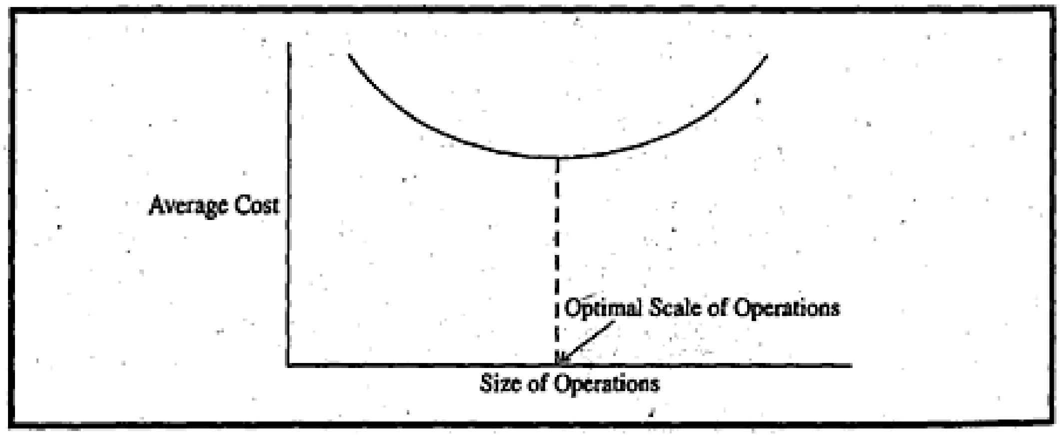

Figure – 1.1

The amalgamated companies will be in a better position to operate than the amalgamating companies individually

3. **Synergy :** Synergy refers to the greater combined value of merged firms than the sum of the values of individual units. It is something like one plus one more than two. It results from benefits other than those related to economies of scale. Operating economies are one of the various synergy benefits of merger or consolidation. The other instances which may result into synergy benefits include, strong R&D facilities of one firm merged with better organised production facilities of another unit, enhanced managerial capabilities, the substantial flnnicial resources of one being combined with profitable investment opprotunities of the other, etc.

4. **Growth :** A company may not grow rapidly through internal expansion. Merger or amalgamation enables satisfactory and balanced growth of a company. It can cross many stages of growth at one time through amalgamation. Growth through merger or amalgamation is also cheaper and less risky. A number of costs and risks of expansion and taking on new product lines are avoided by the acquisition of a going concern. By acquiring other companies a desired level of growth can be maintained by an enterprise.

5. **Diversification :** Two or more companies operating in different lines can diversify their activities through amalgamation. Since different companies are already dealing in their respective lines there will be less risk in diversification. When a company tries to enter new lines of activities then it may face a number of problems in production,

marketing etc. When some concerns are already operating in different lines, they must have crossed many obstacles and difficulties. Amalgamation will bring together the experiences of different persons in varied activities. So amalgamation will be the best way of diversification.

6. **Utilisation of Tax Shields:** When a company with accumulated losses merges with a profit making company it is able to utilise tax shields. A company having losses will not be able to set off losses against future profits, because it is not a profit earning unit. On the other hand if it merges with a concern earning profits then the accumulated losses of one unit will be set off against the future profits of the other unit. In this way the merger or amalgamation will enable the concern to avail tax benefits,

7. **Increase in Value :** One of the main reasons of merger or amalgamation is the increase in value of the merged company. The value of the merged company is greater than the sum of the independent values of the merged companies. For example, if X Ld. and Y Ltd. merge and form Z Ltd., the value of Z Ltd. is expected to be greater than the sum of the independent values of X Ltd. and Y Ltd.

8. **Eliminations of Competition :** The merger or amalgamation of two or more companies will eliminate competition among them. The companies will be able to save their advertising expenses thus enabling them to reduce their prices. The consumers will also benefit in the form of cheap or goods being made available to them.

9. **Better Financial Planning :** The merged companies will be able to plan their resources in a better way. The collective finances of merged companies will be more and their utilisation maybe better than in the separate concerns. It may happen that one of the merging companies has short gestation period while the other has longer gestation period. The profits of the company with short gestation period will be utilised to finance the other company. When the company with longer gestation period starts earning profits then it will improve financial position as a whole.

10. **Economic Necessity :** Economic necessity may force the merger of some units. If there are two sick units, government may force their merger to improve their financial

position and overall working. A sick unit may be required to merge with a healthy unit to ensure better utilisation of resources, improved returns and better management. Rehabilitation of sick units is a social necessity because their closure may result in unemployment etc.

1.6 SUMMARY

In the end we can say that merger is a combination of two or more companies into one company. It may be in the form of one or more companies being merged into an existing company or a new company may be formed to merge two or more existing companies. The Income Tax Act, 1961 of India uses the term 'amalgamation' for merger.

1.7 GLOSSARY

- **Urge-** wants to go higher and higher
- **Synergy-** It refers to the greater combined value of merged firms than the sum of the values of individual units
- **Consolidation-** A consolidation is a combination of two or more companies into a new company
- **Holding Company-** Holding Company is one which holds either whole or majority of the shares in another company.

1.8 SELF ASSESSMENT QUESTIONS

Q.1 What do you mean by expansion?

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Q.2 Explain the various forms of expansion.

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Q.3 What are synergy benefits?

1.9 LESSON END EXERCISE

Q.1 Explain the meaning and forms of expansion. Also explain the various reasons for expansion.

Q.2 Explain the term combination and various forms of combination. Also explain the economics/ reasons of merger.

1.10 SUGGESTED READINGS

- I.M. Pandey, "Financial Management", Vikas Publishing House Pvt. Ltd., Ninth Edition.
- Prasanna Chandra, "Fundamentals of Financial Management", Tata McGraw Hill Ltd., 2006.
- Breaby and Myers, "The principles of Corporate Finance", 6th edition, Tata McGraw Hill, New Delhi.

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FINANCING FOR EXPANSION (MERGERS & ACQUISITIONS)

M.Com II Sem.	**Advanced Accounting**	**Unit-I**
M.Com – C 211		**Lesson No. 2**

STRUCTURE:

2.1 INTRODUCTION

According to Section 2 (IA) of the Income Tax Act, 1961, the term amalgamation means the merger one or more companies with another company or merger of two or more companies to form one company in such a manner that: (i) all the property of the amalgamating company or companies immediately before the amalgamation becomes the property of the amalgamated company by virtue of the amalgamation. (ii) all the liabilities of the amalgamating company or companies immediately before the amalgamation become the liabilities of the amalgamated company by virtue of the amalgamation. (iii) Shareholders holding not less than nine—tenths in value of the shares in the amalgamating company or companies (other than shares already held therein immediately before the amalgamation by or by a nominee for, the amalgamated company by virtue of the amalgamation.

2.2 OBJECTIVES

After going through this lesson, you should be able to understand the various types of mergers, legal and procedural aspects of mergers, valuation of merger

2.3 TYPES OF MERGERS

Notwithstanding terminological forms, mergers can be broadly classified into three major types:

1. **Horizontal Merger :** When two or more concerns dealing in same product or service join together, it is known as a horizontal merger. The idea behind this type of merger is to avoid competition between the units. for example, two manufacturers of same type of cloth, two book sellers, two transport companies operating on the same route—the merger in all these cases will be horizontal merger.

Besides avoiding competition, there-'are 'economies of scale, marketing economies, elimination of duplication of facilities, etc.

2. **Vertical Merger :** A vertical merger represents a merger of firms engaged at different stages of production or distribution of the same product or service. In this case two or more companies dealing in the same product but at different stages may join to carry out the whole process itself. A petroleum producing company may set up its own petrol pumps fonts selling. A railway company may join with coal mining company for carrying coal to different industrial centres. Similarly, a textile unit may merge with a transport company for carrying its products to different places. All these are the examples

of vertical merger. The idea behind this type of merger is to take up two different stages of work to ensure speedy production or quick service.

3. **Conglomerate Merger :** When two concerns dealing in totally different activities join hands it will be a case of conglomerate merger. The merging concerns are neither horizontally nor vertically related to each other. For example, a manufacturing company may merge with an insurance company, a textile company may merge with a vegetable oil mill. There may be some common features in merging companies, such as distribution channels, technology, etc. This type of merger is undertaken to diversify the activities.

2.4 LEGAL AND PROCEDURAL ASPECTS OF MERGER

The procedure of amalgamation or merger is long—drawn and involves some important legal dimensions. Following steps are taken in this procedure:

I. **Analysis of Proposal by the Companies :** Whenever a proposal for amalgamation or merger comes up then managements of concerned companies look into the pros and cons of the scheme. The likely benefits such as economies of scale, operational economies, improvements in efficiency, reduction in costs, benefits of diversification, etc. are clearly evaluated. The likely reactions of shareholders, creditors and others are also assessed. The taxation implications are also studied. After going through the whole analysis work, it is seen whether the scheme will be beneficial or not. It is pursued further only if it will benefit the interested parties otherwise the scheme is shelved.

2. **Determining Exchange Ratios :** The amalgamation or merger schemes involve exchange of shares. The shareholders of amalgamated companies are gives shares of the amalgamated company. It is very important that a rational ratio of exchange of shares should be decided. Normally a number of factors like book value per share, market value per share, potential earnings, value of assets to be taken over are considered for determining exchange ratios.

3. **Approval of Board of Directors :** After discussing the amalgamation scheme thoroughly and negotiating the exchange ratios, it is put before the respective Board of Directors for approval.

4. **Approval of Shareholders :** After the approval of this scheme by the respective Boards of Directors, it must be put before the shareholders. According to section 391 of Indian Companies Act, the amalgamation scheme should be approved at a meeting of the members or class the of members, as the case may be, of the respective companies representing three—fourth in value and majority in number, whether present in person or by proxies. Encase the scheme involves exchange of shares, it is necessary that is approved by not less than 90 per cent of the shareholders (in value) of the transferor company to deal effectively with the dissening shareholders.

5. **Consideration of Interests of the Creditors :** The views of creditors should also be taken into consideration. According to section 391, amalgamation scheme should be approved by majority of creditors in numbers and three—fourth in value.

6. **Approval of the Court :** After getting the scheme approved, an application is filed in the court for its sanction. The court will consider the viewpoint of all parties appearing, if any, before it, before giving its consent. It will see that the interest of all concerned parties are protected in the amalgamation scheme. The court may accept, modify or reject an amalgamation scheme and pass orders accordingly. However, it is up to the shareholders whether to accept the modified scheme or not. It may be noted that no scheme of amalgamation can go through unless the Registrar of Companies sends a report to Court to the effect that the affairs of the company have not been conducted as per the interests of its members or to the public interest.

7. **Approval of Reserve Bank of India :** In terms of Section 19 (1) (d) of the Foreign Exchange Regulation Act, 1973, permission of the RBI is required for the issue of any security to a person resident outside India Accordingly, in a merger, the transferee company has to obtain permission before issuing shares in exchange of shares held in the transferor company. Further, Section 29 restricts the acquisition of the whole or any part of any undertaking in India in which non-residents' interest is more than the specified percentage.

2.5 VALUATION OF FIRMS

The question of valuing the business to be acquired and consolidated poses a problem at the very outset. All parties try to convince about their viewpoints and want to tilt the values in their favour. The valuation issue should be settled impartially because it will affect the whole financial management after merger and consolidation. Not only the bargaining of the parties but practical aspects like earning capacity, present values of assets and future expectations from the concern should be given due weight-age while valuing the concerns:

The issue of valuation is not only important at the time of merger or consolidation but it will also influence the pricing of new issues of securities, in purchase, sale or pledge of existing securities, in re capitalisation; and in re-organisation and liquidation.1

Some of the important methods for valuing property of companies are discussed as follows:

I. Capitalised Earnings : The capitalised earnings method is based on the philosophy that th price which a buyer would like to pay for the property of a concern will depend upon the present and expected earning capacity of the business. The present price is paid in the expectations of future returns from such investments. The capitalised earnings will depend upon the (1) Estimate of earnings, and (2) Rate of capitalisation. The estimation of earnings will involve the study of past earnings. The past earnings over a long period will give an exact idea about the earning position of the business. The past earnings of one or two years rose to be influenced by abnormal causes such as price fluctuations, etc.; so, a true and fair opinion will not be made available and nothing should be concealed If the earnings are showing a stability then the earnings will be easily calculated; if, on the other hand, the earnings are showing a trend then some allowance should be made for the conditions prevailing at that time. After estimating the average earnings, the earnings should be capitalised to arrive at an investment value. A decision about the rate of earnings at which the profits are to be capitalised is very difficult. It is a sort of arbitrary figure. One should be guided by economic factors only while calculating capitalisation rate. If the earnings per share are Rs.5 and the capitalisation rate is 10%, then the value of the share will be Rs.50.

2. **Assets Approach :** Assets approach is the commonly used method of valuation. The assets may be taken at book value, reproduction value and liquidation value. In hook value method, the values of assets are taken from a current balance sheet. The excess of assets over debts will determine the assets values, divided by the number of equity shares will give the value of one share. If preference stock is also outstanding then preference stock should be deducted before dividing the assets values by the number of equity shares. This approach is also known as net worth value. There is a difference of opinion about the assets to be included and assets such as goodwill, patent tights, deferred expenses should be excluded. Another views that goodwill and patents should be included while fictitious assets such as deferred expenses should only be excluded. The fixed assets are taken at book value less depreciation up to present balance sheet period. A company following a rigorous depreciation policy may be at a disadvantage than the company providing lower depreciations. Public utilities may use the reproduction value of assets while valuing the property. Liquidation values of assets are used on the assumption that if the concern is liquidated at present then what values will be fetched by the assest. The concern is taken as a going concern and as such current book values of assets are used in most of the cases.

3. **Market Value Approach :** This approach is based on the actual market price of securities settled between the buyer and the seller. The market value will be the realised value because buyers will be ready to pay in lieu of a purchase. The price of a security in the free market will be its most appropriate value. Market price is affected by the factors like demand and supply and position of money market. The price of a security in the free market will be its most appropriate value. Market value is advice which can be readily applied. at any time.

   A number of practical problems are faced while applying market value approach. The market value will be available for securities of big companies only. The number of shares offered in the market are generally small and it will not be advisable to apply the same value to the whole lot of shares of the company. Another objection against this method is that there are many upward and downward trends in values of securities in the stock exchanges and it becomes a problem to decide about the price to be taken for valuation. Despite practical limitations, market value approach may be used under many conditions.

4. **Earnings per Share :** Another method of determining the values of the firms under merger or consolidation is the earnings per share. According to this approach, the value of a prospective merger or acquisition is a function of the impact of merger / acquisition on the earnings per share. Such impact could either be positive resulting into the increases in EPS or may be negative resulting into dilution of BPS. As the market price per share is a function (product) of EPS and Price-Earning Ratio, the future EPS will have an impact on the market value of the firm. The following illustrative examples explain the effect of merger /acquisition on EPS.

Illustration 2.1 A Ltd. wants to take over B Ltd. and the financial details of both the companies are as below :

	A Ltd. (Rs.)	*B Ltd. (Rs.)*
Equity share capital of Rs. 10 each	2,00,000	1,00,000
Preference share capital [redacted]	40,000	—
Share premium	—	4,000
Profit and loss account	76,000	8,000
10% Debentures	30,000	10,000
Total liabilities	3,46,000	1,22,000
Fixed assets	2,44,000	70,000
Current assets	1,02,000	52,000
Total assets [redacted]	3,46,000	1,22,000
Profit after tax and preference dividend	48,000	30,000
Market price per share	24	27

You are required to determine the share exchange ratio to be offered to the shareholders of B Ltd., based on (*i*) net assets value, (*ii*) EPS, and (*iii*) market price. Which should be preferred from the point of view of A Ltd.

Solution :

(*i*) Calculation of share exchange ratio based on net assets value

		A Ltd. (Rs.)		*B Ltd. (Rs.)*
Total assets		3,46,000		1,22,000
Less : 10% Debentures	30,000		10,000	
Preference share capital	40,000	70,000	—	10,000
Net worth (Net assets value) [a]		2,76,000	[redacted]	1,12,000
Number of equity shares [b]		20,000		10,000
Net worth (assets) per share [a ÷ b]		*Rs. 13.80*		*Rs. 11.20*

$$\text{Share Exchange Ratio} = \frac{\text{Net worth per share of target firm}}{\text{Net worth per share of acquiring firm}}$$ [redacted]

$$= \frac{11.20}{13.80} = 0.81$$

Thus, number of shares to be issued by A Ltd. = 10,000 × 0.81 = 8,100.

(ii) Calculation of share exchange ratio based on earnings per share (EPS)

	A Ltd.	*B Ltd.*
Profit after tax and preference dividend	Rs. 48,000	Rs. 30,000
Number of equity shares	20,000	10,000
Earnings per share (EPS)	Rs. 2.40	Rs. 3.00

$$\text{Share exchange ratio} = \frac{\text{EPS of target firm}}{\text{EPS of acquiring firm}}$$

$$\text{Share exchange ratio} = \frac{3.00}{2.40} = 1.25$$

Thus, number of shares to be issued by A Ltd. = 10,000 × 1.25 = 12,500

(iii) Calculation of share exchange ratio based on market price

	A Ltd.	*B Ltd.*
Market price per share	*Rs. 24*	*Rs. 27*

$$\text{Share exchange ratio} = \frac{\text{Market price per share of B Ltd.}}{\text{Market price per share of A Ltd.}}$$

$$= \frac{27}{24} = 1.125$$

Thus, number of shares to be issued by A Ltd. = 10,000 × 1.125 = 11,250.

Comments : A Ltd. should prefer the share exchange ratio based on net assets value as it has to issue minimum number of shares *i.e.*, 8,100 in that case.

Illustration 2.2 Company X is considering the purchase of company Y. The following are the financial data of the two companies :

	Company X	*Company Y*
Number of Shares	4,00,000	1,00,000
Earnings Per Share (EPS)	Rs.6.00	Rs.4.50
Market Value Per Share	Rs.30.00	Rs.20.00

Assuming that the management of the two companies have agreed to exchange shares in proportion to:

(i) the relative earnings per share of the two firms;

(ii) 4 shares of company X for every 5 shares held in company Y.

You are required to illustrate and comment on the impact of merger on the EPS.

Solution :

***(i)* Effect of Merger on EPS When the Exchange Ratio is in Proportion to Relative Earnings Per Share**

	Rs.
Earnings of company X (No. of Shares × EPS)	24,00,000
Earnings of company Y (1,00,000 × 4.50)	4,50,000
Total Earnings after the merger (as no economics/ synergies are given)	28,50,000

$$\text{Number of shares After the merger} = 4{,}00{,}000 + \left(1{,}00{,}000 \times \frac{4.5}{6}\right) = 4{,}75{,}000$$

$$\text{Earnings per share (EPS) After the merger} = \frac{28{,}50{,}000}{4{,}75{,}000} = \text{Rs. } 6.00$$

Hence, there is no impact on EPS for the shareholders of company X

Equivalent Earnings Per Share for the shareholders of company Y After Merger

= EarningsAfter the merger × Exchange Ratio

$$= \text{Rs. } 6 \times \frac{4.5}{6} = \text{Rs. } 4.5$$

Comments. From the above, it is clear that there is no impact of merger on EPS when the exchange ratio is in proportion to relative earnings per share of the two companies.

(ii)* *Effect of merger on EPS when the Exchange Raio is 4:5 or 8:1

Total Earnings After the Merger = Rs.28,50,000

Number of shares after the merger	$= 4{,}00{,}000 + \left(1{,}00{,}000 \times \frac{4}{5}\right)$
	$= 4{,}80{,}000$
Earnings Per Share (EPS) after the merger	$= \frac{28{,}50{,}000}{4{,}80{,}000} =$ Rs. 5.937

Impact on EPS of company X's shareholders	***Rs***
EPS Before Merger	6.000
EPS After merger	5.937
Dilution in EPS	0.063
Impact on EPS for company Y's shareholders	***Rs***
Equivalent Earnings Per Share before the merger (4.50÷4/5)	5.625
EPS after the merger	5.937
Increase or Accretion in EPS	0.312

Comments : When the exchange ratio is 4:5, the impact of merger on EPS is dilution of Rs.0.063 per share on the earnings per share for the shareholders of the acquiring company and accretion in the EPS of the acquired firm amounting to Rs.0.312 per share. However, for a more reliable analysis of the impact of merger on EPS, the growth rate of the two companies should also have been considered.

Illustration. 2.3 Sunny Lamps Ltd. is taking over Moon Lamps Ltd. As per the understanding between the managements of the two companies, shareholders of Moon Lamps Ltd. would receive 0.7 shares of Sunny Lamps Ltd. for each share held by them. The relevent data for the two companies are as follows:

	Sunny Lamps Ltd.	*Moon Lamps Ltd.*
Net Sales (Rs.Lakhs)	80	30
Profit after tax (Rs.Lakhs)	16	4
Number of shares (Lakhs)	3.2	1
Earnings Per Share (EPS Rs.)	5	4
Market Value Per Share (Rs.)	30	20
Price-Earning Ratio (P/E)	6	5.

Ignoring the economies of scale and the operating synergy, you are required to calculate (i) premium paid by Sunny Lamps Ltd. to the shareholders of Moon Lamps Ltd, (ii) number of shares after the merger; (iii) combined EPS; (iv) combined P/E ratio; (v) market value per share; and (vi) total market capitalisation after the merger.

Solution :

(i) **Premium paid by Sunny Lamps Ltd. to shareholder of Moon Lamps Ltd :**		***Rs.***
Value of each share of Sunny Lamps Ltd	$= 30 \times 0.7$	21.00
Value of each share in Moon Lamps Ltd.		20.00
Premium paid per share		1.00
Premium in percentage	$= 1/20 \times 100 =$	5%
(ii) **Number of shares after merger**		***Rs.***
Number of shares before merger in Sunny Lamps Ltd.		3,20,000
Number of shares paid to shareholders of Moon Lamps Ltd. (1,00,000×.7)		70,000
Total Number of shares after merger		3,90,000
(iii) **Combined EPS**		
Combined Profit after tax	= Rs. 16,00,000+4,00,000=Rs. 20,00,000	

	$= \frac{20,00,000}{3,90,000} = \text{Rs. } 5.13$ [redacted]
(iv) **Combined Price–Earning Ratio**	
	$= \left(6\times\frac{16}{20}\right)+\left(5\times\frac{4}{20}\right) = 5.80$
(v) **Market Value per share After Merger**	
	=P/E Ratio × EPS =5.80 × 5.13 =Rs. 29.754
(vi) **Total Market Capitalisation After Merger**	
	=Market Value per share × No. of shares =29.754 × 3,90,000 =Rs. 116.04 lakhs.

2.6 SUMMARY

To conclude we can say that when two or more concerns dealing in same product or service join together, it is known as a horizontal merger. The idea behind this type of merger is to avoid competition between the units. for example, two manufacturers of same type of cloth, two book sellers, two transport companies operating on the same route—the merger in all these cases will be horizontal merger. Besides avoiding competition, there-'are 'economies of scale, marketing economies, elimination of duplication of facilities, etc. A vertical merger represents a merger of firms engaged at different stages of production or distribution of the same product or service. In this case two or more companies dealing in the same product but at different stages may join to carry out the whole process itself. Conglomerate Merger. When two concerns dealing in totally different activities join hands it will be a case of conglomerate merger. The merging concerns are neither horizontally nor vertically related to each other

2.7 GLOSSARY

- Vertical Merger-A vertical merger represents a merger of firms engaged at different stages of production or distribution of the same product or service.
- Conglomerate Merger. When two concerns dealing in totally different activities join hands it will be a case of conglomerate merger.
- Horizontal Merger. When two or more concerns dealing in same product or service join together, it is known as a horizontal merger.

2.8 SELF ASSESSMENT QUESTIONS

Q.1 Discuss in brief the various types of mergers.

Q.2 What is the legal and procedural aspects of merger?

2.9 LESSON END EXERCISE

Q.1 Discuss merger and consolidation of business concerns.. Why are merger and consolidation necessary.

Q.2 Discuss various methods of valuation at the time of merger and consolidation.

2.10 SUGGESTED READINGS

- I.M. Pandey, "Financial Management", Vikas Publishing House Pvt. Ltd., Ninth Edition.
- Prasanna Chandra, "Fundamentals of Financial Management", Tata McGraw Hill Ltd., 2006.
- Breaby and Myers, "The principles of Corporate Finance", 6th edition, Tata McGraw Hill, New Delhi.

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FINANCING FOR EXPANSION (MERGERS & ACQUISITIONS)

M.Com II Sem.	**Advanced Accounting**	**Unit-I**
M.Com – C 211		**Lesson No. 3**

STRUCTURE:

3.1 INTRODUCTION

You can't grow unless you have money to invest in growth. That may seem strange at first. After all, growth is supposed to generate additional sales and profits, right? That's true, but before you can increase sales, you usually have to increase your current assets, such as inventory and fixed assets such as a plant and equipment. Rapid growth means hiring more people, furnishing more offices and perhaps renting new quarters. Since there's usually a time lag between the moment you need to invest in growth and the moment you receive the resulting sales and profits, you need money before you can grow.

3.2 OBJECTIVES

After going through this lesson, you should be able to understand the various forms of financing a merger.

3.3 FORMS OF FINANCING MERGER

Financing expansion can take many forms. You can use your own money, borrow from friends and family, use internally generated funds, approach equity investors or tap banks and other lenders. The sources for funding growth are generally the same sources you may have used to start your business. In many cases, you'll go back to the same sources to pay for expanding your company. The good news is that it's easier to fund growth in an existing business than it is to fund a startup.

As you learned when you were looking for startup capital, there are many places to go when seeking money for business. As you probably also learned, only a few of those places are right for any given business. Selecting the right type of expansion financing is largely a matter of matching your needs to the restrictions of the source. Each type of financing has its own strengths and limitations.

Personal Sources

Self-financing in the form of personal and family savings is the No. 1 form of financing used by most small business owners. It's low-cost and has other advantages. For instance, when you approach other financing sources, such as bankers and venture capitalists, they'll want to know exactly how much of your own money you are putting into the venture. After all, if you don't have enough faith in your business to risk your own money, why should anyone else risk theirs?

Here are some of the sources of personal and family financing you should consider for growing your business:

- **Personal line of credit, including credit cards:** Although credit card financing is expensive, it can work for emergencies and small amounts.
- **Home equity loan secured by your personal residence:** Interest rates are low, but you may lose your home if you can't repay.

- **Cash-value life insurance:** Interest rates are reasonable on loans against cash-value policies, and you don't have to make payments because the loan will be repaid from proceeds of your insurance in the event of your death.
- **Individual retirement account (IRA) funds:** Laws governing IRAs let you withdraw money from an IRA as long as you replace it within 60 days. It's not a loan, so there's no interest, but if you pay it back late, you'll have to pay a 10 percent penalty plus taxes.

"Friends and Family" Financing

Friends, relatives and business associates are popular sources for financing the growth of small businesses. There are two main advantages of friends and family financing.The all-important issue of the character of the borrower is moot—these people already know you. Depending on who you're borrowing from, repayment terms may be extremely flexible, and you may not even have to pay interest.

The downside is that, if worst comes to worst and you can't repay the loan, the people who will be hurt will be friends, family and business associates. Make sure you explain the risks involved in investing in a growth business before accepting financing from friends and family. Otherwise, their wish to help you out may lead them to do something that could damage your personal relationship as well as your mutual finances.

Internally Generated Funds

One of the most advantageous ways to finance growth is through earnings your business is creating and that you retain. The only cost to using retained earnings is the interest you would receive if you kept the earnings in a bank account. Since this amount is likely to be much less than you will earn by successfully investing the funds in growing your business, plowing retained earnings back into your business is usually a smart move.

One risk to financing with internally generated funds is that you will divert too much of your current profits into expanding the business. This can starve your business and create more trouble than if you financed with a more costly source or never tried to grow at all. Make sure you aren't robbing Peter to pay Paul when you finance with retained earnings, and that your investments in inventories, marketing efforts, production staff and other outlays required for the existing business are maintained.

Banks exist to lend money, so it's no surprise that banks offer a wide variety of ways to fund growth. Here's a look at how lenders generally structure loans, with common variations.

- **Line-of-credit loans:** The most useful type of loan for the small business is the line-of-credit loan. This is a short-term loan that extends the cash available in your business's checking account to the upper limit of the loan contract. You pay interest on the actual amount advanced from the time it is advanced until it is paid back. Line-of-credit loans are intended for purchases of inventory and payment of operating costs for working capital and business cycle needs. They are not intended for purchases of equipment or real estate.
- **Installment loans:** These bank loans are paid back with equal monthly payments covering both principal and interest. Installment loans may be written to meet all types of business needs. You receive the full amount when the contract is signed, and interest is calculated from that date to the final day of the loan. If you repay an installment loan before its final date, there will be no penalty and an appropriate adjustment of interest.
- **Balloon loans:** These loans require only the interest to be paid off during the life of the loan, with a final "balloon" payment of the principal due on the last day. Balloon loans are often used in situations when a business has to wait until a specific date before receiving payment from a client for its product or services.
- **Interim loans:** Interim financing is often used by contractors building new facilities. When the building is finished, a mortgage on the property will be used to pay off the interim loan.
- **Secured and unsecured loans:** Loans can be secured or unsecured. An unsecured loan has no collateral pledged as a secondary payment source should you default on the loan. The lender provides you with an unsecured loan because it considers you a low risk. A secured loan requires some kind of collateral but generally has a lower interest rate than an unsecured loan. The collateral is usually related to the purpose of the loan; for instance, if you're borrowing to buy a printing press, the press itself will

likely serve as collateral. Loans secured with receivables are often used to finance growth, with the banker lending up to 75 percent of the amount due. Inventory used to secure a loan is usually valued at up to 50 percent of its sale price.

- **Letter of credit:** International traders use these to guarantee payment to suppliers in other countries. The document substitutes the bank's credit for the entrepreneur's up to a set amount for a specified period of time.

SBA Loans

Despite what you might see on late-night infomercials or some websites, none of the SBA's loan programs involve free money, government grants or no-interest loans. In fact, the SBA doesn't even lend funds directly to entrepreneurs—you'll need to strike up a relationship with a loan officer at your local bank, credit union or nonprofit financial intermediary to access the programs.

But once you do, there's an array of resources aimed at getting you the capital you need to start or expand your small business. Last year, more than $50 million in SBA loans were being provided per day to U.S. small businesses.

- **7(a) Loan Program :** The 7(a) is the SBA's most popular loan program. As a small-business owner, you can get up to $750,000 from your local 7(a) lender, backed by a partial guarantee from the SBA. Note that the SBA is not lending you any money directly. What they are doing is making it less risky for a local lender to provide you with financing. 7(a) loans are typically used for working capital, asset purchases and leasehold improvements. All the owners of a business who hold an ownership stake of 20 percent or more are required to personally guarantee the loan.

  Once your lender decides that 7(a) money is what you need, you'll probably start hearing the names of the different 7(a) programs. For example if you're borrowing less than $150,000, you may be headed toward the *Lowdoc* program, which was created in 1993 to reduce burdensome paperwork. A Lowdoc loan application is a one-page form; your application is on one side and the lender's request to the SBA for the guaranty for your loan is on the other. The SBA responds to Lowdoc applications within 36 hours.

The *SBA Express* is a program for lenders with a good SBA-lending track record. It's aimed at getting money—in this case, as much as $250,000—quickly into the hands of entrepreneurs. Based on the success of the SBA Express program, the SBA initiated *CommunityExpress*, specifically designed to improve access to capital for low- and moderate-income entrepreneurs and to provide both pre- and post-loan technical assistance.

The eligibility criteria for the 7(a) program are the broadest of all the SBA loan programs, but they're still quite restrictive for startups and businesses related to financial services. In general, all SBA programs are targeted at small companies (that is, businesses with less than $7 million in tangible net worth and less than $2.5 million in net income), but typically most banks won't lend to startup businesses that don't have two to three years' worth of financial statements and some owner's equity in the business. Some banks will allow you to use money from relatives as part of your equity, but you're required to formalize these loans with a repayment plan that's subordinate to the bank debt.

- **504 Loan Program.** The 504 loan program is intended to supply funds for asset purchases, such as land or equipment. Typically, the asset purchase is funded by a loan from a bank or other lender in your area, along with a second loan from a certified development company (CDC) that's funded with an SBA guarantee for up to 40 percent of the value of the asset—which is generally a loan of up to $1 million—and a contribution of 10 percent from the equity of the borrower. This financing structure helps the primary lender—the bank—reduce its exposure by relying on the CDC and the SBA to shoulder much of the risk.

Like the 7(a) program, the 504 program is restricted to small businesses with less than $7 million in tangible net worth and less than $2.5 million in net income. However, since funds from 504 loans can't be used for working capital or inventory, consolidating or repaying debt, or refinancing, this program tends to exclude most service businesses that need to purchase land or equipment. Personal guarantees are also required for 504 loans.

7(m) Microloan Program : The program is intended to provide "small" loans of up to $35,000 that can be used for a broad range of purposes to start and grow a business. Unlike the 7(a) program, the funds to be loaned don't come from banks; rather, they come directly from the SBA and are administered to business owners via nonprofit community-based intermediaries. To find the name of an intermediary micro-lender in your area, **visit this page** of the SBA's website.

The Microloan program is friendlier to startups than established businesses because the "catch" to the Microloan program is borrowers typically have to enroll in technical assistance classes administered by the micro-lender intermediaries. For some entrepreneurs, this is a very helpful resource that provides cost-effective business training. Others, however, perceive it as a waste of time, although it's a necessary pre-condition to getting a Microloan.

3.4 SUMMARY

A merger can be financed through various modes of payment, viz, cash-; exchange of shares, debenture or a combination of cash, shares and debt. Deferred payment plans, leveraged buy—outs and lender offers are also being used as financial techniques in financing of mergers in the recent times. The choice of the means of financing primarily depends upon the financial position and liquidity of the acquiring firm, its impact on capital structure and BPS, availability of debt and market conditions.

3.5 GLOSSARY

- Tender Offer- It is a method that results into hostile or forced take-over.
- Leveraged Buy-Out- A merger of a company which is substantially financed through debt is known as leveraged buy-out.
- Deferred payment - known as earn-out plan is a method of making payment to the target firm which is being acquired in such a manner that only a part of the payment is made initially either in cash or securities.
- Cash Offer-It is the most straight forward method of making-the payment by way of offer for cash payment.

3.6 SELF ASSESSMENT QUESTIONS

Q.1 What is a leveraged buy-out?

Q.2 What do you mean by tender offer?

3.7 LESSON END EXERCISE

Q.1. What are the various forms of financing for expansion of business?

Q.2. Discuss merger and consolidation of business concerns.. Why are merger and consolidation necessary?

3.8 SUGGESTED READINGS

- I.M. Pandey, "Financial Management", Vikas Publishing House Pvt. Ltd., Ninth Edition.
- Prasanna Chandra, "Fundamentals of Financial Management", Tata McGraw Hill Ltd., 2006.
- Breaby and Myers, "The principles of Corporate Finance", 6th edition, Tata McGraw Hill, New Delhi.

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FINANCE FOR EXPANSION (MERGERS & ACQUISITIONS)

M.Com II Sem.	**Advanced Accounting**	**Unit-I**
M.Com – C 211		**Lesson No. 4**

STRUCTURE:

4.1 INTRODUCTION

Wealth maximisation is the main objective of financial management and growth is essential for increasing the wealth of equity shareholders. The growth can be achieved through expanding its existing markets or entering in new markets. A company can expand/ diversify its business internally or externally which can also be known as internal growth and external growth. Internal growth requires that the company increase its operating facilities i.e. marketing, human resources, manufacturing, research, IT etc. which requires huge amount of funds. Besides a huge amount of funds, internal growth also require time. Thus, lack of financial resources or time needed constrains a company's space of growth. The company can avoid these two problems by acquiring production facilities as well as other resources from outside through mergers and acquisitions.

4.2 OBJECTIVES

After going through this lesson, you will be able to

- Understand the financial evaluation of a merger and acquisition.
- Elaborate the financing techniques of merger and acquisition.
- Elaborate the capital structure of merger and acquisition.
- Understand the financial problems of merger and consolidation

4.3 CAPITAL STRUCTURE AFTER MERGER AND CONSOLIDATION

The acquiring company in case of merger and the new company in case of consolidation takes over assets and liabilities of the merging companies and new shares are issued in lieu of the old. The capital structure is bound to be affected by new changes. The capital structure should be properly balanced so as to avoid complications at a later stage.

A significant shift may be in the debt-equity balance. The acquiring company will be requiring cash for making the payments. If it does not have sufficient cash then it will have to give new securities for purposes of an exchange. In all cases the balance of debt and equity will change. The possibility is that equity may be increased more than the debt.

The mergers and consolidations result into the combining of profits of concerned companies. It increase in profitability will reduce risks and uncertainties, It will affect the earnings per share. The investors will be favourably inclined towards the securities of the company. The expectancy of dividend declarations inthe future will also have a positive effect. If merging companies had different pay-out policies, then) shareholders of one company will experience a change in dividend rate. The Overall effect on earnings will be favourable because the increased size of business will experience a number of economies in costs and marketing which will increase profits of the company. The capital structure should be adjusted according to the present needs and requirements. The concern should assess the effects of merger and consolidation on earning pattern, rate of growth, risks and uncertainties The capital can be increased by issuing new preference and equity shares. The capital can be increased by issuing bonus shares too. On the other hand, if long-term debt is to be increased then it can be done by the issue of debentures, conversion of redeemable preference shares into debentures and renewal of bonded indebtness.

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4.4 FINANCIAL PROBLEMS OF MERGER AND CONSOLIDATION

After merger and consolidation the companies face a number of financial problems. The liquidity of the companies has to be established afresh. The merging and consolidating companies pursue their own financial policies when they are working independently. A number of adjustments are required to be made in financial planning and policies so that consolidated efforts may enable to improve short—term and long—term finances of the companies. Some of the financial problems of merging and consolidating companies are discussed as follows:

1. **Cash Management :** The liquidity problem is the usual problem faced by acqpiring companies. Before merger and consolidation, the companies had their own methods of payments, cash behaviour patterns and arrangements with financial institutions. The cash pattern will have to be adjusted according to the present needs of the business.

2. **Credit Policy :** The credit policies of the companies are unified so that same terms and conditions may be applied to the customers. If the market areas of the companies are different, then same old policies may be-followed. The problem will arise only when operating areas of the companies are the same and same credit policy will have to be pursued.

3. **Financial Planning :** The companies may be following different financial plans before merger and consolidation. The methods of budgeting and financial controls may also be different. After merger and consolidation, a unified financial planning is followed. The divergent financial controls will be unified to Suit the needs of the acquiring concerns.

4. **Dividend Policy :** The companies may be following different policies for paying dividend. The stockholders will be expecting higher rates of dividend after merger and consolidation on the belief that financial position and earning capacity has increased after combining the resources of the companies. This is a ticklish problem and management will have to devise an acceptable pay—out policy. In the earlier stages of merger and consolidation it may be difficult to maintain even the old rates of dividend.

5. **Depreciation Policy :** The companies follow different depreciation policies. The methods of depreciation, the rates of depreciation, and the amounts to be taken to revenue accounts will be different. After merger and consolidation the first thing to be decided will be about the depreciable and non-depreciable assets. The second will be about the rates of depreciation. Different assets will be in different stages of use and appropriate amounts of depreciation should be decided.

4.5 MERGERS IN INDIA

In developed economics, corporate mergers and amalgamations are a regular feature where hundreds of mergers take place every day. In India, too mergers have become a corporate game today. In 1988, there were only 15 mergers whereas in 1998 there were over 500 mergers. Corporate takeovers in India, were started by Swaraj Paul when he tried to take over Escorts. Since than many takeovers have taken place in our country such as Ashok Leyland by the Hindujas; Shaw Wallace, Dunlop, and Falcon Tyres by the Chabbria Group; Ceat Tyres by the Goenkas and Consolidated coffee by Tata Tea. The Institute of Chartered Accountants of India has issued Accounting Standard 14 on Accounting for Amalgamations. The government has also favoured mergers and amalgamations when these are in the interest of general public. The government has issued SEB1 (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 to provide greater transparency in the acquisition of shares and takeover of companies.

4.6 FINANCIAL EVALUATION OF A MERGER / ACQUISITION

A merger proposal be evaluated and investigated from the point of view of number of perspectives. The engineering analysis will help in estimating the extent of operating economies of scale, while the marketing analysis may be undertaken to estimate the desirability of the resulting distribution network. However, the most important of all is the financial analysis or financial evaluation of a target candidate. An acquiring firm should pursue a merger only if it creates some real economic values which may arise from any source such as better and ensured supply of raw materials, better access to capital market, better and intensive distribution network, greater market share, tax benefits, etc.

The shareholders of the target firm will ordinarily demand a price for their shares that reflects the firm's value. For prospective buyer, this price may be high enough to negate the advantage of merger. This is particularly true if several acquiring firms are seeking merger partner, and thus, bidding up the prices of available target candidates. The point here is that the acquiring firm must pay for what it gets. The financial evaluation of a target candidate, therefore, includes the determination of the total consideration as well as the form of payment, i.e., in cash or securities of the acquiring firm. An important dimension of financial evaluation is the determination of Purchase Price. Determining the purchase price: The process of financial evaluation begins with determining the value of the target firm, which the acquiring firm should pay. The total purchase price or the price per share of the target firm may be calculated by taking into account a host of factors. Such as assets, earnings, etc. The market price of a share of the target can be a good approximation to find out the value of the firm. Theoretically speaking, the market price of share reflects not only the current earnings of the firm, but also the investor's expectations about future growth of the firm. However, the market price of the share cannot be relied in many cases or may not be available at all. For example, the target firm may be an unlisted firm or not being traded at the stock exchange at all and as a result the market price of the share of the target firm is not available. Even in case of listed and oftenly traded company, a complete reliance on the market price of a share is not desirable because (i) the market price of the share may be affected by insiders trading, and (ii) sometimes, the market price does not fully reflect the firm's financial and profitability position, as complete and correct information about the firm is nto available to the investors. Therefore, the value of the firm should be assessed on the basis of the facts and figures collected from various sources including the published financial statements of the target firm. The following approaches may be undertaken to assess the value of the target firm:

1. **Valuation based on assets:** In a merger situation, the acquiring firm 'purchases' the target firm and, therefore, it should be ready to pay the worth of the latter. The worth of the target firm, no doubt, depends upon the tangible and intangible assets of the firm. The value of a firm may be defined as:

Value = Value of all assets – External liabilities

In order to find out the asset value per share, the preference share capital, if any, is deducted from the net assets and the balance is divided by the number of equity shares. It may be noted that the values of all tangible and intangible assets are incorporated here. The value of goodwill may be calculated if not given in the balance sheet, and included. However, the fictious assets are not included in the above valuation. The assets of a firm may be valued on the basis of book values or realisable values as follows:

2. **Valuation based on earnings:** The target firm may be valued on the basis of its earnings capacity. With reference to the capital funds invested in the target firm, the firms value will have a positive correlations with the profits of the firm. Here, the profits of the firm can either be past profits or future expected profits. However, the future expected profits may be preferred for obvious reasons. The acquiring firm shows interest in taking over the target firm for the synergistic efforts or the growth of the new firm. The estimate of future profits (based on past experience) carry synergistic element in it. Thus, the future expected earnings of the target firm give a better valuation. These expected profit figures

are, however, accounting figures and suffer from various limitations and, therefore, should be converted into future cash flows by adjusting non-cash items. In the earnings based valuation, the PAT (Profit After Taxes) is multiplied by the Price-Earnings Ratio to find out the value.

Market price per share = EPS × PE ratio

The earnings yield gives an idea of earnings as a percentage of market value of a share. It may be noted that for this valuation, the historical earnings or expected future earnings may be considered.

3. Capital Asset Pricing Model (CAPM)-based share valuation: The CAPM is used to find out the expected rate of return, Rs, as follows:

$$Rs = IRF + (RM - IRF)\beta$$

Where,

Rs = Expected rate of return, IRF = Risk free rate of return, RM = Rate of Return on market portfolio, β = Sensitivity of a share to market.

For example, RM is 12%, IRF is 8% and β is 1.3, the Rs is:

$$Rs = IRF + (RM - IRF)\beta$$

$$= 0.08 + (0.12 - 0.08)\ 1.3 = 13.2$$

4. Valuation based on cash flows: Valuation of a target firm can also be made on the basis of firm's cash flows. In this case, the value of the target firm may be arrived at by discounting the cash flows, as in the case of NPV method of capital budgeting as follows:

i) Estimate the future cash inflows (i.e., Profit after tax + Non-cash expenses).

ii) Find out the total present value of these cash flows by discounting at an appropriate rate with reference to the risk class and other factors.

iii) If the acquiring firm is agreeing to takeover the liabilities of the target firm, then these liabilities are treated as cash outflows at time zero and hence deducted form the present value of future cash inflows [as calculated in step (ii) above].

iv) The balancing figure is the NPV of the firm and may be considered as the maximum purchase price, which the acquiring firm should be ready to pay.

5. Other methods of valuation: There are two other methods of valuation of business. Investors provide funds to a company and expect a minimum return which is measured as the opportunity cost of the investors, or, what the investors could have earned elsewhere. If the company is earning less than this opportunity cost of the investors, the company is belying the expectations of the investors. Conversely, if it is earning more, then it is creating additional value. New concepts such as Economic Value Added (EVA) and Market Value Added (MVA) can be used along with traditional measures of Return on Net Worth (RONW) to measure the creation of shareholders value over a period.

(a) Economic Value Added: EVA is based upon the concept of economic return which refers to excess of after tax return on capital employed over the cost of capital employed. The concept of EVA, as developed by Stern Steward and Co. of the U.S., compares the return on capital employed with the cost of capital of the firm. It takes into account the minimum expectations of the shareholders. EVA is defined in terms of returns earned by the company in excess of the minimum expected return of the shareholders. EVA is calculated as the net operating profit (Earnings before Interest but after taxes) minus the capital charges (capital employed × cost of capital). This can be presented as follows:

EVA = EBIT - Taxes - Cost of funds employed

= Net Operating Profit after Taxes - Cost of Capital Employed

where, Net Operating Profit after Taxes represents the total pool of profit available to provide a return to the lenders and the shareholders, and Cost of Capital Employed is Weighted Average Cost of Capital × Average Capital employed.

So, EVA is the post-tax return on capital employed adjusted for tax shield of debt) less the cost of capital employed. It measures the profitability of a company after having taken cost of debt (Interest) is deducted in the income statement. In the calculation of EVA, the cost of equity is also deducted. The resultant figure shows as to how much has been added in value of the firm, after meeting all costs. It should be pointed out that there is more to calculation of cost of equity than simple deduction of the dividends paid. So, EVA represents the value added in excess of the cost of capital employed. EVA increases if:

i) Operating profits grow without employing additional capital, i.e., through greater efficiency.

ii) Additional capital is invested in the projects that give higher returns than the cost of procuring new capital, and

iii) Unproductive capital is liquidated, i.e., curtailing the unproductive uses of capital.

EVA can be used as a tool in decision-making within an enterprise. It can help integration of customer satisfaction, operating efficiencies and, management and financial policies in a single measure. However, EVA is based on the performance of one year and does not allow for increase in economic value that may result from investing in new assets that have not yet had time to show the results. In India, EVA has emerged as a popular measure to understand and evaluate financial performance of a company. Several companies have started showing the EVA during a year as a part of the Annual Report. Hero Honda Ltd., BPL Ltd., Hindustan Lever Ltd., Infosys Technologies Ltd. And Balrampur Chini Mills Ltd. Are a few of them.

(b) Market Value Added (MVA) is another concept used to measure the performance and as a measure of value of a firm. MVA is determined by measuring the total amount of funds that have been invested in the company (based on cash flows) and comparing with the current market value of the securities of the company. The funds invested include borrowings and shareholders funds. If the market value of securities exceeds the funds invested, the value has been created.

4.7 REGULATIONS OF MERGERS AND TAKEOVERS IN INDIA

Mergers and acquisitions may degenerate into the exploitation of shareholders, particularly minority shareholders. They may also stifle competition and encourage monopoly and monopolistic corporate behaviour. Therefore, most countries have legal framework to regulate the merger and acquisition activities. In India, mergers and acquisitions are regulated through the provision of the Companies Act, 1956, the Monopolies and Restrictive Trade Practice (MRTP) Act, 1969, the Foreign Exchange Regulation Act (FERA), 1973, the Income Tax Act, 1961, and the Securities and Controls (Regulations) Act, 1956. The Securities and Exchange Board of India (SEBI) has issued guidelines to regulate mergers, acquisitions and takeovers.

Legal measures against takeovers

The Companies Act restricts an individual or a company or a group of individuals from acquiring shares, together with the shares held earlier, in a public company to 25 per cent of the total paid-up capital. Also, the Central Government needs to be intimated whenever such holding exceeds 10 per cent of the subscribed capital. The Companies Act also provides for the approval of shareholders and the Central Government when a company, by itself or in association of an individual or individuals purchases shares of another company in excess of its specified limit. The approval of the Central Government is necessary if such investment exceeds 10 per cent of the subscribed capital of another company. These are precautionary measures against the takeover of public limited companies.

4.8 REFUSAL TO REGISTER THE TRANSFER OF SHARES

In order to defuse situation of hostile takeover attempts, companies have been given power to refuse to register the transfer of shares. If this is done, a company must inform the transferee and the transferor within 60 days. A refusal to register transfer is permitted if :

- A legal requirement relating to the transfer of shares have not be complied with; or
- The transfer is in contravention of the law; or
- The transfer is prohibited by a court order; or
- The transfer is not in the interests of the company and the public.

Protection of minority shareholders' interests

In a takeover bid, the interests of all shareholders should be protected without a prejudice to genuine takeovers. It would be unfair if the same high price is not offered to all the shareholders of prospective acquired company. The large shareholders (including financial institutions, banks and individuals) may get most of the benefits because of their accessibility to the brokers and the takeover dealmakers. Before the small shareholders know about the proposal, it may be too late for them. The Companies Act provides that a purchaser can force the minority shareholder to sell their shares if:

- The offer has been made to the shareholders of the company;
- The offer has been approved by at least 90 per cent of the shareholders of the company whose transfer is involved, within 4 months of making the offer; and
- The minority shareholders have been intimated within 2 months from the expiry of 4 months referred above.

If the purchaser is already in possession of more than 90 per cent of the aggregate value of all the shares of the company, the transfer of the shares of minority shareholders is possible if:

- The purchaser offers the same terms to all shareholders and
- The tenders who approve the transfer, besides holding at least 90 per cent of the value of shares, should also form at least 75 per cent of the total holders of shares.

4.9 SUMMARY

Corporate restructuring refers to changes in ownership, business mix, assets mix and alliances with a motive to increase the value of shareholders. The economic considerations in terms of motives and effect of business combinations are similar but the legal procedures involved are different. A merger refers to a combination of two or more companies into one company. One or more companies may merge with an existing company or they may merge to form a new company. Mergers may be of three types (i) horizontal, (ii) vertical and (iii) conglomerate merger. The advantages of merger are economics of scale, synergy, strategic benefits, tax benefits and utilisation of surplus funds. The process of financial evaluation begins with determining the value of the target firm. The different approaches may be undertaken to assess the value of the target firm namely valuation based on assets, earnings, dividend, cash flows etc. After the value of a firm has been determined the next step is the choice of the method of payment to the acquired firm. The payment take the form of either cash or securities i.e., ordinary shares, convertible securities, deferred payment plans and tender offers.

4.10 GLOSSARY

- Merger: A merger is said to occur when two or more companies combine into one company. One or more companies may merge with an existing company or they may merge to form a new company.
- Absorption: A combination of two or more companies into an existing company.
- Acquisition: Acquisition may be defined as an act of acquiring effective control over assets or management of a company by another company without any combination of businesses.

4.11 SELF ASSESSMENT QUESTIONS

1. Discuss various methods of valuation at the time of merger and consolidation.

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2. Discuss the legal and procedural aspects of a merger.

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4.12 LESSON END EXERCISE

Q.1 Discuss the capital structure after merger and acquisitions.

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Q.2 Describe the financial problems faced by the concerns after mergers and consolidation.

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4.13 SUGGESTED READINGS

- I.M. Pandey, "Financial Management", Vikas Publishing House Pvt. Ltd., Ninth Edition.
- Prasanna Chandra, "Fundamentals of Financial Management", Tata McGraw Hill Ltd., 2006.
- Breaby and Myers, "The principles of Corporate Finance", 6th edition, Tata McGraw Hill, New Delhi.

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FINANCE FOR EXPANSION (MERGERS & ACQUISITIONS)

M.Com II Sem.	Advanced Accounting	Unit-I
M.Com – C 211		Lesson No. 5

STRUCTURE:

5.1 Introduction

5.2 Objectives

5.3 AS-14 (Accounting For Amalgamations)

5.4 SEBI (Substantial Acquisitions Of Shares And Takeover) Regulations, 1997

5.5 Computation of share exchange ratio, Pre merger EPS and Post merger EPS

5.6 Summary

5.7 Glossary

5.8 Self Assessment Questions

5.9 Lesson End Exercise

5.10 Suggested Readings

5.1 INTRODUCTION

The Accounting Standard 14, which came into force with effect from April I, 995 provides two methods of accounting for amalgamations namely (i) the pooling of interest method and (ii) the purchase method. The pooling of interest method is applicable to amalgamations in the nature of merger. The purchase method is used in accounting for amalgamations in the nature of purchase. Under the purchase method, the transferee company is required to account for the amalgamation either by incorporating the assets and liabilities at their existing values or by allocating the consideration to individual items of assets and liabilities on the basis of their fair value at the date of amalgamation.

5.2 OBJECTIVES

After going through this lesson, you should be able to understand the AS-14 (accounting for amalgamations)

5.3 AS-14 (Accounting For Amalgamations)

The Standard prescribes that if, at the time of amalgamation, the transferor and the transferee companies- have conflicting accounting policies, a uniform accounting policy must be adopted following the amalgamation. The Standard also provides for treatment of. 'reserves' on amalgamation. In the case of an amalgamation in the nature of a merger, the reserves appear in financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. In the case of an amalgamation in the nature of purchase, the identity of reserves other than reserves created under a statute, is not preserved. Similar treatment is provided in the Standard for treatment of the balance in profit and loss account of the transferor company.

The Standard also prescribes certain disclosures to be made in the first financial statements prepared following the amalgamation. The important disclosures to be made are:

(i) Names and general nature of business of the amalgamating companies.

(ii) Effective date of amalgamation for accounting purposes.

(iii) Particulars of the scheme sanctioned.

(iv) Description and number of shares issued together with exchange ratio.

(vi) The amount of difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

5.4 SEBI (SUBSTANTIAL ACQUISITIONS OF SHARES AND TAKEOVER) REGULATIONS, 1997

To safeguard the interests of shareholders and investors, the government has brought a code to regulate the takeover bids through SEBI (Substantial Acquisitions of Shares and Takeover) Regulations, 1997. The main objective of these regulations is to provide greater transparency through a system of disclosures of informations. Regulations 1 to 5 are the preview dealing with short title and commencement, definitions, applicability, the takeover panel and powers of the Board. Regualtions 6 to 29 deal with disclosures of shareholding and control in a listed company whereas regulations 30 to 37 relate to 'bail out takeovers'. Regulations 38 to 47 provide for investigation and action by the board. Regulations 6 to 37 as amended by the SEBI (Substantial Acquistions of Shares and Takeovers) Amendment Regulations, 1998 are reproduced below:

Regulation 6 : Transitional Provision :

(I) Any person, who holds more than five per cent shares or voting rights in any company, shall within two months of notification of these Regulations- disclose the aggregate shareholding in, that company, to the company. - -

(2) Every company whose shares are held by the persons referred to is sub-regulation (1) shall, within three months from the date of notification of these Regulations, disclose to all the stock exchanges on which the shares of the company are listed, the aggregate number of shares held by each person.

(3) A promoter or any person having control over a company shall within two months of notification of these Regulations disclose the number and percentage of shares or voting rights held by him and by person(s) X acting in concert with him in that company, to the company.

(4) Every company, whose shares are listed on a stock exchange, shall within three months of notification of these Regulations, disclose to all stock exchanges on which the shares of the company are listed, the names and addresses of promoters and or person(s) having control over the company, and number and percentage of shares or voting rights held by each such person.

7. Acquisition of 5% and more shares or voting rights of a company :

(I) Any acquirer, who acquires shares or voting rights which (taken together with shares or voting rights, if any, held by him) would entitle him to more than five per cent shares or voting rights in a company, in any manner whatsoever shall disclose the aggregate of his shareholding or voting right in that company, to the company.

(2) The disclosure mentioned in sub-regulation (1) shall be made within four working days of:-(a) the receipt of intimation of allotment of shares; (b) the acquisition of shares or voting rights, as the case may be.

(3) Every company, whose shares are acquired in a manner referred to in sub regulation (1), shall disclose to all the stock exchanges on which the shares of the said company are listed the aggregate number of shares held 3y each of such persons referred above within seven days of receipt of information under sub- regulation (1).

8. Continual disclosures :

(1) Every person, including a person mentioned in Regulation 6 who holds more than (fifteen) percent shares or voting tights in any company, shall, within-2 1 days from the financial year ending March 31, make yearly disclosures to the company, in respect of his holdings as on 31st March.

(2) A promoter or every person having control over a company shall, within2l days from the financial year ending March 31, as well as the record date of the company for the purposes of declaration of dividend, disclose the number and percentage of shares or voting rights held by him and by persons acting in concert with him, in that company to the company. -

(3) Every company whose shares are listed on a stock exchange, shall within 30 days from the financial year ending March 31, as well-as the record date of the company for the purposes of declaration of dividend, make yearly disclosures to all the stock exchanges on which the shares of the company are listed, the changes, if any, in respect of the holdings of the persons referred to under sub-regulation (1) and also holdings of promoters or persons(s) having control over the company as on 31st March.

(4) Every company whose shares are listed on a stock exchange shall maintain a register in the specified format to record the information received under sub-regulation (3) of Regulation 6. sub-regulation (1) of Regulation 7 and sub-regulation (2) of Regulation 8.

9. Power to call for information :

The stock exchanges and the company shall furnish to the Board information with regard to the disclosures made under Regulations 6,7 and 8 as and when required by the Board. Substantial Acquisition of shares or voting rights in and acquisition of control over a listed company.

10. Acquisition of (15%) or more of the shares or voting rights of any company : No acquirer shall acquire shares or voting rights which (taken together with shares or voting right, if any, held by him or by persons acting in concert with him) entitle such acquirer to exercise(fifteen) percent or more of the voting right in a company, unless such acquirer makes a public announcement to acquire shares of such company in accordance with the Regulations. -

11. Consolidation of holdings :

(I) No acquirer who, together with persons acting in concert with him, has acquired, in accordance with the provisions of law 15% or more but less than 75% of the shares or voting rights in a company, shall acquire. either by himself or through or with person acting in concert with him additional shares or voting rights entitling him to exercise more than (5%) of the voting rights, in any period of 12 months, unless such acquirer makes a public announcement to acquire shares in accordance with the Regulations.

(2) No acquirer who, together with persons acting in concert with him has acquired in accordance with the provisions of law, 75% of the shares or voting rights in a company shall acquire either by himself or through persons acting in concert with him any additional shares or voting rights, unless such acquirer makes a public announcement to acquire shares in accordance with the regulations.

Explanation — For the purposes of Regulations 10 and Regulations ii acquisition shall mean and include:

(a) direct acquisition in a listed company to which the Regulations apply;

(b) indirect acquisition by virtue of acquisition of holding companies, whether listed or unlisted, whether in India or abroad.

12. Acquisitions of control over a company :

Irrespective of whether or not there has been any acquisition of shares or voting rights in a company, no acquirer shall acquire control over the target company, unless such person make a public announcement to acquire shares and acquires such shares in accordance with the Regulations. Provided that nothing contained herein shall apply to any change in control which takes place in pursuance to a resolution passed by the shareholders in general meeting.

Explanation- (1) For the purposes of this Regulations, where there are two or more persons in control over the target company, the lesser of any one such person from such control shall not be deemed to be a change in control of management nor shall any change in the nature and quantum of control amongst them constitute change in control of management:

Provided however that if the transfer of joint control to sole control is through sale at less than the market value of the shares, a shareholders meeting of the target company shall be convened to determine mode of disposal of the shares of the outgoing shareholder, by a letter of offer or by block-transfer to the existing shareholders in control in accordance with the decision passed by a special resolution. Market value in such cases shall be determined in accordance with Regulation 20; (ii) where any person or persons are given joint control, such control Shall not be deemed to be change in control so long as the control given is equal to or less than the control exercised by person(s) presently having control over the company.13. Appointment of a Merchant Banker.— Before making any public announcement of offer referred. to in Regulation 10 or Regulation 11 or Regulation 12 the acquirer shall appoint a merchant banker in Category I holding a certificate of registration granted by the Board, who is not associate of or group of the acquirer or the target company.

14. Timing of the Public Announcement of Offer :

(I) The public announcement referred to in Regulation 10 or Regulation 11 shall be made by the merchant banker not later than four working days of entering into an agreement for acquisition of shares or voting right &or deciding to acquire shares or voting rights exceeding the respective percentage specified therein.

(2) In case of, an acquirer acquiring securities, including Global Depository Receipts or American Depository Receipts which, when taken together with the voting rights, if any already held by him or persons acting in concert with him, would entitle him to voting rights, exceeding the percentage specified in Regulation 0 or Regulation lithe public announcement refrred to in sub-regulation (1) shall be made not later than four working days before he acquired voting rights on such securities upon conversion or exercise of option as the case may be.

(3) The public announcement referred loin Regulation 12 shall be made by the merchant banker not later than four working days after any such change or changes are decided to be made as would result in the acquisition of control over the target company by the acquirer.

15. Public Announcement of Offer :

(I) The public announcement to be made under Regulation 10 or 11 or 12 shall be made in all editions of one English national daily with wide circulation, one Hindi national daily with wide circulation and a regional language daily with wide circulation at the place of the 'tock exchange where the shares of the target company are most frequently traded.

(2) A copy of the public announcement to be made under Regulation 10, II or 12 shall be submitted to the Board through the me\chant banker at least two working days before its issuance.

(3) Simultaneous with\the submission of the public announcement to the Board, the public announcement shall also be sent to all th stock exchanges on which the shares of the company are listed for being notified on the notice board, and to the target company at its registered office for being placed before the board of directors of the company.

(4) The offer under these Regulations shall be deemed to have been made on the date on which the public announcement has appeared in any of the newspapers referred to in sub-regulation (I).

16. Contents of the Public Announcement of Offer :

The Public announcement referred to in Regulation 10 or 11 or 12 shall contain the following particulars, namely:

(i) the paid up share capital of the target company, the number of fully paid up and partly paid up shares;

(ii) the total number and percentage of share proposed to be acquired from the public, subject to a minimum as specified in sub-regulation(l) of Regulation 21;

(iii) the minimum offer price for each fully paid up or partly paid up share;

(iv) mode of payment of consideration;

(v). the identity of the acquirer(s) and in case the acquirer is a company or companies, the identity of the promoters and, or the persons having control over such company(ies) and the-group, if any, to which the company(ies) belong;

(vi) the listing holding, if any of the acquirer in the shares of the target company including holding of persons acting in concert with him;

(vii) salient features of the agreement, if any, such as the date, the name of the seller, the price at which the shares are being acquired, the manner of payment of the consideration and the number and percentage of shares in respect of which the acquirer has entered into the agreement to acquire the shares or the consideration, monetary or otherwise, for the acquisition of control over the target company, as the case may be;

(viii) the highest and the average price paid by the acquirer or persons acting in concert with him for acquisition, if any, of shares of the target company made by him during the twelve month period prior to the date of public announcement;

(ix) object and purpose of the acquisition of the shares and future plans, if any, of the acquirer for the target company, including disclosures whether the acquirer proposes, to dispose of or otherwise encumber any assets of the target company in the succeeding two eyars, except in the ordinary course of business of the target company:

Provided that where the future plans are set out, the public announcement shall also set out how the acquirers proposes to implement such future plans.

(x) the 'specified date' as mentioned in Regulation 19;

(xi) the date by which individual letters of offer would be posted to each of the shareholders;

(xii) the date of opening and closure of the offer and the manner in which and the date by which the acceptance or rejection of the offer would be communicated to the shareholders;

(xiii) the date by which the payment of consideration would be made for the shares in respect of which the offer has been accepted;

(xiv) disclosure to the effect that firm arrangement for financial resources required to implement the offer is already in place, including details regarding the sources of the funds whether domestic i.e., from banks, financial institutions, or otherwise or foreign i.e. from Non-resident Indians or otherwise;

(xv) provision for acceptance of the offer by person(s) who own the shares but are not the registered holders of such shares;

(xvi) statutory approvals, is any, required to be obtained for the purpose of acquiring the shares under the Companies Act, 1956 (1 of 1956), the Monopolies and Restrictive Trade Practices Act, 1969 (54 of 1969), the Foreign Exchange Regulation Act, 1973(46 of 1973), and/or any other applicable laws;

(xvii) approvals of banks or financial institutions required, if any;

(xviii) whether the offer is subject to a minimum level of acceptances from the shareholders; and

(xix) such other information as is essential for the shareholders to make an informed decision in regard to the offer.

17. Brochures, advertising material, etc :

The public announcement of the offer or any other advertisement, circular, brochure, publicity material or letter of offer issued in relation to the acquisition of shares shall not contain any misleading information.

18. Submission of letter of offer to the Board :

(1) Within fourteen days from the date of public announcement made under Regulation 10, 11 or 12 as the case may be, the acquirer shall, through its merchant banker, file with the Board, the draft of the letter of offer, containing disclosures as specified by the Board.

(2) The Letter of offer shall be dispatched to the shareholders not earlier than 21 days from its submission to the Board under sub-regulation (1)

Provided that if, within 21 days from the date of submission of the letter of offer, the Board specifies changes, if any in. the letter of the merchant banker and the acquirer shall carry Out such changes before the letter of offer is dispatched to the shareholders.

(3) The acquirer shall, along with the draft letter of offer to in sub-regulation (1), pay a fee of Rs. 50,000 to the Board either by a bank cherub or demand draft in favored the Securities and Exchange Board of India, payable at Mumbai.

19. Specified date :

The public announcement shall specify a date, which shall be the 'specified date' for the purpose of determining the names of the shareholders to whom the letter of offer should be sent:

Provided that such specified date shall not be later than the thirtieth day from the date of the public announcement.

20. Minimum offer price :

(1) The offer to acquire the shares under Regulation 10, 11 or 12 shall be made at a minimum offer price which shall be payable —

(a) in cash; or (b) by exchange and, or transfer of share of acquirer company, if the person seeking to acquire the shares is a listed body corporate; or

(c) by exchange and for transfer of secured instruments with a minimum of 'A' grade rating form a credit rating agency; (d) a combination of clause (a, (b) or (c); Provided that where payment had been made in cash to any class of shareholders for acquiring their shares under any agreement or pursuant to any acquisition in the open market or in any other manner during the preceding 12 months from the date of public announcement, the offer document shall provide that .the shareholders have the option to accept payment either in cash or by exchange of shares or other secured instruments referred to. above. (2) For the purpose of sub-regulation (1), the minimum offer price shall be the highest of —

(a) the negotiated price under the agreement referred to in sub-regulations (1) of Regulation 14;

(b) highest price paid by the acquirer or persons acting in concert with him for any acquisitions, including by way of allotment in a public-or rights issue, if any, during the 26 week period prior to the date of public announcement;

(c) the price paid by the acquirer under a preferential allotment made to him or to persons acting iq concert with him, at any time during the twelve month period upto the date of closure of the offer;

(d) the average of the weekly high and low of the closing prices of the shars of the target company as quoted on the stock exchange where the shares of the company are most frequently traded during the 26 weeks preceding the date of public announcement.

(3) Where the shares of the target company are infrequently traded, the offer price shall be determined by the issuer and the merchant banker taking into account the following factors:

(a) the negotiated price under the agreement referred to in sub-regulation (I) of Regulation 14;

(b) highest price paid by the acquirer or persons acting in concert with him for acquisitions including by way of allotment in a public or rights issue, if any, during the 26 week period prior to the date of public announcement; (c) the price paid by the acquirer under a preferential allotment made to him or to persons acting in connection with him, at ant time during the twelve month period upto the date of closure of the offer; (d) other parameters including return on net worth, book value of the shares of the target company, earning per share, price earning multiple vis-a-vis the industry average.

Explanation :

(i) For the purpose of this clause, shares will be deemed to be infrequently traded if on the exchange, the annual trading turnover in that share during the preceding 6 colander months prior to the month in which the public announcement is made is less than two per cent (by number of shares) of the listed shares. For this purpose, the weighted average number of shares listed during the said six months period may be taken.

(ii) In case of shares which have been listed within six months preceding the public announcement, tube trading turnover may be annualized with reference to the actual number of days for which the share has been listed. -.- .

(4) Notwithstanding the provisions of sub-regulations (I), (2) and (3) above, where the acquirer has acquired shares in the open market or through negotiation or otherwise, after the date of public announcement at a price higher than the minimum offer price stated in the letter of offer, then the highest price paid for such acquisition shall be payable for all acceptances received under the offer:

Financing for Expansion Mergers Provided that no such acquisition shall be made by the acquirer during the last seven working day prior to the closure of the offer.)

(5) In case where the shares or secured instruments of the acquirer company are offered in lieu of cash payment, the value of such shares or secured instruments, shall be determined in the same manner as mentioned in sub-regulations (2) and (3) above to the extent applicable, as duly certified by an independent Category I Merchant Banker (other than the managers to the offer) or an independent Chartered Accountant of 10 years standing.

(6) The letter of offer shall contain justification on the basis on which the price has been determined. Explanation (1) The highest price under clause (b) or the average price under clause Cod) of sub-regulation (2) may be adjusted for quotation, if any, on cum-right or cum-bonus basis during the said period.

(2) Where the public announcement of offer is pursuant to acquisition by way of firm allotment in a public issue or preferential allotment, the average price under clause (d) of sub-regulation (2) shall be calculated with reference to the 26 week period preceding the date of the board resolution which authorised the firm, preferential allotment.

(3) Where the shareholders have been provided with an option to accept payment either in cash or by way of exchange of security, then, subject to the provisions of Regulation 20, the pricing for the cash offer could be different from that of a share exchange offer or offer for exchange with secured instruments, provided that the disclosures in the offer documents contain suitable justifications for such differential pricing.

(4) Where the offer is subject to a minimum level of acceptances, the acquirer may subject to the provision of Regulation 20, indicate a lower price for the minimum acceptance of 20% should the offer not receive full acceptance.

21. Minimum number of shares to be acquired :

(1) The public offer shall be made to the shareholders of the target company to acquire from them an aggregate minimum of 20% of the voting capital of the company; Provided that where the open offer is made in pursuance to sub regulation (2) of Regulation 11, the public offer shall be for such percentage of the voting capital of the company as may be decided by the acquirer.

(2) Where the offer is conditional upon minimum level of acceptances from the shareholders as provided for in clause (xviii) if Regulation 16 the provisions of sub regulation (1) of this regulation shall not be applicable, if the acquirer has deposited in escorw account in cash a sum of 50% of the consideration payable under the public offer.

(3) If the public offer results in the public shareholding being reduced to 10% or less of the voting capital of the company, or if the public offer is in respect to a company which has public share holding of less than 10% of the voting capital of the company, the acquirer shall either —

(a) with in a period of three months from the date of closure of the public offer, make an offer or buy out the outstanding shares remaining with the shareholders at the same offer price, which may result in delisting of the target company; or

(b) undertake to disinvest through an offer for sale or by a fresh issue of capital to the public, which shall open within a period of 6 months from the date of closure of the public offer, such number of shares so as to satisfy the listing requirements.

(4) The letter of offer shall state clearly the option available to the acquirer under sub-regulation (3).

(5) For the purpose of computing the perventage referred to sub-regulations (I), (2) and (3) the voting rights as at the expiration of 30 days after the closure of the public offer shall be reckoned.

(6) Where the number of shares offered for sale by the shareholders are more than the shares agreed to be acquired by the person making the offer, such person shall, accept the offers received from the shareholders on a proportional basis, in consulation with the merchant banker, taking care to ensure that the basis of acceptance is decided in a fair and equitable manner and does not result in non-marketable lots

Provided that acquisition of shares from a shareholder shall not be less than the minimum marketable lot or the entire holding if it is less than the marketable lot.

22. General obligations of the acquirer :

(I) The public announcement of offer to acquire the shares of target company shall be made only when the acquirer is able to implement the offer.

(2) Within 14 days of the public announcement of the offer, the acquirer shall send a copy of the draft letter of offer to the target company at its registered office address, for being placed before the board of directors and to all the stock exchanges where the shares of the company are listed.

(3) The acquirer shall ensure that the letter of offer is sent to all the shareholders (including non-resident Indians) of the target company, whose names appear on the register of members of the company as on the specified date mentioned in the public announcement, so as to reach them within 45 days from the date of public announcement:

Provided that where the public announcement is made pursuant to an agreement to acquire shares or control over the target company, the letter of offer shall be sent to shareholders other than the parties to the agreement.

Explanation.—

(i) A copy of the letter of offer shall also be sent to the Custodians of Global Depository Receipts or American Depository Receipts to enable such persons to participate in the open offer, if they are entitled to do so.

(ii) A copy of the letter of offer shall also be sent to warrant holders or-convertible debenture holders, where the period of exercise of option or conversion falls within the offer period.

(4) The date of opening of the offer, shall be not later than the sixtieth day form the date of public announcement.

(5) The offer to acquire shares form the shareholders shall remain open for a period of 30 days.

(6) In case the acquirer is a company, the public announcement of offer, brochure, circular, letter of offer or any other advertisement or publicity material issued to shareholders in connection with the offer must state that the directors accept the responsibility for the information contained in such documents.

Provided that if any of the directors desires to exempt himself from responsibility for the information in such document, such director shall issue a statement to that effect, together with reasons thereof for such statement.

(7) During the otter period, the acquirer or persons acting in concert with him shall not be entitled to be appointed on the Board of Directors of the target company.

(8) Where an offer is made conditional upon minimum response to the minimum level of acceptances acquirer or any person acting in concert with him;

(i) shall, irrespective of whether or not the offer received response to the minimum level of acceptances, acquire shares from the public to the extent of the minimum percentage specified in sub-regulation (l) of Regulation 2L

Provided that the provisions of this clause shall not be applicable in case the acquirer has deposited in the escrow account, in cash 50% of the consideration payable under the public offer;

(ii) shall not acquire, during the offer period, any shares in the target company, except by way of fresh issue of shares of the target company, as provided for under regulations 3;

(iii) shall be liable for penalty of forfeiture of entire escrow amount, for the non-fulfillment of obligations under the Regulations.

(9) If any of the persons representing or having interest in the acquirer is already a director on the board of the target company Uris an “insider” within the meaning of SEBI (Insider Trading) Regulations, 1992. he shall recues himself and not participate in any matter(s) concerning or relating’ to the offer including any preparatory steps leading to the offer. -.

(10) On or before the date of issue of public announcement of offer, the acquirer shall create an escrow account as provided under Regulations 28.

(11) The acquirer shall ensure that firm financial arrangement has been made for fulfilling the obligations under the public offer and suitable disclosures in this regard shall be made in the public announcement of offer.

(12) The acquirer shall, within a period of 30 days from the date of the closure of the offer complete all procedures relating to the offer including payment of consideration to be shareholders who have accepted the offer and for the purpose open a special account as provided under Regulations 29:

Provided that where the acquirer is unable to make the payment to the shareholders who have accepted the offer before the said period of 30 days due to non-receipt of requisite statutory approvals, the Board may, if satisfied that non-receipt of requisite statutory, approvals was not due to any willful default or neglect of the acquirer or failure of the acquirer to diligently pursue the applicants for such approvals, grant extension of cherub for the purpose, subject to the acquirer agreeing to pay interest to the shareholders of delay beyond 30 days, as may be specified by the Board from time to time.

(13)Where the acquirer fails to obtain the requisite statutory approvals in time on account of willful default or neglect or inaction or non-action on his part, the amount being in the escrow account shall be liable to be forfeited and dealt with in the manner provided in clause (e) of sub-regulation (I 2). of Regulations 28, apart from the acquirer being liable for penalty as provided in the Regulations.

(14) In the event of withdrawal of offer in terms of the Regulations, the acquirer shall not make any offer for acquisition of shares of the target company for a period of six months from the date of public announcement of withdrawal of offer.

(15) In the event of non-fulfillment of obligations under Chapter III or Chapter IV of the Regulations, the acquirer shall not make any offer for acquisition of shares of any failed company for a period of twelve months from the date of closure of offer.

(16) If the acquirer, in pursuance to an agreement, acquire shares which along with his existing holding, f any, increases his shareholding beyond (15%) then such agreement for sale of shares shall contain a clause to the effect that in case of non compliance of any provisions of this regulation, the agreement for such sale not be acted upon by the seller or the acquirer. -

(17) Where the acquirer or persons acting in concert with him has acquired any shares (in terms of sub regulation 4 of regulation 20), he shall disclose the number, percentage, the price and the mode of acquisition of such shares to the stock exchanges on which the shares of the target company are listed and to the merchant bankers, within 24 hours of such acquisition.

(18) Where the acquirer has noting the public announcement and, or the letter of offer stated his intention to dispose of or otherwise encumber any assets of the target company except in the ordinary course of business of the target company, the acquirer, where he has acquired control over the target company, shall be debarred from disposing of or otherwise encumbering the assets of the target company for a period 2 years from the date of closure of the public offer.

23. General obligations of the board of directors of the target company :

(I) Unless the approval of the general body of shareholders is obtained after the date of the public announcement of offer, the Board of Directors of the target company shall not, during the offer period.—

(a) sell, transfer, encumber or otherwise dispose of pr enter into an agreement for sale, transfer, encumbrance or for disposal of assets otherwise, not being sale or disposal of assets in the ordinary course of business, of the company or its subsidiaries; or

(b) issue any authorized but unissued securities carrying voting rights during the offer period;

(c) enter into any material contracts.

Explanation.— Restriction on issue of securities under clause (b) of sub-regulation (1) shall not affect the right of the target company to issue and allot shares carrying voting rights upon conversion of debentures already issued or upon exercise of option against warrants as per-determined terms of conversion/exercise of option.

(2) The target company shall furnish to the acquirer, within 7 days of the request of the acquirer or within 7 days from the specified date, whichever is later, a list of shareholders Or warrant holders or convertible debenture holder as are eligible for participation under Explanation (2)to sub-regulation (3) of Regulation 22 containing names, addresses, shareholding and folio number, and of those persons whose applications for registration of transfer of shares are pending with the company.

(3) Once the public announcement has been made, the board of directors of the target company shall ,not,—

(a) appoint as additional director or fill in any casual vacancy on the Board of Directors, by any person(s) representing or having interest in the acquirer till the date of certification by the merchant banker as provided under sub-regulation (6) below:

Provided that upon closure of the offer and the full amount of consideration payable to the shareholders being deposited in the special account, changes as would give the acquirer representation on the Board or control over the company, can be made by the target company;

(b) allow any person or persons representing or having no interest in the acquirer, if he is already a director on the board of the target company before the data of the public announcement, to participate in any mater relating to the offer, including any preparatory steps leading thereto.

(4) The board of directors of the target company may, if they so desire, send their unbiased comments and recommendations on the offer(s) to the shareholders, keeping in mind the opinion of an independent merchant banker or a committee of Independent Directors:

Provided that for any misstatement or for concealment of material information, the directors shall be liable for action in terms of these Regulations and the Act.

(5) The Board of Directors of the target company shall facilitate the acquirer in verification of securities tendered for acceptances.

(6) Upon fulfillment of all obligations by the acquirers under the Regulations as certified by the merchant banker, the Board of Directors of the target company shall transfer the securities acquired by the acquire, whether under the agreement or from market purchases, in the name of the acquirer and, or allow such changes in the Board of Directors as would give the acquirer representation on the board or control over the compan3l

(7) The obligations provided for in sub-regulation (16) of Regulation 22 shall be complied with by the company in the circumstances specified therein.

24. General obligations of the merchant banker:

(I) Before the public announcement of offer is made, the merchant banker shall ensure that:

(a) the acquirer is able to implement the offer;

(b) the provision relating to Escrow account referred to in Regulation 28 has been made;

(c) firm arrangements for funds and money for payment through verifiable means to fulfil the obligations under the offer are in place;

(d) the public announcement of offer is made in terms of the Regulations.

(2) The merchant banker shall furnish to the Board a due diligence certificate which shall accompany the draft letter of offer.

(3) The merchant banker shall ensure that the draft public announcement and the letter of offer is filed with the Board, target company and also sent to all the stock exchanges on which the shares of the target company are listed in accordance with the Regulations.

(4) The merchant banker shall ensure that the contents of the public announcement of offer as well as the letter of offer are true, fair and adequate and based on reliable sources quoting the source wherever necessary.

(5) The merchant banker shall ensure compliance of the Regulations and any other laws or rules as may be applicáble in this regard.

(6) Upon fulfillment of all obligations by the acquirers under the Regulations, the merchant banker shall cause the bank with whom the escrow amount has been deposited to release the balance amount to the acquirers.

(7) The merchant banker shall send a final report to the Board within 45 days from the date of closure of the offer.

25. Competitive bid :

(I) Any person, other than the acquirer who has made the first public announcement, who is desirous of making any offer, shall, within 21 days of the public announcement of the first offer make a public announcement of his offer for acquisition of the shares of the same target company, Explanation— An offer made under sub-regulation (1) shall be deemed to be a competitive bid.

(2) No public announcement for an offer or competitive bid shall be made after 21 days from the date of public announcement of the first offer.

(3) Any competitive offer by an acquire shall be for such number of shares which when taken together with shares held by him along with persons acting in concert with him, shall be at least equal to the number of shares for which the first public announcement has been made.

(4) Upon the public announcement of a competitive bid or bids, the acquirer who had made the public announcement of the earlier offer shall have the option to make an announcement:

(a) revising the offer; or (b) withdrawing the offer, with the prior approval of the Board.

Provided that if no such announcement is made within fourteen days of the announcement of the competitive bid(s), the earlier offer(s) on the original terms shall continue to be valid and binding on the acquirer(s) who had made the offer(s) except that the date of closing of the offer shall stand extended to the date of the closure of the public offer under the last subsisting competitive bid.

(5) The provisions of these Regulations shall mutatis mutandis apply to the competitive bid(s) made under sub-regulation (I).

(6) The acquirers who had made the public announcement of offer(s) including the public announcement of competitive bid(s) but have not withdrawn the offer in terms of sub-regulation (4) shall have the option to make upward revisions in his offer(s) ,in respect to the price and the number of shares to be acquired, at any time up to seven working days prior to the date of closure of the offer:

Provided that the acquirer shall not have the option to change any other terms and conditions of their offer:

Provided further that any such upward revision shall be made only upon the acquirer—

(a) making a public announcement in respect of such changes or amendments in all the newspapers in which the original public announcement was made;

(b) simultaneously with the issue of public announcement referred in clause (a), informing the Board, all the stock exchanges on which the shares of the company are listed, and the target company at its registered office;

(c) increasing the value of the escrow account as provided under sub-regulation (9) of Regulation 28;

(7) Where there is a competitive bid, the date of closure of the original bid as also the date of closure of all the subsequent competitive bids shall be date of closure of public offer

under the last subsisting competitive bid and the public offers under all the subsisting bids shall close on the same date.

26. Upward revision of offer :

Irrespective of whether or not there is a competitive bid, the acquirer who has made the public announcement of offer, may make upward revisions in his offer in respect to the price and the number of shares to be acquired, at any time up to seven working days prior to the date of the closure of the offer.

Provided that any such upward revision of offer shall be made only upon the acquirer —

(a) making a public announcement in respect of such changes or amendments in all the newspapers in which the original public announcement was made;

(b) simultaneously with the issue of such public announcement, informing the Board, all the stock exchanges on which the shares of the company are listed and the target company at its registered office.

(c) increasing the value of the escrow account as provided under sub-regulation (9) of Regulation 28.

27. Withdrawal of offer :

(1) No public offer, once made shall be withdrawn except under the following circumstances:

(a) the withdrawal is consequent upon any competitive bid. (Is) the statutory approval (s) required have been refused;

(c) the sole acquirer, being a natural person person; has died;

(d) such circumstances as in the opinion of the Board merits withdrawal.

(2) In the event of withdrawal of the offer under any of the circumstances specified under sub-regulation (I), the acquirer or the merchant banker shall:

(a) make a public announcement in the same newspapers in which the public announcement of offer was published, indicating reasons for withdrawal of the offer;

(b) simultaneously with the issue of such public announcement, inform —(i) the Board (ii) all the stock exchanges on which the shares of the company are listed; and (iii) the target company as its registered office.

28. Provision of Escrow :

(1) The acquirer shall as and by way of security forperformance of-his obligations under the Regulations, deposit in an Escrow Account such amount as specified in sub-regulation (2).

(2) The escrow amount shall be calculated in the following manner

(a) For consideration payable under the public offer upto and including Rs. 100 crores —25% exceeding Rs. 100 crores — 25% upto Rs. 100 crores and 10% thereafter.

(b) For offers Which are subject to a minimum level of acceptance and the acquirer does not want to acquire a minimum of 20%, then 50% of the consideration payable under the public offer in cash shall be deposited in the escrow amount.

(3) The total consideration payable under the public offer shall be calculated assuming acceptances and at the highest price if the offer is subject to differential pricing, irrespective of whether the consideration for the offer is payable in cash or otherwise.

(4) The Escrow account referred in sub-regulation (I) shall consist of,

(a) cash deposit with a scheduled commercial bank; or

(b) bank guarantee in favour of the merchant banker; or

(c) deposit of acceptable securities with appropriate margin with the merchant banker; or

(d) cash, deposited with a scheduled commercial bank in case of clause (b) of sub-regulation (2) of this Regulation.

(5) Where the Escrow account consist of deposit with a scheduled commercial bank. acquirer shall, while opening the account, empower the merchant banker

appointed for the offer to instruct the bank to issue a banker's cheque or demand draft for the amount lying to the credit of the Escrow Account, as provided in the regulations.

(6) Where the Escrow Account consist of bank guarantee, such bank guarantee shall be in favour of the merchant banker and shall be valid at least for a period commencing from the date of public announcement until 30 days after the closure of the offer.

(7) The acquirer shall, in case the Escrow Account consists of securities empower the merchant banker to realise the value of such Escrow Account by sale or otherwise provided that if there is any deficiton realisation of the value of the securities, the merchant banker shall be liable to make good any such deficit.

(8) In case the Escrow Account consists of bank guarantee or approved securities these shall not be returned by the merchant banker till after cmpletion of all obligations under the Regulations.

(9) In case there is any upward revision of offer, consequent upon a competitive bid-or otherwise, the value of the Escrow Account shall be increased to equal at least 10% of the consideration payable upon such revision.

(10) Where the Escrow Account consist of bank guarantee or deposit of approved securities, the acquirer shall also deposit with the bank a sum of at least 1% of the total consideration payable, as and by way of security of fulfillment of the obligations under the Regulations by the acquirers.

(11) The Board shall in case of non-fulfillment of obligations under the Regulations by the acquirer forfeit the Escrow Account either in full or in part.

(12) The Escrow Account deposited with the bank in cash shall be realised only in the following manner,—

(a) the entire amount to the acquirer upon with drawl of offer in terms of Regulations 27 upon certification by the merchant banker;

(b) for transfer to the special account opened in terms of sub-regulation (t) of Regulation 29;

Provided the amount so transferred shall not exceed 90% of the cash deposit made under clause (a) of sub-regualtion (2) of this Regulation;

(c) to the acquirer, the balance of 10% of the cash deposit made under clause (a) sub-regulation (2) of this Regulation or the cash deposit made under sub-regulations, upon certification by the merchant banker, where the offer is for exchange of shares or other secured instruments;

(d) the entire amount to the merchant banker, in the event of forefeiture for no-fulfillment of any of the obligations under the Regulations, for distributions among the target company, the regional stock exchange and to the shareholders who had accepted the offer in the following manner, after deduction of expenses if any, of the merchant banker and the registrar to the offer.—

(i) one-thrid of the amount to the target company;

(ii) one-thrid of the amount to the regional stock exchange for credit of the investor protection fund or any other similar fund for investor education, research, grievance redresal and similar such purposes as may be specified by the Board from time to time.

(iii) residual one-thrid to be distributed pro rata among the shareholders who have accepted the offer.

(13) In the event of non-fulfillment of obligations by the acquirer, the merchant banker shall ensure realisation of Escrow Amount by way of foreclosure of deposit, invocation of bank guarantee or sale of securtiies and credit proceeds thereof to the regional stock exchange of the target company, for the credit of the Investor Protection Fund or any other similar fund,

29. Payment of consideration :

(1) For the amount of consideration payable in cash, the acquirer shall, within a period of 21 days from the date of closure of the offer, open a special account with a Bankers to an Issue registered with the Board and deposit therein, such sum as would, together with 90% of the amount lying in the Escrow Account, if any, make up the entire sum due and payable to the shareholders as consideration

for acceptances received and accepted in terms of these Regulations and for this purpose, transfer the funds from the Escrow Account.

(2) The unclaimed balance lying to the credit of the account referred in sub-regulation (I) at the end of 3 years from the date of deposit thereof shall be transferred to the investor protection fund of the regional stock exchange of the target company.

(3) In respect of consideration payable by way of exchange of securities, the acquirer shall ensure that the securities are actually issued and despatched to the shareholders.

30. Bail out takeovers :

(1) The provisions of this Chapter shall apply to a substantial acquisition of shares in financially weak company not being a sick industrial company, in pursuance to a scheme of rehabilitation approved by a public financial Institution or a scheduled bank; (hereinafter referred to as lead institution).

(2) The lead institution shall be responsible for ensuring compliance with the provisions of this Chapter.

(3) The lead institution shall appraise the financially weak company taking into account the financial viability, and assess the requirement of funds for revival and draw up the rehabilitation package on the principle of protection of interests of minority shareholders, good management, effective revivial and transparency.

(4) The rehabilitation scheme shall also specifically provide the details of any change in management.

(5) The scheme may provide for acquisition of shares in the financially weak company many of the following manner;

(b) exchange of shares, or

(c) a combination of both;

Provided that the scheme as far as possible may ensure that after the proposed acquisition the erstwhile promoters do not own any shares in case such acquisition is ma4e by the new promoters pursuant to such scheme.

Explanation.— For the purpose of this Chapter, the expression “financially week company" means a company, which has at the end of the previous financial year cumulated losses, which has resulted in erosion of more than 50% but less than 100% of its net worth as at the beginning of the previous financial year, that is to say, of the total of the paid-up capital and free reserves.

31. Manner of acquisition of shares :

(I) Before giving effect to any scheme of rehabilitation the lead institution shall invite offers for acquisition of shares from) at least three parties.

(2) After receipt of the offers under sub-regulation (1) the lead institution shall select one of the parties having regard to the managerial competence, adequacy of financial resources and technical capability of the person acquiring shares to rehabilitate the financially weak company.

(3) The lead institution shall provide necessary information to any person intending to make an offer to acquire shares about the financially weak company and particularly in relation to its present management, technology range of products manufactured, shareholding pattern financial holding and performance and assets and liabilities of such company for a period covering five years from the date of the offer as also the minimum financial and other commitments expected of from the person acquiring shares for such rehabilitation.

32. Manner of evaluation of bi1ls :

(I) The lead institution shall evaluate the bids received with respect to the purchase price or exchange of shares, track record, financial resources, reputation of the management, of the person acquiring shares and ensure fairness and transparency in the process. (2) After making evaluation as provided in sub-regulation (1), the offers received shall be listed in order of preference and after consultation with the persons in the affairs of the management of the financially weak company accept one of the bids.

33. Person acquiring shares to make an offer :

The person acquiring shares who has been identified by the lead institution under sub-regulation (2) of Regulation 32, shall on receipt of a communication in this behalf from the lead institution make a formal offer to acquire shares from the promoters or persons-in-charge of the affairs of the management of the financially weak company, financial institutions and also other shareholders of the company at a price determined by mutual negotiation between the person acquiring the shares and the lead institution. V

Explanation.—Nothing in this Regulation shall prohibit the lead Institution offering the shareholdings held by it in the financially weak company as part of the scheme of rehabiliation.

34. Persons acquiring shares to make public announcement :

(I) The person acquiring shares from the promoters or the persons in charge of management of the affairs of the financially weak company or the financial institution shall make public announcement for acquisition of shares from the other shareholders, of the company.

(2) Such public announcement shall contain relevant details about the offer including the information about the identity and background of the person acquiring shares, number and percentage of shares proposed to be acquired, offer price, the specified date, the date of opening of the offer and the period for which the offer shall be kept open and such other particulars as may be required by the board.

(a) outright purchase of shares, or

(3) The letter of offer shall be forwarded to each of the shareholders other than the promoters or the persons-in-charge of management of the financially weak company and the financial institutions.

(4) If the offer referred to in sub-regulation (I) results in the public shareholding being reduced to 10%-or less of the voting capital of the company, the acquirer shall either—(a) within a period of three months from the date of closure of the public offer make an offer to buy out the outstanding shares remaining with the-shareholder at the same offer price, which-may have the effect of delisting the target company or -

(b) undertake to disinvest through an offer for sale or by a fresh issue of capital to the public which shall open within a period of 6 months from the date of closure of public offer, such number of shares so as to satisfy the listing requirements.

(5) The letter of offer shall state clearly the option available to the acquirer under sub-regulation (4).

(6) For the purposes of computing the percentage referred to in sub-regulation (4), the voting rights as at the expiration of thirty days after the closure of the public offer shall be reckoned.

(7-) While accepting the offer from the shareholders other than the promoters or persons-in-charge of the financially weak company or the financial institutions, the person acquiring shares shall offer to acquire from the individual shareholder his entire holding if such holding is up to hundred shares of the face value of rupees ten each or ten shares of the face value of rupees hundred each.

35. Competitive bid :

No person shall make a competitive bid of acquisition of shares of the financially weak company once the lead institution had evaluated the bid and accepted the bid of the acquirer who has made -the public announcement of offer for acquisition of shares from the shareholders other than the promoters or- the persons in charge of the management of the financially weak company.

36. Exemption from the operations :

(I) Every offer which has been made in pursuance of Regulation 30 shall be accompanied with an application to the Board for exempting such acquisitions form the provisions of Chapter 111 of these Regulations. -

(2) For considering such request the Board may call for such information from the company as also from the lead institution, in relation to the manner of vetting the offers, evaluation of such offers and similar other matters

(3) Notwithstanding grant of exemption by the board, the lead institution or the acquirer as far as may be possible, shall adhere to the time limits specified for various activities for public offer specified in Chapter III.

37. Acquisition of shares by a state level public financial institution :

Where proposals for acquisition of shares in respect of financially weak company is made by a state level public financial institution, the provisions of these Regulations in so far as they relate to scheme of rehabilitation prepared by a public financial institution, shall apply except that in such a case the Industrial Development Bank of India, a corporation established under the Industrial Development Bank of India Act, 1964 shall be the agency for ensuring the compliance of these Regulations for acquisition of shares in the financially weak company.

(iv) An unwilling acquisition is known as lake—over.

(v) There is no impact of merger on BPS when the exchange ratio is in proportion to relative earnings of the companies. –

5.5 COMPUTATION OF SHARE EXCHANGE RATIO, PRE MERGER EPS AND POST MERGER EPS

The question of valuing the business to be acquired and consolidated poses a problem at the very outset. All parties try to convince about their viewpoints and want to tilt the values in their favour. The valuation issue should be settled impartially because it will affect the whole financial management after merger and consolidation. Not only the bargaining of the parties but practical aspects like earning capacity, present values of assets and future expectations from the concern should be given due weightage while valuing the concerns, The issue of valuation is not only important at the time of merger or consolidation but it will also influence the pricing of new issues of securilies, in purchase, sale or pledge of existing securities, in recapitalisation: and in reorganis ation and liquidmion.

Some of the important methods for valuing property of companies are discussed as follows :

I. **Capitalised Earnings**: The capitalised earnings method is based on the philosophy that the price which a buyer would like to pay for the property of a concern will depend upon the present and expected earning capacity of the business. The present price is paid in the expectations or future returns from such investments. The capitalised earnings will depend upon the (l) Estimate of earnings, and (2) Rate of capitalisation.

The estimation of earnings will involve the study of past earnings, The past earnings over a long period will give un exact idea about the earning position of the business, The past earnings of one or two years may be inf1uenced by abnormal causes such as price fluctuations, etc.; so, a true and fair opinion will not be made available nnd nothing should be concealed, the earnings are showing a stability then the earnings will be easily calculated; its on the other hand, the earnings will showing a trend then some allowance should be made for the conditions prevailing at that time.

After estimating the average earnings, the earnings should be capitalised to arrive at an investment value, A decision about the rate of earnings at which the profits are to be capitalised is very difficult. It is a sort of arbitrary figure, One should be guided by economic factors only while calculating capitalisation rare. If the earnings per share arc ₹ 5 and the capitalisation rate is 10%, then the value of the share will be ₹ 50.

2. **Assets Approach :** Assets approach is the commonly used method of valuation, The assets may be taken at book value, reproduction value and liquidation value. In book value method, the values of assets are taken from a current balance sheet. The excess of assets over debts will determine the assets values, divided by the number of equity shares will give the value of one share, If preference stock is also outstanding then preference stock sbould be deducted before dividing the assets values by the number of equity shares. This approach is also known , as net worth value. There is a difference of opinion about the assets to be included and assets such as goodwill, patent rights, deferred expenses should be excluded. Another view is thnt goodwill and patents should be included while fictitious assets such ns deferred expenses should only be exduded, The fixed assets are taken at book value less depreciation upto present balance sheet period. A company following a rigorous depreciation policy may be at a disadvantage than the company providing lower depreciations. Public utilities may use the reproduction value of assets while valuing the propery Liquidation values or assets are used on the assumption that if the concern is liquidated at present then what values will be fetched by the assests. The concern is taken as a going concern and as such current book valucs of assets

are used in most of the cases.

3. **Market Value Approach :** This approach is based on the actual market price of securities settled between the buyer and the seller. The market value will be the realistic value because buyers will be ready to pay in lieu of a purchase. The price of a security in the free market will be its most appropriate value. Market price is affected by the factors like demand and supply and position of money market. The price of a security in the free market will be its most appropriate value" Market value is a device which can be readily applied at any time.

A number of practical problems are faced while applying market value approach. The market value will be available for securities of big companies only. The number of shares offered in the market is generally small and it will not be advisable to apply the same value to the whole lot of shares of the company. Another objection against this method is that there are many upward and downward trends in values of securities in the stock exchanges and it becomes a problem to decide about the price to be taken for valuation. Despite practical limitations market value approach may be used under many conditions.

4. **Earnings per Share :** Another method of determining the values of the firms under merger or consolidation is the earnings per share. According to this approach, the value of a prospective merger or acquisition is a function of the impact of merger/ acquisition on the earnings per share. Such impact could either be positive resulting into the increases in EPS or may be negative resulting into dilution or EPS. As the market price per share is a function (product) of EPS and Price-Earning Ratio, the future EPS will have an impact on the market value of the firm. The following illustrative examples explain the effect of merger/acquisition on EPS.

5.6 SUMMARY

In order to safeguard the interests of shareholders and investors, the government has

Illustration 5.1- A Ltd. wants to take over B Ltd. and the financial details of both the companies are as below :

	A Ltd. (₹)	B Ltd. (₹)
Equity share capilal of ₹ 10 each	2,00,000	10,00,000
Preference share capital	40,000	—
Share premium	—	4,000
Profit and loss account	76,000	8,000
10% Debentures	30,000	10,000
Total liabilities	3,46,000	1,22,000
Fixed assets	2,44,000	70,000
Current assets	1,02,000	52,000
Total assets	3,46,000	1,22,000
Profit and tax and preference dividend	48,000	30,000
Markt price per share	24	27

Your are required to determine the share exchange ratio to be offered to the shareholders of B Ltd., based on (i) net assets value, (ii) EPS, and (iii) market price. Which should be preferred from the point of view of A Ltd.?

Solution:

(i) Calculation of share exchange ratio based on net assets value

		A Ltd (₹)		B Ltd (₹)
Total assets		3,46,000		1,22,000
Less : 10% Debentures	30,000		10,000	
Preference share capital	40,000	70,000	—	10,000
Net worth (Net assets value) [a]		2,76,000		1,12,000
Number of equity shares [b]		20,000		10,000

Net worth (assets) per share [a + b]	₹ 13.80	₹ 11.20

$$\text{Share Exchange Ratio} = \frac{\text{Net worth per share of target firm}}{\text{Net worth per share of acquiring firm}}$$

$$= \frac{11.20}{13.80} = 0.81$$

Thus, number of shares to be issued by A Ltd. = 10,000 x 0.81 = 8,100.

(ii) Calculation of share exchange ratio based on earnings per share (EPS)

	A Ltd.	B Ltd.
Profit after tax and preference dividend	₹ 48,000	₹ 30,000
Number of equity shares	20,000	10,000
Earnings pe:r share (EPS)	₹ 2.40	₹ 3.00

$$\text{Share exchange ratio} = \frac{\text{EPS of target firm}}{\text{EPS of acquinng firm}}$$

$$\text{Share exchange ratio} = \frac{3.00}{2.40} = 1.25$$

Thus, number oof shares to be issued by A Ltd. = 10,000 ×1.25 = 12,500

(iii) Calculation of share exchange ratio based on market price

	A Ltd.	B Ltd.
Market price per share	₹ 24	₹ 27

$$\text{Share exchange ratio} = \frac{\text{Market price per share of B Ltd.}}{\text{Market price per share of A Ltd.}}$$

$$= \frac{27}{24} = 1.125$$

Thus, number of shares to be issued by A Ltd. = 10,000 ×1.125 = 11.250.

Comments: A Ltd. should prefer the share exchange ratio based on net assets value as it has to issue minimum number of shares i.e, 8,100 in that case.

Illustration 5.2 - Company X is considering the purchase of company Y. The following are the financial data of the two companies

	Company X	***Company Y***
Number of Shares	4,00,000	1,00,000
Earnings Per Share (EPS)	₹ 6.00	₹ 4.50
Market Value Per Share	₹ 30.00	₹ 20.00

Assuming that the management or the two companies have agreed to exchange shares in proportion to:

(i) the relative earnings per share of the two firms;

(ii) 4 shares of company X for every 5 shares held in company Y.

You are required to illustrate and comment on the impact of merger on the EPS

Solution:

(i) Effect of Merger on EPS When the Exchange Ratio is in Proportion to Relative Earnings Per Share

	₹
Earnings of'company X (No. of Shares x EPS)	24,00,000
Earnings of company Y (1.00,000 x 4.50)	4,50,000
Total Earnings after the merger (as no econmnies/ synergies are given)	28,50,000

Number of shares After the merger = 4,00.000 + $\left(1.00.000 \times \frac{4.5}{6}\right)$ = 4,75.000

Earnings per share (EPS) After the merger = $\frac{28,50,000}{4,75,000}$ = Rs. 6.00

Hence, there is no impact on FPS for the shareholders of company X

Equivalent Earnings Per Share for the shareholders of company Y After Merger

= Earnings After the merger X Exchange Ratio

$$= \text{Rs. } 6 \times \frac{4.5}{6} = \text{Rs. } 4.5$$

Comments. From the above, it is clear that there is no impact of merger on EPS when the exchange ratio is in proportion to relative earnings per share of the two companies.

(ii) Effect of Merger on EPS when the Exchange Ratio is 4:5 or 8:1

Total Earnings After the Merger = ₹ 28,50,000 .

Number of shares after the merger = 4,00,000 + $\left(1,00,000 \times \frac{4}{5}\right)$

= 4,80,000

Earning per Share (EPS) after the merger = $\frac{28,50,000}{4,80,000}$ = Rs. 5.937

Impart on EPS for Company X's Shareholders	**Rs.**
EPS Before Merger	6.000
EPS After Merger	5.937
Dilution in EPS	0.063
Impact on EPS for Company Y's Shareholders	**Rs.**
Equivalent Earnings Per Share before the merger (4.50÷4/5)	5.625
EPS after the merger	5.937
Increase or Accretion in EPS	0.312

Comments: When the exchange ratio is 4:5, the impact of merger on EPS is dilution of ₹ 0.063 per share on the earnings per share for the shareholders of the acquiring company and accretion in the EPS of the acquired firm amounting to ₹ 0.312 per share. However, for a more reliable analysis or the impact of merger on EPS, the growth rate of the two companies should also have been considered.

Illustration 5.3 - Sunny Lamps Ltd. is taking over Moon Lamps Ltd. As per the understanding between the managements of the two companies, shareholders of Moon Lamps Ltd. would receive 0.7 shares of Sunny Lamps Ltd. for each share held by them. The relevent data for the two companies are as follows:

	Sunny l.amps Ltd.	***Moon Lamps Ltd.***
Net Sales (₹ Lakhs)	80	30
Profit after tax (₹ Lakhs)	16	4
Number of shares (Lakhs)	3.2	1
Earnings per Share (EPS ₹)	5	4
Market Value Share (₹)	30	20
Price Earning Ratio (P/E)	6	5.

Ignoring the economies of scale and the operating synergy, you are required to calculate (i) premium paid by Sunny Lamps Ltd. to the shareholders of Moon Lamps Ltd, (ii) number of shares uner the merger; (iii) combined EPS; (iv) combined P/E ratio; (v) market value per share; and (vi) total market capitalisation after the merger.

Solution :

(i) Premium paid by Sunny Lamps Ltd. to shareholder of Moon Lamps Ltd		₹
Value of each share of Sunny Lamps Ltd.	= 30×0.7	21.00
Value of each share in Moon Lamps Ltd.		20.00
Premium paid per share		1.00
Premium in percentage	= 1/20×100=	5%

(ii) Number of shares after merger	₹
Number of shares before merger in Sunny Lamps Ltd.	3,20,00
Number of share paid to shareholdcrs of Moon Lamps (l.00,000×7)	70,000
Total Number or share after merger	3,90,000

(iii) **Combined EPS**

Combined Profit after Tax = ₹ 16,00,000+4,00,000 = ₹ 20,00,000

Combine EPS $= \dfrac{\text{Combined Profit After Tax}}{\text{Number of Share After Mcrger}}$

$= \dfrac{20,00,000}{3,90,000}$ = Rs. 5.13

(iv) Combined Price-Earning Ratio

$$= 6 \times \frac{16}{20} + 5 \times \frac{4}{20} = 5.80$$

(v) Market Value per share After Merger

= P/E Ratio × EPS

= 5.80 × 5.13

= ₹ 29.754

(vi) Total Market Capitalisation After Merger

= Market Value per share × No. of shares

= 29.754 × 3.90,000

= ₹ 116.04 lakhs.

brought a code to regulate the takeover bids through SEBI (Substantial Acquisitions of Shares and Takeover) Regulations, 1997. The main objective of these regulations is to provide greater transparency through a system of disclosures of information. Regulations I to 5 are the preview dealing with short title and commencement, definitions, applicability, the takeover panel and powers of the Board. Regulations 6 to 29 deal with disclosures of shareholding and control in a listed company whereas regulations 30 to 37 relate to 'bail out takeovers'. Regulations 38 to 47 provide for investigation and action by the board.

5.7 GLOSSARY

- Acquisition of shares- purchase of shares
- Takeover: Unwilling acquisition is called takeover.
- Synergy: Synergy refers to benefits other than those related to economies of scale.
- Lever aged Buy-outs (LBO): An acquisition of a company in which the acquisition is substantially financed through debt.
- Spin-off: When a company creates a new firm from the existing entity.
- Self-off: Selling a part of business to a third party is called sell-off.

5.8 SELF ASSESSMENT QUESTIONS

Q.1 What are the general obligations of the acquirer?

____

____

____

Q.2 Discuss the manner of acquisition of shares.

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5.9 LESSON END EXERCISE

Q.1 Discuss the AS-14-accounting for amalgamations.

Q.2. Discuss various important regulations as provided in SEBl (Substantial Acquisitions of Shares and Takeovers 5.-Regulations, 1997.

5.10 SUGGESTED READINGS

- I.M. Pandey, "Financial Management", Vikas Publishing House Pvt. Ltd., Ninth Edition.
- Prasanna Chandra, "Fundamentals of Financial Management", Tata McGraw Hill Ltd., 2006.
- Breaby and Myers, "The principles of Corporate Finance", 6th edition, Tata McGraw Hill, New Delhi.

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ACCOUNTS OF GOVERNMENT COMPANIES AND STATUTORY CORPORATIONS

M.Com II Sem.	**Advanced Accounting**	**Unit-II**
M.Com – C 211		**Lesson No. 6**

STRUCTURE

6.1 INTRODUCTION

A government company is a company registered under the Indian Companies Act in which not less than 51% of paid up share capital is held by the central government or any state government or partly by central government partly by one or more state governments. Private participation in capital and management is not allowed in this form of organization. It enjoys financial autonomy and has independent staffing system. Such a company does not have to worry about auditing, accounting and budgetary controls.

6.2 OBJECTIVES

After going through this lesson, the students will be able to understand-

- the accounts of a government companies;
- preparation and presentation of the final accounts; and
- forms and contents of statement of profit and loss account.

6.3 ACCOUNTS OF GOVERNMENT COMPANIES

Section 2(45) of the Companies Act, 2013 defines a Government company as, "any company in which not less than 51 per cent of paid up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments and includes a company which is a subsidiary company of such a Government Company". Shares held by municipal and other local authorities or public corporations are not to be taken into consideration for the calculation of 51% of paid up share capital. The term Government Company also includes a company which is a subsidiary of a Government Company even though neither the Central Government nor the State Government holds any shares in the subsidiary company.

The provisions of Sections 128, 129 and 130 of the Companies Act, 2013 relating to the accounts of companies are applicable to Government Companies

Section 128 of the Companies Act requires that every company shall keep at its registered office proper books of accounts, with respect to—

(a) all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure takes place,

(b) all sales and purchases of goods by the company,

(c) the assets and liabilities of the company, and

(d) in the case of company pertaining to any class of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilisation of material or labour or to other items of cost as may be prescribed in such class of companies is required by the Central Government to include such particulars.

All or any of the above stated books of account may be kept at such other place in India as the Board of Directors may decide. If the Board of Directors so decide, the company must within 7 days of the decision, file with the Registrar a notice in writing giving the full address of that other place.

Where a company has a branch office, whether in or outside India, the company shall be deemed to have complied with the provisions given above, if proper books of account relating to the transactions effected at the branch office are kept at that office and proper summarised returns, made up-to-date at intervals of not more than 3 months, are sent by the branch office to the co at the registered office or the other place referred to earlier.

The books of account and other books and papers shall be open to inspection by any director during business hours.

The managing director or manager is responsible for maintaining and preserving the books of account. If there is no managing director or manager, the Board of Directors will be responsible for maintaining and preserving the books of account. In case there is a default, any person responsible will be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than 50,000 but which may extend to five lakh rupees or with both.

The books of account together with vouchers supporting the entries therein are to be preserved by every company for at least eight years. In the case of a company incorporated less than eight years before the current year, the books of account for the entire period must be preserved. The Registrar of Companies may direct a company to preserve any of these documents for a longer period.

6.4 PREPARATION AND PRESENTATION OF THE FINAL ACCOUNTS

In respect of preparation and presentation of the final accounts some of the requirements of Sections 128 & 129 of the Companies Act, 2013 given below:

1. At every annual general meeting of a company, the Board of Directors of the company shall lay before the company-

   (a) A Balance Sheet for the financial year and

   (b) a Statement of Profit and Loss for that period.

2. In the case of a company not carrying on business for profit, an Income and Expenditure Account shall be laid before the company at its annual general meeting instead of Statement of Profit and Loss and all references to "Statement of Profit and Loss", 'profit" and "loss" in this section and elsewhere

in this Act shall be construed, in relation to such a company as references respectively to the Income and Expenditure Account", "the excess of income over expenditure" and "the excess of expenditure over income".

3. The financial statements shall give a true and fair view of the state of affairs of the Government company, comply with the accounting standards and shall be in the form or forms as provided in Schedule III.

4. If any person, being a director of a company, fails 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:

6.5 FORM AND CONTENTS OF STATEMENT OF PROFIT AND LOSS

Every statement of profit and loss of a Government company shall give true and fair view of the profit or loss of the company for the financial year and comply with the requirements of Part II of Schedule III so far as they are applicable thereto.

The Central Government may, but notification in the Official Gazette exempt any class of companies from the compliance with any of the requirements in Schedule III if, in its opinion, it is necessary to grant exemption in the public interest. Any such exemption may be granted either unconditionally or subject to such conditions as may be specified in the notification.

PART II – STATEMENT OF PROFIT AND LOSS

Name of the Company…………………….

Profit and loss statement for the year ended ………………………

(Rupees in …………)

	Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
	1	2	3	4
I.	Revenue from operations		xxx	
II.	Other income		xxx	**xxx**
III.	Total Revenue (I + II)		xxx	**xxx**

	Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
	1	2	3	4
				xxx
IV.	Expenses:			
	Cost of materials consumed			
	Purchases of Stock-in-Trade			
	Changes in inventories of finished goods work-in-progress and Stock-in-Trade		xxx xxx xxx	xxx xxx xxx
	Employee benefits expense Finance costs		xxx	xxx
	Depreciation and amortisation expense			
	Other expenses			
	Total expenses		xxx	xxx
V.	Profit before exceptional and extraordinary items and tax (III–IV)		xxx	xxx
VI.	Exceptional items		xxx	xxx
VII.	Profit before extraordinary items and tax (V–VI)		xxx	xxx
VIII.	Extraordinary items		xxx	xxx
IX.	**Profit before tax (VII – VIII)**		**xxx**	**xxx**
X.	Tax expense:			
	(1) Current tax		xxx	xxx
	(2) Deferred tax		xxx	xxx
XI.	Profit (Loss) for the period from continuing operations (VII -VIII)		xxx	xxx
XII.	Profit/(loss) from discontinuing operations		xxx	xxx
XIII.	Tax expense of discontinuing operations		xxx	xxx
XIV.	Profit/(loss) from Discontinuing operations (after tax) (XII–XIII)		xxx	xxx
XV.	Profit (Loss) for the period (XI + XIV)		xxx	xxx
XVI.	Earnings per equity share:			
	(1) Basic (2) Diluted		xxx xxx	xxx xxx

6.6 GENERAL INSTRUCTIONS FOR PREPARATION OF STATEMENT OF PROFIT AND LOSS

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

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

   (a) Sale of products;

   (b) Sale of services;

   (c) Other operating revenues;

   Less:

   (d) Excise duty.

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

   (a) Interest; and

   (b) Other financial services.

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

3. Finance Costs

   Finance costs shall be classified as:

   (a) Interest expense;

   (b) Other borrowing costs;

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

4. Other income

   Other income shall be classified as:

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

   (b) Dividend Income;

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

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

5. Additional Information

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

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

(b) Depreciation and amortisation expense;

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

(d) Interest Income;

(e) Interest expense;

(f) Dividend income;

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

(h) Adjustments to the carrying amount of investments;

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

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

(k) In case of Companies covered under section 135, amount of expenditure incurred on corporate social responsibility activities;

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

(m) Prior period items;

(ii) (a) In the case of manufacturing companies,—

(1) Raw materials under broad heads.

(2) goods purchased under broad heads.]

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

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

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

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

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

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

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

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

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

(vi) Expenditure incurred on each of the following items, separately for each item:—

(a) Consumption of stores and spare parts;

(b) Power and fuel;

(c) Rent;

(d) Repairs to buildings;

(e) Repairs to machinery;

(f) Insurance;

(g) Rates and taxes, excluding, taxes on income;

(h) Miscellaneous expenses,

(vii) (a) Dividends from subsidiary companies.

(b) Provisions for losses of subsidiary companies.

(viii) The profit and loss account shall also contain by way of a note the following information, namely:—

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

I. Raw materials;

II. Components and spare parts;

III. Capital goods;

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

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

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

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

I. Export of goods calculated on F.O.B. basis;

II. Royalty, know-how, professional and consultation fees;

III. Interest and dividend;

IV. Other income, indicating the nature thereof.

6.7 SUMMARY

A government company is a company registered under the Indian Companies Act in which not less than 51% of paid up share capital is held by the central government or any state government or partly by central government partly by one or more state governments. Private participation in capital and management is not allowed in this form of organization. It enjoys financial autonomy and has independent staffing system. Such a company does not have to worry about auditing, accounting and budgetary controls.

Reasons behind establishing the company form by the government are stated below:

Public interest: Such companies are formed by the government in the interests of the country. Shares of existing private firms are taken by government if they don't get profit or are in financial crisis or have become insolvent.

Industrial promotion: Another reason for establishing such companies is to encourage industrial promotion. National Industries Development Corporation sand National Small Industries Corporation fall under this category.

Promotion of trade and commerce: Some companies are formed in order to promote trade and commerce. For example, State Trading Corporation, Export Credit and Guarantee Corporation.

Lack of incentive: In order to get some incentives, government establish such companies. Private businessmen do not find it suitable to establish firms due to heavy investment outlay, lack of profit in the initial years of its formation etc.

Distinction between Government and Non-government Companies:

Annual reports: In a central government company, annual reports and audit reports of government companies are laid or presented before Parliament and in a state government company, such reports are laid before the state legislature. Audit and annual reports are laid before the General Body, in a non-government company.

Provisions of Companies Act: It is in the hands of central government to exempt any provision of companies act from applying to a government company except provisions regarding audit. On the other hand, central government cannot exempt any provision of companies act from applying to a non-government company.

Auditor appointment: Government on the advice of Comptroller and Auditor General of India appoints the auditor of a government company. Whereas, it is the General Body that appoints the auditor of a non-government company.

Paid-up capital: Not less than 51% of paid up share capital is held by central or state government or jointly by central or one or more state governments. In order to form a government company, the total paid up capital owned by one or more governments should be 51% or more (in case of a government company). On the other hand, major share of paid up capital is held by private individual in case of non-government companies.

6.8 GLOSSARY

- **Government company-** A government company is a company registered under the Indian Companies Act in which not less than 51% of paid up share capital is held by the central government or any state government or partly by central government partly by one or more state governments.
- **Employee Benefits Expense-** It includes salaries and wages, contribution to provident and other funds,
- **ESOP-** Expense on Employee Stock Option Scheme
- **ESPP-**Employee Stock Purchase Plan
- **B. O. D-** Board of Directors

6.9 SELF ASSESSMENT QUESTIONS

Q.1 What is government accounting?

Ans. ____

____

Q.2 Write a brief note on accounts of a government company.

Ans.

Q.3 Give the forms and contents of profit and loss account of government company.

Ans.

6.10 LESSON END EXERCISE

1. What is government company? State the reasons behind establishing the company form by the government.
2. Explain in detail the general guidelines for the preparation and presentations of final accounts of a government company.

3. Prepare the profit and loss account of government company with imaginary figures.

6.11 SUGGESTED READINGS

- Jain, S.P and Narang, K.L. (2014). Advanced Accountancy-Vol-II. Kalyani Publisher, New Delhi.
- Gupta, Sashi, K. (2015). Management Accounting. Kalyani Publisher, New Delhi.
- Gupta, Sashi, K. and Mehra, A. (2015). Contemporary Issues in Accounting. Kalyani Publisher, New Delhi.
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ACCOUNTS OF GOVERNMENT COMPANIES AND STATUTORY CORPORATIONS

M.Com II Sem.	**Advanced Accounting**	**Unit-II**
M.Com – C 211		**Lesson No. 7**

STRUCTURE

7.1 INTRODUCTION

Section 129 of the Companies Act requires that at every annual general meeting of the shareholders, the Board of Directors of the company shall lay before the company a Balance Sheet as at the end of each trading period. It is laid down in Section 129 that every Balance Sheet of a company shall be prepared in the form given in the Part I of Schedule III of the Companies Act, 2013, or as near thereto as circumstances admit, or in such other form as may be approved by the Central Government either generally or in a particular case. It further states that in preparing the Balance Sheet due regard shall be had, as far as may be, to the general instructions for preparation of the Balance Sheet.

7.2 OBJECTIVES

After going through this lesson the students will be able to understand –

- the forms and contents of balance sheet;

- general instructions for the preparation of balance sheet; and
- classification of various assets and liabilities

7.3 FORM AND CONTENTS OF BALANCE SHEET

The objective of prescribing the form for the Balance Sheet in Schedule III is to make sure that Balance Sheet exhibits a true and fair view of the state of affairs of the company. There should be no room for window dressing showing a better position than what actually is, and secret reserves showing a worse picture than, what actually is. If the information required to be given under any of the items in the prescribed form cannot be conveniently shown in the Balance Sheet itself, it should be shown in a separate note or notes to be attached to the Balance Sheet. From the above stated provisions it can be said that maintenance of accounts of a Government company is no way different from that of an ordinary joint stock company. Requirements of Schedule III are to be followed by Government Companies as other companies follow for preparation and presentation of the final accounts.

Annual Reports on Government Companies. As per Section 394 of the Companies Act, 2013, where the Central Government is a member of Government company, the Central Government shall cause an annual report on the working and affairs of that company to be prepared within 3 months of its annual general meeting before which the comments given by the comptroller and Auditor-General of India and the audit report is placed. Annual report and audit report together with comments shall be laid before both Houses of Parliament as soon as may be after such preparation of reports. If a State Government is also a member, the same should by done by the State Government and reports should be laid before the House or both Houses of the State Legislature. As per Section 395 of the. Companies Act, 2013, where the Central Government is not a member of a Government Company, every State Government which is a member of the company, shall cause an annual report on the working and affairs of the company to be prepared within 3 months of its annual general meeting. As soon as may be after such preparation, laid before the House or both Houses of the State Legislature together with a copy of the audit report and comments upon the audit report.

7.4 GENERAL INSTRUCTIONS FOR THE PREPARATION OF BALANCE SHEET

While preparing the balance sheet as per the requirement of schedule III of companies Act 2013, the following instructions must be followed:

1. Where compliance with the requirements of the Act including Accounting Standards as applicable to the companies require any change in treatment or disclosure including addition, amendment, substitution or deletion in the head or sub-head or any changes, inter se, in the financial statements or statements forming part thereof, the same shall be made and the requirements of this Schedule shall stand modified accordingly.

2. The disclosure requirements specified in this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Accounting Standards prescribed under the Companies Act, 2013. Additional disclosures specified in the Accounting Standards shall be made in the notes to accounts or by way of additional statement unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act shall be made in the notes to accounts in addition to the requirements set out in this Schedule.

3. (i) Notes to accounts shall contain information in addition to that presented in the Financial Statements and shall provide where required (a) narrative descriptions or dis-aggregations of items recognised in those statements; and (b) information about items that do not qualify for recognition in those statements.

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

4. (i) Depending upon the turnover of the company, the figures appearing in the Financial Statements may be rounded off as given below:—

Turnover	Rounding off
(a) less than one hundred crore rupees	To the nearest hundreds, thousands, lakhs or millions, or decimals thereof.
(b) one hundred crore rupees or more	To the nearest lakhs, millions or crores, or decimals thereof

(ii) Once a unit of measurement is used, it should be used uniformly in the Financial Statements.

5. Except in the case of the first Financial Statements laid before the Company (after its incorporation) the corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Financial Statements including notes shall also be given.

6. For the purpose of this Schedule, the terms used herein shall be as per the applicable Accounting Standards.

Note :- This part of Schedule sets out the minimum requirements for disclosure on the face of the Balance Sheet, and the Statement of Profit and Loss (hereinafter referred to as "Financial Statements" for the purpose of this Schedule) and Notes. Line items, sub-line items and sub-totals shall be presented as an addition or substitution on the face of the Financial Statements when such presentation is relevant to an understanding of the company's financial position or performance or to cater to industry/sector-specific disclosure requirements or when required for compliance with the amendments to the Companies Act or under the Accounting Standards.

PART I — BALANCE SHEET

Name of the Company ....

Balance Sheet as at ....

(Rupees in ....)

	Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
	1	2	3	4
I.	EQUITY AND LIABILITIES			
	(1) Shareholders' funds			
	(a) Share capital (b) Reserves and surplus (c) Money received against share warrants			

	Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
	1	2	3	4
	(2) Share application money pending allotment			
	(3) Non-current liabilities (a) Long-term borrowings (b) Deferred tax liabilities (Net) (c) Other Long term liabilities (d) Long-term provisions			
	(4) Current liabilities (a) Short-term borrowings 2[(b) Trade payables (A) total outstanding dues of micro enterprises and small enterprises; and (B) total outstanding dues of creditors other than micro enterprises and small enterprises] (c) Other current liabilities (d) Short-term provisions			
	TOTAL			
II.	ASSETS			
	Non-current assets			
	(1) (a) Property, Plant and Equipment (i) Tangible assets (ii) Intangible assets (iii) Capital work-in-progress (iv) Intangible assets under development (b) Non-current investments (c) Deferred tax assets (net) (d) Long-term loans and advances (e) Other non-current assets			

	Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
	1	2	3	4
	(2) Current assets			
	(a) Current investments (b) Inventories (c) Trade receivables (d) Cash and cash equivalents (e) Short-term loans and advances (f) Other current assets			
	TOTAL			

Note :

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

   (a) it is expected to be realised in, or is intended for sale or consumption in, the company's normal operating cycle;

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

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

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

   All other assets shall be classified as non-current.

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

3. A liability shall be classified as current when it satisfies any of the following criteria:—

   (a) it is expected to be settled in the company's normal operating cycle;

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

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

(d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.

4. A receivable shall be classified as a "trade receivable" if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.

5. A payable shall be classified as a "trade payable" if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.

6. A company shall disclose the following in the notes to accounts.

A. Share Capital

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

(a) the number and amount of shares authorised;

(b) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;

(c) par value per share;

(d) a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;

(e) the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;

(f) shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;

(g) shares in the company held by each shareholder holding more than 5 per cent. shares specifying the number of shares held;

(h) shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts;

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

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

   (B) Aggregate number and class of shares allotted as fully paid-up by way of bonus shares.

   (C) Aggregate number and class of shares bought back.

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

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

(l) forfeited shares (amount originally paid-up).

B. Reserves and Surplus

(i) Reserves and Surplus shall be classified as:

   (a) Capital Reserves;

   (b) Capital Redemption Reserve;

   (c) Securities Premium

   (d) Debenture Redemption Reserve;

   (e) Revaluation Reserve;

   (f) Share Options Outstanding Account;

   (g) Other Reserves–(specify the nature and purpose of each reserve and the amount in respect thereof);

   (h) Surplus i.e., balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves, etc.;

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

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

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

C. Long-Term Borrowings

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

(a) Bonds/debentures;

(b) Term loans:

(A) from banks.

(B) from other parties.

(c) Deferred payment liabilities;

(d) Deposits;

(e) Loans and advances from related parties;

(f) Long term maturities of finance lease obligations;

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

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

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

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

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

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

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

D. Other Long-term Liabilities

Other Long-term Liabilities shall be classified as:

(a) Trade payables;

(b) Others.

E. Long-term Provisions

The amounts shall be classified as:

(a) Provision for employee benefits;

(b) Others (specify nature).

F. Short-term borrowings

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

(a) Loans repayable on demand:

(A) from banks.

(B) from other parties.

(b) Loans and advances from related parties;

(c) Deposits;

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

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

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

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

FA. Trade Payable

The following details relating to Micro, Small and Medium Enterprises shall be disclosed in the notes:—

(a) the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year;

(b) the amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year;

(c) the amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006;

(d) the amount of interest accrued and remaining unpaid at the end of each accounting year; and

(e) the amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

Explanation.- The terms 'appointed day', 'buyer', 'enterprise', 'micro enterprise', 'small enterprise' and' supplier', shall have the same meaning assigned to those under clauses (b), (d), (e), (h), (m) and (n) respectively of section 2 of the Micro, Small and Medium Enterprises Development Act, 2006.]

G. Other current liabilities

The amounts shall be classified as:

(a) Current maturities of long-term debt;

(b) Current maturities of finance lease obligations;

(c) Interest accrued but not due on borrowings;

(d) Interest accrued and due on borrowings;

(e) Income received in advance;

(f) Unpaid dividends;

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

(h) Unpaid matured deposits and interest accrued thereon;

(i) Unpaid matured debentures and interest accrued thereon;

(j) Other payables (specify nature).

H. Short-term provisions

The amounts shall be classified as:

(a) Provision for employee benefits.

(b) Others (specify nature).

I. Tangible assets

(i) Classification shall be given as:

(a) Land;

(b) Buildings;

(c) Plant and Equipment;

(d) Furniture and Fixtures;

(e) Vehicles;

(f) Office equipment;

(g) Others (specify nature

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

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

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

J. Intangible assets

(i) Classification shall be given as:

(a) Goodwill;

(b) Brands/trademarks;

(c) Computer software;

(d) Mastheads and publishing titles;

(e) Mining rights;

(f) Copyrights, and patents and other intellectual property rights, services and operating rights;

(g) Recipes, formulae, models, designs and prototypes;

(h) Licenses and franchise;

(i) Others (specify nature).

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

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

K. Non-current investments

(i) Non-current investments shall be classified as trade investments and other investments and further classified as:

(a) Investment property;

(b) Investments in Equity Instruments;

(c) Investments in preference shares;

(d) Investments in Government or trust securities;

(e) Investments in debentures or bonds;

(f) Investments in Mutual Funds;

(g) Investments in partnership firms;

(h) Other non-current investments (specify nature).

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

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

(iii) The following shall also be disclosed:

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

(b) Aggregate amount of unquoted investments;

(c) Aggregate provision for diminution in value of investments.

L. Long-term loans and advances

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

(a) Capital Advances;

(b) Security Deposits;

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

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

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

(a) Secured, considered good;

(b) Unsecured, considered good;

(c) Doubtful.

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

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

M. Other non-current assets

Other non-current assets shall be classified as:

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

(ii) Others (specify nature);

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

(A) (a) Secured, considered good;

(B) Unsecured, considered good;

(C) Doubtful.

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

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

N. Current Investments

(i) Current investments shall be classified as:

(a) Investments in Equity Instruments;

(b) Investment in Preference Shares;

(c) Investments in Government or trust securities;

(d) Investments in debentures or bonds;

(e) Investments in Mutual Funds;

(f) Investments in partnership firms;

(g) Other investments (specify nature).

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

(ii) The following shall also be disclosed:

(a) The basis of valuation of individual investments;

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

(c) Aggregate amount of unquoted investments;

(d) Aggregate provision made for diminution in value of investments.

O. Inventories

(i) Inventories shall be classified as:

(a) Raw materials;

(b) Work-in-progress;

(c) Finished goods;

(d) Stock-in-trade (in respect of goods acquired for trading);

(e) Stores and spares;

(f) Loose tools;

(g) Others (specify nature).

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

(iii) Mode of valuation shall be stated.

P. Trade Receivables

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

(ii) Trade receivables shall be sub-classified as:

(a) Secured, considered good;

(b) Unsecured, considered good;

(c) Doubtful.

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

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

Q. Cash and cash equivalents

(i) Cash and cash equivalents shall be classified as:

(a) Balances with banks;

(b) Cheques, drafts on hand;

(c) Cash on hand;

(d) Others (specify nature).

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

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

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

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

R. Short-term loans and advances

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

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

(b) Others (specify nature).

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

(a) Secured, considered good;

(b) Unsecured, considered good;

(c) Doubtful.

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

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

S. Other current assets (specify nature)

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

T. **Contingent liabilities and commitments (to the extent not provided for)**

(i) Contingent liabilities shall be classified as:

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

(b) Guarantees;

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

(ii) Commitments shall be classified as:

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

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

(c) Other commitments (specify nature).

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

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

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

X. Every company shall disclose the details of Specified Bank as provided in the Table below:-

	SBNs	Other denomination notes	Total
Closing cash in hand as on			
(+) Permitted receipts			
(-) Permitted payments			
(-) Amount deposited in Banks			
Closing cash in hand as on			

7.5 SUMMARY

Section 129 of the Companies Act requires that at every annual general meeting of the shareholders, the Board of Directors of the company shall lay before the company a Balance Sheet as at the end of each trading period. It is laid down in Section 129 that every Balance Sheet of a company shall be prepared in the form given in the Part I of Schedule III of the Companies Act, 2013, or as near thereto as circumstances admit, or in such other form as may be approved by the Central Government either generally or in a particular case. It further states that in preparing the Balance Sheet due regard shall be had, as far as may be, to the general instructions for preparation of the Balance Sheet.

7.6 GLOSSARY

- **Assets**- Property of any kind owned by the business.
- **Tangible assets-** Those assets which can be seen, touched and can be expressed in terms of money e.g. plant, machinery, furniture, building etc.
- **Intangible assets-** Those assets which cannot be seen, touched and expressed in terms of money e.g. goodwill, copy rights, patents, trademarks etc.
- **Current assets**- Those assets which can be converted into cash within one year are called current assets.
- **Current liabilities**- These are those liabilities which are liable to be paid within one year.

7.7 SELF ASSESSMENT QUESTIONS

Q1. Define a Government Company.

Ans. ____

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Q2. Give in brief various provisions of the Companies Act, 2013 applicable to Government Companies.

Ans. ____

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7.8 LESSON END EXERCISE

1. Write a detailed note on forms and contents of balance sheet as per Part-I of Schedule III of Companies Act 2013.
2. Give in brief various provisions of the Companies Act, 2013 applicable to Government Companies.
3. Prepare the balance sheet of Government Company as per Part-I of Schedule III of Companies Act 2013 with imaginary figures.

7.9 SUGGESTED READINGS

- Jain, S.P and Narang, K.L. (2014). Advanced Accountancy-Vol-II. Kalyani Publisher, New Delhi.
- Gupta, Sashi, K. (2015). Management Accounting. Kalyani Publisher, New Delhi.
- Gupta, Sashi, K. and Mehra, A. (2015). Contemporary Issues in Accounting. Kalyani Publisher, New Delhi.
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ACCOUNTS OF GOVERNMENT COMPANIES AND STATUTORY CORPORATIONS

M.Com II Sem.	**Advanced Accounting**	**Unit-II**
M.Com – C 211		**Lesson No. 8**

STRUCTURE

8.1 INTRODUCTION

A profit and loss statement or income statement or statement of operations, is a financial report that provides a summary of a company's revenues, expenses, and profits/losses over a given period of time. The profit and loss statement shows a company's ability to generate sales, manage expenses, and create profits. It is prepared based on accounting principles that include revenue recognition, matching, and accruals, which makes it different from the cash flow statement.

8.2 OBJECTIVES

After going through this lesson, you will be able to understand the general instructions for preparation of financial statements of a company required to comply with Ind AS.

8.3 GENERAL INSTRUCTIONS FOR PREPARATION OF FINANCIAL STATEMENTS OF A COMPANY REQUIRED TO COMPLY WITH Ind AS

Those companies which are required to comply with Ind AS are required to follow the following instructions while preparing financial statements.

1. Every company to which India Accounting Standards apply, shall prepare its financial statements in accordance with this Schedule or with such modification as may be required under certain circumstances

2. Where compliance with the requirements of the Act including Indian Accounting Standards (except the opinion of presenting assets and liabilities in the order of liquidity as provided by the relevant Ind AS as applicable to the companies require any change in treatment or disclosure including addition, amendment, substitution or deletion in the head or sub-head or any changes, *inter se,* in the financial statements or statements forming part thereof, the same shall be made and the requirements under this Schedule shall stand modified accordingly.

3. The disclosure requirements specified in this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Indian Accounting Standards. Additional disclosures specified in the Indian Accounting Standards shall be made in the notes or by way of additional statement or statements unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act, 2013 shall be made in the notes to accounts in addition to the requirements set out in this Schedule.

4. (*i*) Notes shall contain information in addition to that presented in the Financial Statements and shall provide where required-

    (*a*) narrative descriptions or disaggregations of items recognised in those statements; and (*b*) information about items that do not qualify for recognition in those statements.

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

5. Depending upon the turnover of the company, the figures appearing in the Financial Statements shall be rounded off as below:—

Turnover	Rounding off
(*i*) less than one hundred crore rupees	To the nearest hundreds, thousands, lakhs or millions, or decimals thereof.
(*ii*) one hundred crore rupees or more	To the nearest, lakhs, millions or crores, or decimals thereof.

Once a unit of measurement is used, it should be used uniformly in the Financial Statements.

6. Financial Statements shall contain the corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Financial Statements including notes except in the case of first Financial Statements laid before the company after incorporation.

7. Financial Statements shall disclose all 'material' items, i.e, the items if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size or nature of the item or a combination of both, to be judged in the particular circumstances.

8. For the purpose of this Schedule, the terms used herein shall have the same meanings assigned to them in Indian Accounting Standards.

9. Where any Act or Regulation requires specific disclosures to be made in the stand alone financial statements of a company, the said disclosures shall be made in addition to those required under this Schedule.

10. The NBFCs preparing financial statements as per this Schedule may change the order of presentation of line items on the face of financial statements or order of line items within the schedules in order of liquidity, if appropriate, considering the operations performed by the NBFC.

    Note:— This Schedule sets out the minimum requirements for disclosure on the face of the Financial Statements, i.e, Balance Sheet, Statement of Changes in Equity for the period, the Statement of profit and Loss for the period (The term 'Statement of Profit and Loss' has the same meaning as 'profit and Loss Account') and Notes. Cash flow statement shall be prepared, where applicable, in accordance with requirements of the relevant Indian Accounting Standard.

    Line items, sub-line items and sub-totals shall be presented as an addition or substitution on the face of the Financial Statements when such presentation is relevant to an understanding of the company's financial position or performance or to cater to industry or sector-specific disclosure requirements or when required for compliance with the amendments to the Companies Act, 2013 or under the Indian Accounting Standards.

8.4 GENERAL INSTRUCTIONS FOR PREPARATION OF BALANCE SHEET

1. An entity shall classify an asset as current when-
   (a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;
   (b) it holds the asset primarily for the purpose of trading;
   (c) it expects to realise the asset within twelve months after the reporting period; or
   (d) the asset is cash or a cash equivalent unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting

   An entity shall classify all other assets as non-current.

2. The operating cycle of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. When the entity's normal operating cycle is not clearly identifiable, it is

assumed to be twelve months.

3. An entity shall classify a liability as current when-
   - (a) it expects to settle the liability in its normal operating cycle;
   - (b) it holds the liability primarily for the purpose of trading;
   - (c) the liability is due to be settled within twelve months after the reporting period; or
   - (d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

   An entity shall classify all other liabilities as non-current.

4. A receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.

5. A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.

6. A company shall disclose the following in the Notes:

A. Non-Current Assets

I. Property, Plant and Equipment :

(i) Classification shall be given as:

(a) Land

(b) Buildings

(c) Plant and Equipment

(d) Furniture and Fixtures

(e) Vehicles

(f) Office equipment

(g) Bearer Plants

(h) Others (specify nature)

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

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

II. Investment Property:

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

III. Goodwill:

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

IV. Other Intangible assets:

(i) Classification shall be given as:

(a) Brands or trademarks

(b) Computer software

(c) Mastheads and publishing titles

(d) Mining rights

(e) Copyrights, patents, other intellectual property rights, services and operating rights

(f) Recipes, formulae, models, designs and prototypes

(g) Licenses and franchises

(h) Others (specify nature)

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

V. Biological Assets other than bearer plants:

A reconciliation of the carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments shall be disclosed separately.

VI. Investments:

(i) Investments shall be classified as:

(a) Investments in Equity Instruments;

(b) Investments in Preference Shares;

(c) Investments in Government or trust securities;

(d) Investments in debentures or bonds;

(e) Investments in Mutual Funds;

(f) Investments in partnership firms; or

(g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate that are-

(i) subsidiaries,

(ii) associates,

(iii) joint ventures, or

(iv) structured entities,

in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). Investments in partnership firms alongwith names of the firms, their partners, total capital and the shares of each partner shall be disclosed separately.

(ii) The following shall also be disclosed:

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

(b) Aggregate amount of unquoted investments; and

(c) Aggregate amount of impairment in value of investments.

VII. Trade Receivables:

(i) Trade receivables shall be sub-classified as:

(a) Secured, considered good;

(b) Unsecured considered good; and

(c) Doubtful.

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

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

VIII. Loans:

(i) Loans shall be classified as-

(a) Security Deposits;

(b) Loans to related parties (giving details thereof); and

(c) Other loans (specify nature).

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

(a) Secured, considered good;

(b) Unsecured, considered good; and

(c) Doubtful.

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

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

IX. Bank deposits with more than 12 months maturity shall be disclosed under 'Other financial assets';

X. Other non-current assets: Other non-current assets shall be classified as-

(i) Capital Advances; and

(ii) Advances other than capital advances;

(1) Advances other than capital advances shall be classified as:

(a) Security Deposits;

(b) Advances to related parties (giving details thereof); and

(c) Other advances (specify nature).

(2) Advances to directors or other officers of the company or any of them either severally or jointly with any other persons or advances to firms or private companies respectively in which any director is a partner or a director or a member should be separately stated. In case advances are of the nature of a financial asset as per relevant Ind AS, these are to be disclosed under 'other financial assets' separately.

(iii) Others (specify nature).

B. Current Assets

I. Inventories:

(i) Inventories shall be classified as-

(a) Raw materials;

(b) Work-in-progress;

(c) Finished goods;

(d) Stock-in-trade (in respect of goods acquired for trading);

(e) Stores and spares;

(f) Loose tools; and

(g) Others (specify nature).

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

(iii) Mode of valuation shall be stated.

II. Investment

(i) Investments shall be classified as-

(a) Investments in Equity Instruments;

(b) Investment in Preference Shares;

(c) Investments in government or trust securities;

(d) Investments in debentures or bonds;

(e) Investments in Mutual Funds;

(f) Investments in partnership firms; and

(g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate that are-

(a) subsidiaries,

(b) associates,

(c) joint ventures, or

(d) structured entities,

in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing *separately* investments which are partly-paid).

(ii) The following shall also be disclosed-

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

(b) Aggregate amount of unquoted investments;

(c) Aggregate amount of impairment in value of investments.

III. Trade Receivables:

(i) Trade receivables shall be sub-classified as:

(a) Secured, considered good;

(b) Unsecured considered good; and

(c) Doubtful.

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

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

IV. Cash and cash equivalents: Cash and cash equivalents shall be classified as-

a. Balances with Banks (of the nature of cash and cash equivalents);

b. Cheques, drafts on hand;

c. Cash on hand; and

d. Others (specify nature).

V. Loans:

(i) Loans shall be classified as:

(a) Security deposits;

(b) Loans to related parties (giving details thereof); and

(c) Others (specify nature).

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

(a) Secured, considered good;

(b) Unsecured, considered good; and

(c) Doubtful

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

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

VI. Other current assets (specify nature): This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories. Other current assets shall be classified as-

(i) Advances other than capital advances

(1) Advances other than capital advances shall be classified as:

(a) Security Deposits;

(b) Advances to related parties (giving details thereof);

(c) Other advances (specify nature).

(2) Advances to directors or other officers of the company or any of them either severally or jointly with any other persons or advances to firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

(ii) Others (specify nature)

C. Cash and Bank balances: The following disclosures with regard to cash and bank balances shall be made:

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

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

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

D. Equity

I. Equity Share Capital: For each class of equity share capital:

(a) the number and amount of shares authorised;

(b) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;

(c) par value per share;

(d) a reconciliation of the number of shares outstanding at the beginning and at the end of the period;

(e) the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;

(f) shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;

(g) shares in the company held by each shareholder holding more than five per cent. shares specifying the number of shares held;

(h) shares reserved for issue under options and contracts or commitments for the sale of shares or disinvestment, including the terms and amounts;

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

- aggregate number and class of shares allotted as fully paid up pursuant to contract without payment being received in cash;
- aggregate number and class of shares allotted as fully paid up by way of bonus shares; and
- aggregate number and class of shares bought back;

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

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

(l) forfeited shares (amount originally paid up).

II. Other Equity:

(i) 'Other Reserves' shall be classified in the notes as-

(a) Capital Redemption Reserve;

(b) Debenture Redemption Reserve;

(c) Share Options Outstanding Account; and

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

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

(ii) Retained Earnings represents surplus i.e. balance of the relevant column in the Statement of Changes in Equity;

(iii) A reserve specifically represented by earmarked investments shall disclose the fact that it is so represented;

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

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

E. Non-Current Liabilities

I. Borrowings:

(i) borrowings shall be classified as-

(a) Bonds or debentures

(b) Term loans

(I) from banks

(II) from other parties

(c) Deferred payment liabilities

(d) Deposits

(e) Loans from related parties

(f) Long term maturities of finance lease obligations

(g) Liability component of compound financial instruments

(h) Other loans (specify nature);

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

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

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

(v) particulars of any redeemed bonds or debentures which the company has power to reissue shall be disclosed;

(vi) terms of repayment of term loans and other loans shall be stated; and

(vii) period and amount of default as on the balance sheet date in repayment of borrowings and interest shall be specified separately in each case.

III. Provisions: The amounts shall be classified as-

(a) Provision for employee benefits; and

(b) Others (specify nature),

IV. Other non-current liabilities:

(a) Advances; and

(b) Others (specify nature).

F. Current Liabilities

I. Borrowings:

(i) Borrowings shall be classified as-

(a) Loans repayable on demand

(I) from banks

(II) from other parties

(b) Loans from related parties

(c) Deposits

(d) Other loans (specify nature);

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

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

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

II. Other Financial Liabilities: Other Financial liabilities shall be classified **as-**

(a) Current maturities of long-term debt;

(b) Current maturities of finance lease obligations;

(c) Interest accrued;

(d) Unpaid dividends;

(e) Application money received for allotment of securities to the extent refundable and interest accrued thereon;

(f) Unpaid matured deposits and interest accrued thereon;

(g) Unpaid matured debentures and interest accrued thereon; and

(h) Others (specify nature).

'Long term debt' is a borrowing having a period of more than twelve months at the time of origination

III. Other current liabilities:

The amounts shall be classified as-

(a) revenue received in advance;

(b) other advances (specify nature); and

(c) others (specify nature);

IV. Provisions: The amounts shall be classified as-

(i) provision for employee benefits; and

(ii) others (specify nature).

G. The presentation of liabilities associated with group of assets classified as held for sale and non-current assets classified as held for sale shall be in accordance with the relevant Indian Accounting Standards (Ind ASs).

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

(i) Contingent Liabilities shall be classified as-

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

(b) guarantees excluding financial guarantees; and

(c) other money for which the company is contingently liable.

(ii) Commitments shall be classified as-

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

(b) uncalled liability on shares and other investments partly paid; and

(c) other commitments (specify nature).

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

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

K. When a company applies an accounting policy retrospectively or makes a restatement of items in the financial statements or when it reclassifies items in its financial statements, the company shall attach to the Balance Sheet, a "Balance Sheet" as at the beginning of the earliest comparative period presented.

L. Share application money pending allotment shall be classified into equity or liability in accordance with relevant Indian Accounting Standards. Share application money to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable shall be separately shown under 'Other financial liabilities'.

M. Preference shares including premium received on issue, shall be classified and presented as 'Equity' or 'Liability' in accordance with the requirements of the relevant Indian Accounting Standards. Accordingly, the disclosure and presentation requirements in this regard applicable to the relevant class of equity or liability shall be applicable *mutatis mutandis* to the preference shares. For instance, redeemable preference shares shall be classified and presented under 'non-current liabilities' as 'borrowings' and the disclosure requirements in this regard applicable to such borrowings shall be applicable *mutatis mutandis* to redeemable preference shares.

N. Compound financial instruments such as convertible debentures, where split into equity and liability components, as per the requirements of the relevant Indian Accounting Standards, shall be classified and presented under the relevant heads in 'Equity' and 'Liabilities'

O. Regulatory Deferral Account Balances shall be presented in the Balance Sheet in accordance with the relevant Indian Accounting Standards.

8.5 GENERAL INSTRUCTIONS FOR PREPARATION OF STATEMENT OF PROFIT AND LOSS

1. The provisions of this Part shall apply to the income and expenditure account, in like manner as they apply to a Statement of Profit and

Loss.

2. The Statement of Profit and Loss shall include:

   (1) Profit or loss for the period;

   (2) Other Comprehensive Income for the period.

   The sum of (1) and (2) above is ‘Total Comprehensive Income’.

3. Revenue from operations shall disclose separately in the notes

   (a) sale of products (including Excise Duty);

   (b) sale of services; and

   (c) other operating revenues.

4. Finance Costs: Finance costs shall be classified as-

   (a) interest;

   (b) dividend on redeemable preference shares;

   (c) exchange differences regarded as an adjustment to borrowing costs; and

   (d) other borrowing costs (specify nature).

5. Other income: Other income shall be classified as-

   (a) interest Income;

   (b) dividend Income; and

   (c) other non-operating income (net of expenses directly attributable to such income).

6. Other Comprehensive Income shall be classified into-

   (A) Items that will not be reclassified to profit or loss

      (i) Changes in revaluation surplus;

      (ii) Re-measurements of the defined benefit plans;

      (iii) Equity Instruments through Other Comprehensive Income;

      (iv) Fair value changes relating to own credit risk of financial liabilities designated at fair value through profit or loss;

(v) Share of Other Comprehensive Income in Associates and Joint Ventures, to the extent not to be classified into profit or loss; and

(vi) Others (specify nature).

(B) Items that will be reclassified to profit or loss;

(i) Exchange differences in translating the financial statements of a foreign operation;

(ii) Debt Instruments through Other Comprehensive Income;

(iii) The effective portion of gains and loss on hedging instruments in a cash flow hedge;

(iv) Share of Other Comprehensive Income in Associates and Joint Ventures, to the extent to be classified into profit or loss; and

(v) Others (specify nature).

7. Additional Information: A Company shall disclose by way of notes, additional information regarding aggregate expenditure and income on the following items:

(a) employee Benefits expense [showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) share based payments to employees, (iv) staff welfare expenses].

(b) depreciation and amortisation expense;

(c) any item of income or expenditure which exceeds one per cent of the revenue from operations or Rs.10,00,000, whichever is higher, in addition to the consideration of 'materiality' as specified in clause 7 of the General Instructions for Preparation of Financial Statements of a Company;

(d) interest Income;

(e) interest Expense;

(f) dividend income;

(g) net gain or loss on sale of investments;

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

(i) payments to the auditor as (a) auditor, (b) for taxation matters, (c) for company law matters, (d) for other services, (e) for reimbursement of expenses;

(j) in case of companies covered under section 135, amount of expenditure incurred on corporate social responsibility activities; and

(k) details of items of exceptional nature;

8. Changes in Regulatory Deferral Account Balances shall be presented in the Statement of Profit and Loss in accordance with the relevant Indian Accounting Standards.

8.6 SUMMARY

Every company to which India Accounting Standards apply, shall prepare its financial statements in accordance with this Schedule or with such modification as may be required under certain circumstances. Where compliance with the requirements of the Act including Indian Accounting Standards (except the opinion of presenting assets and liabilities in the order of liquidity as provided by the relevant Ind AS as applicable to the companies require any change in treatment or disclosure including addition, amendment, substitution or deletion in the head or sub-head or any changes, *inter se*, in the financial statements or statements forming part thereof, the same shall be made and the requirements under this Schedule shall stand modified accordingly. The disclosure requirements specified in this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Indian Accounting Standards. Additional disclosures specified in the Indian Accounting Standards shall be made in the notes or by way of additional statement or statements unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act, 2013 shall be made in the notes to accounts in addition to the requirements set out in this Schedule.

8.7 GLOSSARY

- **Inventories-** it includes raw material, work in progress, semi-finished goods, finished goods, stock in trade, stores and spares, loose tools etc.
- **NBFC-** Non banking financial corporations
- **P&L STATEMENT-** Profit and loss statement
- **Contingent liabilities-** Those liabilities which may or may not occur are

called contingent liabilities.

8.8 SELF ASSESSMENT QUESTIONS

Q1. What is meant by contingent liabilities?

Ans. ____

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Q2. Write a brief note on equity.

Ans. ____

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Q3. What do you mean by non-current liabilities?

Ans. ____

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8.9 LESSON END EXERCISE

1. Discuss the general instructions followed by companies comply with Ind AS for the preparation of profit & loss account.
2. Discuss the general instructions followed by companies comply with Ind AS for the preparation of balance sheet.
3. Give the classification of assets and liabilities.

8.10 SUGGESTED READINGS

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ACCOUNTS OF GOVERNMENT COMPANIES AND STATUTORY CORPORATIONS

M.Com II Sem.	**Advanced Accounting**	**Unit-II**
M.Com – C 211		**Lesson No. 9**

STRUCTURE

9.1 INTRODUCTION

A statutory corporation is a body corporate formed by a special act of parliament or by the central or state legislature. It is fully financed by the government. Its powers, objects, limitations etc. are also decided by the act of the legislature. It is also called" public corporation". State helps the statutory corporations by subscribing full capital and it is fully owned by the state. Government nominates the board of directors and they manage and operate such corporations. It enjoys the financial autonomy and is answerable to legislature only which creates it.

9.2 OBJECTIVES

After going through this lesson, you will be able to understand –

- the meaning of statutory corporations;
- features of statutory corporations;
- merits of statutory corporations;
- demerits of statutory corporations; and

9.3 MEANING OF STATUTORY CORPORATIONS

Statutory corporations are body corporates formed by a special act of parliament or by the central or state legislature. It is fully financed by the government. Its powers, objects, limitations etc. are also decided by the act of the legislature. Examples include Air India, State Bank of India, Life Insurance Corporation of India etc. A statutory corporation is an autonomous corporate body created by a Special Act of Parliament or state legislature with defined functions, powers, duties, immunities etc. It is also called 'public corporation'. State helps the statutory corporations by subscribing the full capital and it is fully owned by the state. Government nominates the Board of Directors and they manage and operate such corporations. It enjoys financial autonomy and is answerable to legislature only which creates it.

The statutory corporations are fully owned by the government, therefore raising capital for them is an easy process. They can easily raise required capital by floating bonds at a low rate of interest. Since these bonds are safe, the public also feels comfortable in subscribing such bonds.

9.4 FEATURES OF STATUTORY CORPORATIONS

The main characteristics of the statutory corporation are:

1. **It is a Corporate Body**

   It is an artificial person created by law & is a legal entity. Such corporations are managed by the board of directors constituted by the government. A corporation has a right to enter into contracts & can undertake any kind of business under its own name.

2. **Owned by State**

   State provides help to such corporations by subscribing to the capital fully or wholly. It is fully owned by the state.

3. **Answerable to the Legislature**

A statutory corporation is answerable either to parliament legislature or state assembly whosever creates it. Parliament has no right to interfere in the working of statutory corporations. It can only discuss policy matters & overall performance of corporations.

4. **Own Staffing System**

Employees are not government servants, even though the government owns & manages a corporation. Employees of various corporations receive balanced or uniform pay & benefits by the government. They are recruited, remunerated & governed as per the rules laid down by the corporation.

5. **Financial Independence**

A statutory corporation enjoys financial autonomy or independence. It is not subject to the budget, accounting & audit controls. After getting the prior permission from the government, it can even borrow money within & outside the country.

9.5 MERITS OF STATUTORY CORPORATIONS

The main advantages of the statutory corporation are:

- **Initiative & flexibility :** Operations & management of a statutory corporation is done independently, without any government's interference, with its own initiative & flexibility.
- **Administrative autonomy :** A public corporation is able to manage its affairs with independence & flexibility.
- **Quick decisions :** A public corporation is relatively free from red-tapism, as there is less file work & less formality to be completed before taking decisions.
- **Service motive :** The activities of the public corporation are discussed in parliament. This ensures the protection of public interest.
- **Efficient staff :** The public corporations can have their own rules & regulations regarding remuneration & recruitment of employees. It can provide better facilities & attractive terms of service to staff to secure efficient working from its staff.

- **Professional management :** Board of directors of statutory corporation consists of business experts & the representatives of various groups such as labor, consumers nominated by the government.
- **Easy to raise capital :** As such corporations are fully owned by the government, they can easily raise required capital by floating bonds at a low rate of interest. Since these bonds are safe, the public also feels comfortable in subscribing such bonds.

9.6 DEMERITS OF STATUTORY CORPORATIONS

- **Autonomy on paper only:** The autonomy & flexibility of public corporation is only for name's sake. Practically ministers, government officials & political parties often interfere with the working of these operations.
- **Lack of initiative:** Public corporations do not have to face any competition & are not guided by a profit motive. So the employees do not take initiative to increase the profit & reduce loss. The losses of the public corporation are made good by the government.
- **Rigid structure:** The objects & powers of public corporations are defined by the act & these can be amended only by amending the statute or the act. Amending the act is a time-consuming & complicated task.
- **Clash amongst divergent interests:** The government appoints the board of directors & their work is to manage & operate corporations. As there are many members, it is quite possible that their interests may clash. Because of this reason, the smooth functioning of the corporation may be hampered.
- **Unfair practices:** The governing board of a public corporation may indulge in unfair practices. It may charge an unduly high price to cover up inefficiency.
- **Suitability:** The public corporation is suitable where the undertakings require:
  - o monopoly powers.
  - o special powers, defined by the act or statute.
  - o regular grants from the government.

- o an appropriate combination of public accountability & operational autonomy.

- **Ignores commercial principles :** Statutory corporations may ignore the commercial principles in their working because they do not work to earn profit and do not have any fear of loss. Without these principles, inefficiency and losses can take place in a corporation.
- **Excessive public accountability :** Such corporations work with the motive to render services and not profit motive. This public accountability of corporation act as a stumbling block in operational efficiency of the enterprise.

9.7 ACCOUNTS OF STATUTORY CORPORATIONS

A statutory corporation is created by means of a Special Act of the Parliament or any State L

Such corporations are also known as statutory companies because these are created by the Spe Acts. Such corporations are governed by their respective Acts and are generally formed to carry out some special public undertaking such as waterworks, gas, oil exploration, electricity generation etc. Examples of public corporations created by Special Acts in India are Oil and Natural Gas Commission, Damodar Valley Corporation, Reserve Bank of India, Life Insurance Corporation of India, Central Warehousing Corporation, State Trading Corporation, State Financial Corporation, Food Corporation of India, Unit Trust of India etc.

A corporation is governed by the special Act creating it. It is not required to have any memorandum or articles of association. Changes in its structure are possible only by making amendments in the Act creating it. It has to maintain proper books of accounts so as to exhibit a true and fair view of its state of affairs. The fundamental accounting principles are to be followed for the maintenance of accounts. While preparing the accounts, the provisions of the special Act creating it are to be followed. The provisions of the Companies Act, 2013 apply to the statutory corporations except where the provisions of the Companies Act are inconsistent with the provisions of the special Acts creating them. The annual report on the working of each statutory corporation is required to be placed on the table of the Parliament or the State Legislature as the case may be. Even though a statutory corporation is owned by the Government but it has a separate legal entity and it has to prepare its final accounts according to the format prescribed in the special Act creating it. If the format of final accounts is not given in the special Act, the format of final accounts is prescribed by the Central or State Government in consultation with the Comptroller and Auditor General of India.

9.8 SPECIMEN OF DIRECTIONS ISSUED BY THE COMPTROLLER AND AUDITOR-GENERAL

I. SYSTEM OF ACCOUNTS AND BOOK-KEEPING.

In respect of the following matters, please offer your observations on the basis of your examination of the books of accounts of the company.

1. Are there any important deficiencies in the accounting system for the purpose of "auditing in depth and in the manuals and other instructions laying down the detailed accounting procedures and specify the financial powers, duties and responsibilities of the different officers?"

2. Is there an effective system of re-conciliation of the of by taking out periodical trial balance and is the reconciliation of the bank accounts, control accounts and subsidiary accounts (including those pertaining to the branches and units) up-to-date?.

3. Are Property/Plant Registers kept up-to-date and reconciled with the financial books ? Important cases of failure to report to the Accounts Department regarding the disposal of items of property, plant and equipment may be mentioned.

4. Is the allocation of expenditure during construction between capital and revenue properly done so that cost of an identifiable unit of plant (e.g., coke oven in steel plant) can be ascertained ? If not, the defective cases should be indicated.

II. INTERNAL CONTROL

1. Has a manual outlining the scope and programme of work for the internal audit been drawn up ? If so, had the programme keen kept up?

2. (a) Are you satisfied that the important points thrown up by the internal audit have been considered by the Administration and necessary actions taken? If not, indicate the more important

points on which consideration/action is outstanding. Have any drawbacks in the system of internal control been noticed?

(b) Is the procedure for write off, discounts, refund, etc., adequate? Have any receipts been forgone in the shape of unusual concessions involving material amounts allowed to customers, the term of discount, rebate, wastage, etc. ? If so, instances may be given indicating the amount involved.

(c) Is there an adequate procedure in force for recovery of charge for materials issued in respect of major construction works? Have you noticed cases where charges for materials etc., issued have not been recovered? If so, instances may be given indicating the amount involved.

(d) (i) In what classes of cases does the company's purchasing procedure provide for the calling of the open tenders? Is the prescribed procedure of the calling of open tenders considered adequate? Give instances exceeding '...individually, if any, which have come to your notice, in the course of your audit (a) where such procedure has not been followed, and (b) where tender has not been accepted though open tenders were called for. Reasons given by the management in both type of cases should be indicated.

(ii) What is the purchasing procedure followed in regarding to other items where open tenders are not invited, e.g., whether quotations are obtained from a panel of suppliers maintained.

3. Does the company prepare capital, revenue, production and sales budget for a financial year with the adequate details and sufficiently in advance? If so, the actual performance, in relation to the original budget provision and the reasons given by amendment for abnormal variations, if any, may be indicated.

III. Manufacturing and Production Accounts

1. (a) In the case of manufacturing companies, has the consumption of the major raw materials for manufacture of major products

been more than the estimated quantity as per project report or norms fixed by the management ? If so, indicate such cases (Minor variations may be ignored).

(b) In the case of construction companies, has the consumption of major materials for construction of major projects been more than the estimate quantity as per project report or norms fixed by the management. If so, indicate such cases (Minor variations may be ignored).

2. Does the company maintain periodical quantity accounts, of production of the major products? What were the rated capacity of production of the major products? What were the rated capacity target fixed by management, and the actual production of the major products during the last 3 years?

3. Are the existing manufacturing accounts drawn up properly ? Where appropriate, the lines of improvement may be suggested.

4. Are records maintained for determining the rejections in production ? Have you noticed any abnormal variations? -

5. Cost Accounts.

(a) Does the company prepare accounts indicating the cost of each unit of its major products? Have you any comments to make on the effectiveness of the system of costing and also any suggestions to make on the maintenance of cost records or distribution of overhead ? Are the costs compiled in time or is there a time lag in the compilation of costs?

(b) Have standard costs of various main products been fixed ? How did they compare with the actual cost of production during the last 5 years.

(c) In the case of companies undertaking construction or repair contracts, how do the cost estimates prepared by the company for the purpose of quotations for undertaking such work compare with the actual costs? Give instance, if any, which have come to your notice.

(d) Has the company a system for ascertaining the idle time for labour and machinery, specifying the reasons therefore? Give instances, if any, which have come to your notice, of machinery costing more than 5 lakhs which had remained idle for more than 3 years.

IV. Statement of Profit and Loss

1. Is the method of valuation of closing stock and work-in-progress acceptable ? Defects, if any, may be indicated with any suggestions for improvement.

2. Indicate the method of depreciation adopted and your comments, if any.

3. How do the selling prices compare with cost of production? Indicate separately whether material losses were incurred on the sale/trade of the major commodities dealt with? Give the management's reason for such loss.

4. Were there any special features in the year which have affected the results shown by Profit and Loss account substantially?

5. What is the break-up of turnover, i.e., value of sales/business in respect of major products for the past 3 years ? The percentage of increase or decrease for the total turnover of major products, with the management's reasons for the variations, may be given.

6. Indicate instances where substantial demurrage has been paid.

V. BALANCE SHEET

1. Sundry Debtors

(a) Mention important cases of failure to obtain confirmation of outstanding debts.

(b) Mention the details of debts outstanding for more than one year in the following form:

(i) Debts over 1 year but less than 2 years.

(ii) Debts outstanding for 2 years but less than 3 years.

(iii) Debts outstanding for 3 years and above.

(c) Is the system of allowing credit reasonable? Are the debts vigorously pursued?

2. Plant and Machinery. Have all items of plant and machinery costing more than ‘lakhs each been installed and commissioned? In case of non-commissioning of such plant, which are the reasons given by the management?

3. Inventory Procedure and Control

(a) Is the pricing of stores issued does on a uniform basis?

(b) What are the results of the physical verification of stocks of finished and semi-finished goods, stores and spares, and raw materials conducted periodically by the company ? What action has been taken by the management on the excess and shortages revealed as a result of such physical verification ,? Are you satisfied with the system of verification?

(c) Does the system of procurement and disposal of stores ensure that (i) stores in excess of the reasonable requirement of maintenance and production are not accumulated; (ii) the amount of (a) surplus, (b) unserviceable stores are periodically determined ; (iii) surplus and unserviceable stores are disposed of without undue delay?

What is the value of stores declared as surplus or obsolete in the last three years? Indicate how much has been awaiting disposal for more than (a) one year, (b) two years.

(d) Indicate the class of items where maximum and minimum units of stores/spares holding have not been fixed. Indicate also the classification and value of stores/spares which have not moved for 3 years and more.

(e) How many months’ cost of production did the total stock inventory work out to for the past 3 years? A table may be given in the following form:

(i) Cost of production.
(ii) Inventory as at the end of the year.
(iii) Inventory in terms of number of months’ cost of production.

(f) How many months' consumption was represented by the stock of raw materials, stores, and spares held t the date of the balance sheet during the past three years?

(g) How many months' cost of production was the work-in-progress equivalent to during the past 3 years? The figure of total cost of production and work-in-progress for these years may also be given.

(h) Has there been substantial accumulation of finished product? Give instances which have come to your notice where the value of the closing stock of such products exceeds the value of six months' scale of these products.

4. Working Capital. How many months' cost of production/business was represented by the total working capital?

VI. GENERAL REVIEW

1. Are proforma accounts maintained in respect of the operation of service units, for the benefit of staff during the last 3 years, e.g., transport, canteen, etc. If so, the results may be indicated.

2. Following ratios for the last three years may be given:

(a) Long-term loans to paid-up capital.

(b) Net current assets to fixed assets.

(c) Gross profit to sales.

(d) Return on capital invested (share capital, long term loans and free reserves).

The profit will include interest on long-term loans.

You may also given any other ratio which you feel might offer significant information in the case of the particular company under review.

3. How does the manpower actually employed compare with manpower envisaged in the Project Report/Norm fixed by the management ? A statement showing the comparative figures may be given.

VII. TOWNSHIP

1. What is the amount of financial assistance, if any, availed of by the company under the subsidised housing scheme for industrial worker? The amount of financial assistance sanctioned but not availed of, and the reasons therefore given by the management may be indicated.
2. The actual expenditure on the township and the percentage of such expenditure to the actual capital outlay may be given.

9.9 SUMMARY

A statutory corporation is a body corporate formed by a special act of parliament or by the central or state legislature. It is fully financed by the government. Its powers, objects, limitations etc. are also decided by the act of the legislature. It is also called" public corporation". State helps the statutory corporations by subscribing full capital and it is fully owned by the state. Government nominates the board of directors and they manage and operate such corporations. It enjoys the financial autonomy and is answerable to legislature only which creates it.

9.10 GLOSSARY

- O.N.G.C- Oil and Natural Gas Commission
- D.V.C-Damodar Valley Corporation
- R.B.I- Reserve Bank of India
- L.I.C.I- Life Insurance Corporation of India
- C.W.C- Central Warehousing Corporation
- S.T.C- State Trading Corporation
- S.F.C- State Financial Corporation
- F.C.I- Food Corporation of India
- U.T.I-Unit Trust of India

9.11 SELF ASSESSMENT QUESTIONS

Q1. What do you mean by the statutory corporation?

Ans. ____

____

Q2. For statutory corporations, it is very easy to raise capital. Explain this statement in terms of merit.

Ans.

9.12 LESSON END EXERCISE

1. Discuss the meaning and features of statutory corporations.
2. Give the merits and demerits of statutory corporations.
3. Write a detailed note on accounts of statutory corporations.
4. Give the specimen of directions issued by Comptroller and Auditor General.

9.13 SUGGESTED READINGS

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ACCOUNTS OF GOVERNMENT COMPANIES AND STATUTORY CORPORATIONS

M.Com II Sem.	Advanced Accounting	Unit-II
M.Com – C 211		Lesson No. 10

STRUCTURE

10.1 INTRODUCTION

A statutory company definition is defined as a company that is created by a Special Act of the Parliament and it provides services of value to the public. A statutory company is defined as a company that is created by a Special Act of the Parliament. It is a company that provides services of value to the public. A statutory company can be approved by either the Central or State Legislature Statutory Company. A statutory company is usually created with the intention of serving people rather than the traditional business goal of creating profits. Despite the fact that statutory companies have limited liability, they are not always required to utilize the limited title. They are required, however, to provide annual reporting to the Legislature-Parliament. A few well-known statutory companies include the following:

Reserve Bank of India

State Bank of India

Industrial Finance Corporation

Food Corporation of India

Life Insurance Corporation of India

10.2 OBJECTIVES

After going through this lesson, you will be able to understand the forms of accounts of (statutory corporations) Electricity Supply Company and Railway Company.

10.3 PRESCRIBED FORMS OF ACCOUNTS OF ELECTRICITY SUPPLY COMPANY

Every electricity supply company is required to submit to the State Government (or to its nominee which is the State Electricity Board) certain statistical statements in the prescribed form according to Rule 26 of the Indian Electricity Rules, 1956.

The forms are:

Form Nos.		Contents
I	:	Statement of Share and Loan Capital
II	:	Statement of Capital Expenditure
IIA	:	Statement showing the written-down cost of Fixed Assets Retired
III	:	Statement of operating Revenues
IV	:	Statement of operating Expenses
V	:	Statement of provision for Depreciation
VI	:	Statement of Contingencies Reserve
VII	:	Statement of Tariffs and Dividends Control Reserve
VIII	:	Statement of Consumers' Rebate Reserve
IX	:	Statement of Special Appropriation permitted by the State Govt.
X	:	Statement of Net Revenue and Appropriation Account
XI	:	General Balance Sheet.

Note 1:

Statements I and II resemble the ‘Receipts and Expenditure on Capital’ under Double Account System whereas, Statements III and IV; constitute the ‘Revenue Account’ Statement X is the ‘Net Revenue Account’.

Some of the above prescribed forms are presented:

I. Statement of Share and Loan Capital for the Year Ended on 31st March 2019:

Description of Capital	Balance at the beginning	Receipts during the year	Redeemed during the year	Balance at the end of year	Remarks
A. *Share Capital*					
Authorised Capital :		[redacted]	[redacted]	[redacted]	[redacted]
... Ord. Shares of Rs. ... each					
...% Pref. Shares of Rs. ... each					
Issued, Subscribed and Paid up Capital :					
(*Less* : Calls-in-Arrear to be specified) [redacted]					
Total Paid-up Capital					
B. *Capital Reserve*					
Share Forfeiture					
Share Premium		[redacted]	[redacted]	[redacted]	[redacted]
Other items (to be specified)					
Total Capital Reserves					
C. *Loan Capital*					
Loan from State Electricity Board					
(...% Debt. of Rs. ... each)	[redacted]		[redacted]	[redacted]	[redacted]
Other Secured Loans					
Unsecured Loans & Adv.					
Total Loan Capital					
D. *Other Capital*					
Contributions from Consumers and Local Authority	[redacted]		[redacted]	[redacted]	[redacted]
Special items (to be specified)					
Total Other Capital					
Total Capital (A + B + C)					

N.B. : Local Authority Licenses are required to prepare this statement in a slightly different form given in Proforma No. 1A(1) and 1A(e), which are not given here.

II. Statements of Capital Expenditure for the Year Ended as 31st March 2019 :

Particulars	*Balance at the beginning*	*Additions during the year*	*Retirement during the year*	*Balance at the end*	*Remarks*
A. ***Intangible Assets***					
1. Preliminary and Promotional Exp.					
2. Cost of Licence					
3. Other Expenses					
Total Intangible Capital					
B. ***Hydraulic Power Plant***					
1. Land and Rights					
2. Buildings and Civil Engineering Works					
3. Hydraulic Works (including dams, canals, pipeline, tank etc.)					
4. Water Wheels, Generators etc.					
5. Switchgear including Cable Connections					
6. Misc. Power Plant Equipment					
7. Other Civil Works					
Total Hydraulic Power Plant					
C. ***Steam Power Plant***					
1. Land and Rights					
2. Buildings and Civil Eng. Works					
3. Boiler Plant and Equipment					
4. Engine, Turbines, Generators etc.					
5. Water Cooling System					
6. Switchgear and Cable connections					
7. Misc. Power Plant and Equipment					
8. Other Civil Works					
Total Steam Power Plant					

D. *Internal Combustion Power Plant*					
1, 2, 3, 4, 5, 6, 7, 8 — Do, from (C) above					
Total Internal Combustion Power Plant					
E. *Transmission Plant (High and Extra High Voltage)*					
1. Land and Rights					
2. Buildings and Structure					
3. Sub-station Transformers etc.					
4. Switchgear and Cable Connections					
5. Towers, Poles, Fixtures etc.					
6. Underground Cables and Devices					
Total Transmission Plant					
F. *Distribution Plant (High Voltage)*					
1, 2, 3, 4, 5, 6 —Do, from (E) above					
7. Service Lines					
8. Metering Equipment					
Total Distribution Plant (H. V.)					
G. *Distribution Plant (Medium and Low Voltage)*					
1, 2, 3, 4, 5, 6, 7, 8, —Do, from (F) above					
Total Distribution Plant (M. and L. V.)					
H. *Public Lightings*					
1. Street and Signal Lighting Systems					
I. *General Equipment (Not allocated to other sub-heads)*					
1. Land and Rights					
2. Buildings and Structure					
3. Office Furniture and Equipments					
4. Transportation Equipment					
5. Laboratory and Meter Testing Equip.					
6. Workshop Plant and Equipment					
7. Tools and Work Equipment					
8. Communication Equipments					
9. Miscellaneous Equipments					
Total General Equipment					
Total Capital Assets in use					

III. Statements of Operating Revenue for the Year Ended on 31st March 2019

Particulars of Revenue	*Corresponding amount for previous year*	*Amount for current year*	*Remarks*
A. ***Net Revenue by Sale of Electricity***			
1. *Domestic and Residential :*			
(a) Light and Fans			
(b) Heating and Small Power			
2. *Commercial :*			
(a) Lights and Fans			
(b) Heating and Small Power			
3. *Industrial :*			
(a) Low and Medium Voltage			
(b) High Voltage			
4. Public Lighting			
5. Public Water Works and Sewage Pumping			
6. Irrigation			
7. Traction			
8. Supplies in bulk to Distributing Licensees			
Total Revenue by Sale of Electricity			
B. ***Miscellaneous Revenue from Consumers***			
1. Rent from (a) Meter			
(b) Motors, Fittings etc. hired			
2. Service Connection Fees			
3. Public Lighting Maintenance			
Total Misc. Revenue from Consumers			
C. ***Other Revenues***			
1. Sale of Stores			
2. Repair for Lamps and apparatus			
3. Commission for collection of duty etc.			
4. Other Misc. Items			
Total Other Revenues			
Total Operating Revenues (A + B + C)			
Less : Total Operating Expenses (as per Statement No. IV)			
Net Surplus/Deficit (carried to Net Revenue Appropriation A/c Statement No. X)			

IV. Statements of Operating Revenue for the Year Ended on 31st March 19

Particulars of Revenue	Corrsponding amount for previous year	Amount for current year	Remarks
A. ***Hydraulic Power Generation :***			
(a) Operation			
(b) Maintenance			
(c) Depreciation			
B. ***Steam Power Generation :***			
(a), (b), (c) —same as above			
C. ***Internal Combustion Power Generation :***			
D. ***Power Purchased***			
Total Production Expenses = A + B + C			
E. ***Transmission (High and Extra High Voltage)***			
(a) Operation and Maintenance			
(b) Depreciation			
Total Transmission Expenses (H and EHV)			
F. ***Distribution (High Voltage)***			
Same as E			
G. ***Distribution (Medium and Low Voltage)***			
Same as E			
H. ***Public Lighting :***			
Same as E			
I. ***Consumers Servicing, Meter Reading Billing, Connecting Accounting Sales Promoting etc.***			
J. ***Rates and Taxes***			
K. ***General Establishment Charges***			
L. ***Other Charges***			
M. ***Management Expenses***			
Total Operating Expenses (transferred to Statement No. III)			

V. Statement of Net Revenue and Appropriation for Account for the Year Ended on 31st March 19

Correspon-ding figure of previous year	*Particulars*	*Amount*	*Correspon-ding figures of previous year*	*Particulars*	*Amount*
	To Balance of loss brought forward from last account, if any			By Balance of Profit brought forward from Last Account	
	" Net Operating Deficit as per Statement III, if any			" Net Operating Surplus as per Statement III	

	To Taxes on Income and Profit			By interest on Securities and Investments	
	" Instalments			" Other Receipts (Nonoperating)	
	" Contribution towards Contingency Reserve			(a) Rent	
	" Appropriation to Tariffs and Dividend Control Reserve			(b) Transfer Fees	
				(c) Others	
	" Appropriation to Consumers Rebate Reserve			" Balance of Loss c/d (if any)	
	" Other Special Appropriations				
	" Interest on Debenture				
	" Interest on Other Secured Loans				
	" Interest on Unsecured Loans, Advances, Deposits, Bank O/D etc.				
	" Dividend on Pref. Shares Capital				
	" Dividend on Ord. Shares Capital				
	" Balance of Profit c/d				

VI. Statement of General Balance Sheet as on 31st March 19

Correspon-ding figures of previous year	*Particulars*	*Amount*	*Correspon-ding figures of previous year*	*Particulars*	*Amount*
	1. Capital Raised and Appropriated (Vide Statement 1 for 1A)			1. Capital amount expended on works in use (vide Statement II)	
	Reserves and Surplus			***Net Block***	
	2. Non-statutory Reserve			2. Balance of Written-down	
	3. Contingency Reserve Fund			cost of obsolete, inadequate etc. Assets.	
	4. Tariffs and Dividend			***Current Assets***	
	Control Reserve			3. Capital Work-in-Progress	
	5. Consumer Rebate Reserve			4. Stores and Materials in hand	
	6. Special Appropriation Reserve			(a) Fuel—Coal, Oil etc. at cost	
	7. Balance of Net Revenue and Appropriation A/c			(b) General Stores at or below cost	

	Current Liabilities and *Provisions*			5. Debtors for amounts paid in advance on account of contracts	
	8. Balance due on construction of Plant, Machinery etc.			6. Sundry Debtors for Electricity supplied	
	9. Creditors on open accounts			7. Other Debtors	
	10. Consumers' Security Deposits			8. Account Receivables	
	11. Accounts Payable			9. Investment in Statutory Securities cost	
	12. Temporary Accomodation Bank O/D and Other Finances			10. Special Deposit (a) In respect of Taxation (b) Others (to be specified)	
	13. Other Accrued Liabilities			11. Balance at Bank (a) Deposit Account (b) Current Account and at call	
	14. Contingent Liabilities and outstanding commitments			12. Cash in hand Debit Balance	
				13. Net Revenue and Appropriation Account Balance (Dr.) Statement X	
				14. Deferred Payments	

10.4 FINANCIAL PROVISIONS CONTAINED IN THE SIXTH AND SEVENTH SCHEDULES OF THE ELECTRICITY (SUPPLY) ACT

It has already been stated earlier that there are some financial provisions contained in the Sixth and Seventh Schedules of the Electricity (Supply) Act.

These financial provisions are:

(a) Adjustment of Rates

(b) Clear Profits

(c) Reasonable Returns

(d) Capital Base

(e) Disposal of Excess Clear Profits

(f) Contingencies Reserve

(g) Development Reserve

(h) Depreciation

(i) Service Connections.

(a) Adjustment of Rates: Prior to 19410, electricity supply companies charged high rates from the consumers and did not make any reduction on rates. According to paragraph I of the Sixth Schedule, it is obligatory for all companies to adjust these rates for the sale of electricity by periodical revision in such a way so that their clear profit does not exceed the amount of reasonable return by more than 15% in any year. The said rates must neither be enhanced more than once in a year nor be enhanced without giving a proper notice of at least 60 clear days to the State Government or the State Electricity Board.

(b) Clear Profits: It is the difference between the total expenditure (including special appropriation). According to paragraph XVII of the Sixth Schedule, the clear profit may be calculated as under:

Statement of Clear Profit

Expenditure	*Rs.*	*Income*	*Rs.*
1. Cost of generation and purchase of energy		1. Sale of energy less discounts	
		2. Meter Rents etc.	
2. Cost of distribution and sale of energy		3. Sale and repair of lamps and apparatus	
3. Rent, Rates and Taxes other than tax on income		4. Other Rents	
4. Interest on loans advanced by State Electricity Board		5. Income from investments and bank deposits	
5. Interest on Consumer's Security Deposit		6. Sundry receipts which are liable to income-tax	
6. Bad Debts			
7. Auditors' fees			
8. Management Expenses			
9. Depreciation			
10. Other expenses (including interest on debentures and loans) which are admissible for income-tax			
11. Contribution of P.F., Staff Pension and Gratuity or any such scheme as is approved by the State Government			
12. Bonus to employees			

Special Appropriations

	Rs.		Rs.
1. Past losses			
2. Taxes on income and profit			
3. Write-off intangibles			
4. Contribution to Contingency Reserve			
5. Arrear Depreciation			
6. Development Reserve			
7. Appropriation (special) Permitted by State Govt.			

(c) Reasonable Returns: According to sub-paragraph (9) of paragraph XVII of Sixth Schedule, the reasonable return means the sum of the following items in respect of any year:

(i) A standard rate of interest (bank rate) plus 2% on the Capital Base

(ii) Income derived from investments other than those included in the Capital Base

(iii) An amount equal to on the loans advanced by the State Electricity Board

(iv) An amount equal to ½% on the amounts borrowed from approved financial institutions

(v) An amount equal to ½% on the amount realised by the issue of debentures

(vi) An amount equal to ½% on the balance of the Development Reserve.

(d) Capital Base: It means capital employed. According to sub-paragraph (1) of paragraph XVII of the Sixth Schedule, amount of capital base is the sum of the following items:

(i) The original cost of fixed assets available for use and necessary for the purpose of the undertaking less the cost of service lines contributed by consumers.

(ii) The cost of intangible assets (i.e., underwriting commission, preliminary expenses etc. excluding goodwill).

(iii) The original cost of work-in-progress.

(iv) Compulsory investments made on account of contingencies reserves.

(v) The amount of working capital, being the monthly average or, ½ of stores, materials and supplies including

  (a) full in hand at the end of each month of the year of account.

  (b) 1/12 of the sum of cash and bank balances and call and short-term deposits at the end of each month of the year of account not exceeding ¼th of the operating expenses excluding generation, interest and depreciation.

Deductions:

(i) The amounts written-off or set aside on account of depreciation of fixed assets and the amounts written-off in respect of intangible assets in the books of the Company.

(ii) The amounts of any loans advanced by the State Electricity Board.

(iii) The amounts of any loans borrowed from organisations or institutions approved by the State Government.

(iv) The amount of any debenture issued by the Company.

(v) The amounts deposited in Cash with the Company by consumers by way of security.

(vi) The amounts standing to the credit of the Development Reserve at the close of the year of account.

(vii) The amounts standing to the credit of the Tariffs and Dividends Control Reserve at the beginning of the year of account.

(viii) The amount carried forward at the beginning of the year of account to the Consumers' Benefit Reserve.

(e) Disposal of Excess Clear Profits:

Clear Profit: According to paragraph II of the Sixth Schedule, if the amount of clear profit is in excess of the amount of reasonable return to the extent of 20% in any year, such excess shall be applied as under:

(i) 1/3rd of such excess, not excluding 5% of the amount of reasonable return, is to be placed at the disposal of the undertaking (as a reward for efficiency),

(ii) Of the balance of excess, ½ shall be transferred to Tariffs and Dividends Control Reserve, and the remaining ½) ½ shall be distributed in shape of proportionate rebate to the consumers on the amounts collected from the sale of energy and meter rental. Pending distribution, if any (this remaining ½) is carried to a 'Consumers' Benefit Reserve'.

The Tariffs and Development Control Reserve shall be available for disposal only to the extent by which the clear profit is less than the reasonable return in any year of account.

Any excess over 20% of reasonable return must be refunded to customers.

(f) Contingencies Reserve: According to paragraphs III, IV and V of the Sixth Schedule, every electricity company is required to maintain Contingencies Reserve. It is created out of revenues of each year—a sum not less than ¼% and not more than ½% of the original cost of fixed assets until it amounts to 5% of the original cost of fixed assets. The amount of such reserve shall be invested in trust securities and the investment must be made within a period of 6 months from the date of appropriation.

The reserve may be utilised for the following purposes, with the approval of the State Government:

(i) Expenses or loss of profits arising out of accidents, or circumstances which management could not have prevented.

(ii) Expenses or replacement or removal of plant or works other than expenses requisites for normal maintenance of renewal;

(iii) Compensation payable under any law for the time being in force and for which no other provision is made.

(g) Development Reserve: According to paragraph VA of the Sixth Schedule, a development reserve is to be created every year—a sum equal to the amount of income-tax on the amount of development rebate to which the licensee is entitled by virtue of Income-tax Act. This reserve may also be appropriated in annual instalment spread- over within a period of 5 years.

It must be remembered that if in any year the clear profit (before considering special appropriations plus balance of Tariff and Dividend Control Reserve) is less than the required amount of Development Reserve, the deficiency so made may not be compensated.

(h) Depreciation : Depreciation must be provided on all fixed assets. Total amount of depreciation must be 90% of the original cost of fixed assets. Only two methods are recognised here for the amount of depreciation on fixed assets, viz., Compound Interest Method and the Straight Line Method.

Compound Interest Method:

It is also known as Modified Sinking Fund Method. Under this method, such an amount should be set aside every year throughout the life of the asset, accumulating @ 4% compound interest, which will produce an amount equal to 90% of the original cost of the assets. Interest on accumulated balance will, however, be allowed as an expense from revenue.

Straight Line Method:

Under this method, an allowance is made in each year in respect of depreciation .of fixed assets—such an amount which is arrived at by dividing 90% of the original cost by the period of its prescribed life. Amount of depreciation so made shall be invested only in the electricity supply company or, in other cases, approval of the State Govt, must be taken. An amendment in Electric Supply Act was made in 1971 which states that from 1st April 1979, Straight Line Method of Depreciation may be adopted.

According to paragraph VIII of the Sixth Schedule, if an asset has been written-down in the books to 10% or less of its original cost, no further depreciation shall be allowed. Similarly, when any fixed asset ceases to be available for use through obsolescence, inadequacy, superfluity, or for any other reason, it shall be described in the books as discarded asset and, consequently, no further depreciation is allowed.

When any fixed asset is discarded due to obsolescence or any other reason, the w.d.v. of the same shall be charged against Contingency Reserve and, if any discarded assets are sold, Contingency Reserve will be credited.

Expected Life of Fixed Assets of electricity (as prescribed by the III Schedule) are given below in brief:

	Nature of Assets	*No. of Years*
A.	Land owned under full title	Infinite
B.	Land held under lease	Period of Lease
C.	Asset Purchased (new) :	
(i)	Plant and Machinery	
	Hydro-electric	35
	Steam-electric	25
	Diesel electric	15
(ii)	Cooling Tower	30
*(iii)	Hydraulic	100
*(iv)	Building	50
*(v)	Transformers	35
(vi)	Switchgear	20
(vii)	Batteries	10
(viii)	Underground Cables	40
(ix)	Meters	15
*(x)	Overhead lines	30
(xi)	Self-propelled vehicles	7
(xii)	Static machine tools	20
*(xiii)	Air-conditioning plant	15
*(xiv)	Office Furniture	20
*(xv)	Apparatus let on hire	7
D.	**Assets Purchased (Second-hand)**	Reasonable period

* It is the general rate. In specific case other rates may be taken into consideration.

(i) Service Connections: It has already been stated earlier that at the time of computing Capital Base contribution received from customers towards the cost of service connections are to be deducted from the capital outlay. The cost of service connections must be shown as a fixed asset and the amount so received from the customers for this purpose will be shown in the liabilities side of the Balance Sheet under the head 'Contributions by customers towards cost of Service Lines'.

Illustration 10.1

Saharanpur Electricity Ltd. earned a profit of Rs. 17,40,000 during the year ended 31st March 1997 after charging interest on debentures amounting to Rs. 45,000 @ 7^%.

You are required to show the disposal of profits assuming bank rate at 6% with the help of the following data:

	Dr. Rs.
Fixed Assets at Cost	2,50,00,000
Preliminary Expenses	5,00,000
Monthly average of current assets including amounts due from customers Rs. 6,00,000	36,00,000
Reserve Fund (represented by 6% Govt. Securities)	40,00,000
Total Depreciation written-off	77,00,000
Contingency Reserve Investment	10,00,000
Loan from Electricity Board	50,00,000
Tariff and Dividend Control Reserve	2,00,000
Security Deposit received from Customers	5,00,000
Development Reserve	5,00,000

[I.C.W.A. Final]

Solution :

	Rs.	Rs.
Capital Base		
Fixed Assets at Cost	2,50,00,000	
Preliminary expenses	5,00,000	
Monthly average of Current Assets	36,00,000	
Contingency Reserve Investments	10,00,000	
		3,01,00,000
Less :		
Total Depreciation written-off	77,00,000	
Loan from Electricity Board	50,00,000	
Debentures $\frac{45,000 \times 100}{7^1/_2}$	6,00,000	
Security deposit of customers	5,00,000	
Tariff and Dividend Control Reserve	2,00,000	
Development Reserve	5,00,000	
		1,45,00,000
Capital Base		1,56,00,000

	Rs.	Rs.
Reasonable Return		
@ 8% (i.e., 6% Bank Rate + 2%) on Rs. 1,56,00,000	12,48,000	
Income from Reserve Fund Investment @ 6% on Rs. 40,00,000	2,40,000	
$\frac{1}{2}$% on Loan from Electricity Board on Rs. 50,00,000	25,000	
$\frac{1}{2}$% on Development Reserve on Rs. 5,00,000	2,500	
	15,15,500	
Disposal of Surplus		
Net Profit after charging Debenture Interest	17,40,000	
Less: Reasonable Return	15,15,500	
Surplus	2,24,500	
Disposal		
$\frac{1}{3}$rd of surplus or 5% of Reasonable Return, whichever is less		
i.e., $\frac{1}{3}$rd of Rs. 2,24,500 = Rs. 74,833		
or, Rs. 15,15,500 × $\frac{5}{100}$ = Rs. 75,775	74,833	
And, of the balance, i.e., Rs. 1,49,667 (2,24,500 – 74,833)		
50% or $\frac{1}{2}$ = to be transferred to Tariff and		
Development Control Reserve (i.e., Rs. 1,49,667 × $\frac{50}{100}$)	74,833	
and, 50% or $\frac{1}{2}$ = to be distributed among consumers by way		
of reduction of rate i.e., Consumers' Benefit Reserve	74,834	
	2,24,500	

Illustration 10.2

From the following information and details relating to the year ended 31st March 20110 and bearing in mind the provisions of the Electricity (Supply) Act, 19410, indicate the disposal of profits of X Electricity Corporation Limited:

	Rs.
Net Profit before charging debenture interest	35,00,100
Fixed Assets	4,20,00,000
Depreciation written-off on fixed assets	98,00,000
Loan from Electricity Board	1,20,00,000
6% Investments of the Reserve Fund (F.V. Rs. 90,00,000)	90,00,000
6% Investments of the Contingencies Reserve	76,00,000
Tariffs and Dividends Control Reserve	8,40,000
Security deposits of Customers	4,84,000
Customers' Contribution to Main Lines	3,20,000
Preliminary expenses	1,40,000
Average of current assets — excluding customers'	Rs.
Balances of Rs. 6,20,000	23,70,000
Development Reserve	4,40,000
10% Debentures interest paid in the year	7,50,000

The Reserve bank of India rate on the relevant date was 8%.

[C.A.]

Solution :

Capital Base

	Rs.	Rs.
Fixed Assets as original cost	4,20,00,000	
Less : Customers' contibution to Main Lines	3,20,000	
		4,16,80,000
Preliminary expenses		1,40,000
Working Capital — average of current assets		23,70,000
Contingencies Reserve Investments		76,00,000
		5,17,90,000
Less : Total Depreciation written-off	98,00,000	
Loan from Electricity Board	1,20,00,000	
Debentures $(7{,}50{,}000 \times \frac{100}{10})$	75,00,000	
Security Deposits	4,84,000	
	Rs.	Rs.
Tariff and Dividend Control Reserve	8,40,000	
Development Reserve	4,40,000	
		3,10,64,000
Capital Base		2,07,26,000

Reasonable Return

@ 10% (8% + 2%) on Capital Base	20,72,600
Income from Reserve Fund Investment @ 6% on Rs. 90,00,000	5,40,000
$\frac{1}{2}$% on loan from Electricity Board ($\frac{1}{2}$% on Rs. 1,20,00,000)	60,000
$\frac{1}{2}$% on Development Reserve ($\frac{1}{2}$% on Rs. 4,40,000)	2,200
$\frac{1}{2}$% on Debentures ($\frac{1}{2}$% on Rs. 75,00,000)	37,500
	27,12,300

Disposal of Surplus

Net Profit before charging debenture interest	35,00,100
Less : Debenture Interest	7,50,000
	27,50,100
Less : Reasonable Return	27,12,300
Surplus	37,800

Disposal

$\frac{1}{3}$rd of Surplus or 5% of Reasonable return, whichever is less i.e.,	
$\frac{1}{3}$rd of Rs. 37,800 = Rs. 12,600	
Or, 5% of Rs. 27,12,300 = Rs. 1,35,615	12,600
Of the balance (i.e., 37,800 – 12,600) = 25,200	
50% or $\frac{1}{2}$ = to be transferred to	
Tariff and Development Control Reserve (25,000 × $\frac{1}{2}$)	12,600
and, 50% or $\frac{1}{2}$ to be distributed among	
Consumers' Benefit Reserve (25,200 × $\frac{1}{2}$)	12,600
	37,800

10.5 PREPARATION OF ACCOUNTS OF RAILWAY COMPANIES (WITH FORMAT)

The following accounts of railway companies are prepared under the Railway Companies Act, 1911:

(a) Revenue Receipts and Expenditures (of the whole undertaking);

(b) Capital Account (Receipts and Expenditures on Capital Account); and

(c) General Balance Sheet.

(a) Revenue Receipts and Expenditures (of the Whole Undertaking)

It is prepared in a statement form and is similar to Revenue Account in the sense that all revenue expenditures and incomes are recorded here. This statement includes gross receipts and expenditures and also the net receipts of each of the sections along with the undertaking as a whole including amounts relating to the working of: Railways, Omnibuses, Steamboats, and Canals, Docks and Harbours, Hotels etc. and any other business if carried on by the company.

Appropriation of Net Income:

Balance of un-appropriated profits b/d

Add: Net income of the current year

Appropriation from Reserve (if any)

Minus: Interest and other fixed charges

Appropriation towards Reserves etc.

Dividend on Pref. Shares

Dividend on Equity Shares

Balance Carried Forward

10.6 STATUTORY FORMS OF RAILWAY COMPANIES ACCOUNT

(a) Revenue Receipts and Expenditures (of the Whole Undertaking)

	Gross Receipts	*Expenditures*	*Net Receipts*
	Rs.	*Rs.*	*Rs.*
Railways			
Omnibuses			
Steamboats			
Canals			
Docks, Harbours etc.			
Hotels etc.			
Other separate business			
Miscellaneous Receipts (Net)			
Rents from Houses			
Rents from Hotel			
Other Rents			

	Rs.	Rs.	Rs.
Interest and Dividend on investments			
General Interest			
Transfer Fee etc.			Total Net Income
			Add: Balance b/d (from last year)
			" Appropriation from Reserve
			Less:
			Interest and other fixed charges
			Interest on other Funds
			Rent Charges
			Interest on Loans
			Interest on Debentures
			Balance
			Less:
			Appropriation towards Reserve
			Dividend on Preference Shares
			Balance available for Dividend

(b) Capital Account (Receipts and Expenditures on Capital Account)

It is similar to Capital Account which is applicable in the case of Electricity Supply Companies. The principle is same.

The form is presented:

.... Railway
Receipts and Expenditures on Capital Account
for the year ended...........

Dr. Cr.

Expenditure	*Amount expended to 31st Dec. 20*	*Amount expended during the year*	*Total*	*Receipts*	*Amount receipts to 31st Dec. 20*	*Amount receipts during the year*	*Total*
	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
To Lines open for traffic				By Shares & Stocks			
" Lines not open for traffic				" Loans			
" New Lines				" Debenture Stock			
" Widening of existing lines				" Premiums on Shares & Stocks			
" Lines leased				" Premium on Debentures			
" Lines jointly owned				" Stocks			
" Lines jointly leased				" Total Premiums			
" Rolling Stock				" Discount on Shares & Stocks			
" Manufacturing & Repairing Works & Plants				" Discount on Debentures Stock			
" Land and Building				" Total Discounts			
" Land & Machinery				" Balance of Premium and Discounts			
" Total Capital expended upon Railway							

	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
Horses							
Road vehicles employed in collection and delivery of parcels, goods and passengers:							
To							
(1) Goods & Parcels road vehicles							
(2) Passengers' vehicles							
Steamboats							
" Canals							
Docks, Harbours and Wharves							
" Hotels,							
Electric Power stations, etc. Land, Properties etc. not forming part of the railway or stations :							
(a) Used in connection with railway working							
(b) Not used in connection with railway working							
Other industries (to be separately stated)							
Subscription to other companies							
Special items							
	Total Expenditure			Total Receipts			
	To Balance			By Balance			
	Total			Total			

(c) General Balance Sheet: It is also similar to the General Balance Sheet of Electricity Supply Companies stated earlier. But there are certain differences, although the method and principles of its preparation is same.

The form of General Balance Sheet of a Railway Company is presented:

.... Railway
General Balance Sheet
as at ....

Liabilities	*Rs.*	*Assets*	*Rs.*
Capital A/c, balance at credit thereof as per Account		Capital A/c balance at debit thereof, as per Account	
Amount due to Bankers		Cash at Bankers and in hand	
Temporary loans and calls paid in adv.		Cash on Deposit at interest	
Lloyd's bonds		Investments in Consols and Government Securities	
Unpaid interest and dividends		Investments in Stocks and Shares held by the Company, not charged as capital expenditure	
Interest & dividends payable or accruing & provided for		Investment of superannuation and other Provident Funds	
Amount due to Rly. Companies and Committees		Stocks of stores and materials	
Amount due to Rly. Clearing Houses		Outstanding traffic accounts	
Savings Bank			*Contd.*
Superannuation and other Provident Funds		Amount due by Rly. Companies and Committees	
Accounts payable		Amount due by Rly. Clearing Houses	
Liabilities Accrued		Amount due by Postmaster-General	
Miscellaneous Accounts		Accounts Receivable	
Special items (to be detailed)		Miscellaneous Accounts	
Fire Insurance Funds		Suspense Account (if any) to be enumerated	
Depreciation Funds :		Special items (to be detailed)	
Railway			
Steamboats (including Ins. Fund)			
Other businesses			
General Reserve Fund			
Balance available for Dividends and Reserve as per Account			
Less: Interim Dividends paid as per Statement No.			

Illustration 10.3

The following balances have been extracted from the books of Underground Railways for the year ended 31.3.2009:

	Dr. Rs.	Cr. Rs.
5% Preference Shares of Rs. 100 each		3,00,000
Equity Shares of Rs. 10 each		4,00,000
6% Debentures		2,00,000
Lines open for Traffic	7,50,000	
Lines Leased	4,06,000	
Lines in the course of construction	36,000	
Rolling Stock (Engine, Wagon etc.)	2,35,000	
Premium on Equity Shares		1,60,000
Interests on Debentures	12,000	
Rent on Leased Lines	36,000	
Rates and Taxes	90,000	
Maintenance of Ways	5,10,000	
Locomotive Power	8,82,000	
Traffic Expenses	3,50,000	
Carriage and Wagon Repairs	1,32,000	
Compensation (Accident and Losses)	6,000	
Received from Passengers Carried		12,50,000
Received Merchandise		5,40,000
Received Parcels		1,60,000
Received Mails		1,45,000
Received Minerals		80,000
Balance to be carried of Net Revenue Account on 1.1.2009		55,000
General Interest Account (Cr.)		600
Cash in hand and at Bank	1,28,600	
General Store (stock in hand)	25,000	
Amounts due by other companies	28,000	
Amounts due to other companies		18,000
Sundry Creditors		14,500
Outstanding Traffic Accounts	12,000	
Fire Insurance Fund		2,05,500
Superannuation Fund		1,10,000
	36,38,600	36,38,600

During the year the company issued 500, 5% Preference shares at par and 10,000 Equity shares at a premium of Rs. 4 per share. Both the shares were fully subscribed and paid-up. The amount spent during the year on Lines open to traffic was Rs. 2, 52,000, on Lines in the course of construction Rs. 12,000, and on Rolling Stock Rs. 70,000.

You are required to prepare:

(i) Revenue Account;

(ii) Net Revenue Account;

(iii) Capital Account;

(iv) General Balance Sheet.

Solution:

In the Books of ... Railway
Receipts and Expenditures on Capital Account
for the year ended 31st March 2009

Dr. Expenditure	Expenditure up to 31.3.2009	Expenditure during the year	Total Expenditure	Receipts	Receipts up to 31.3.2008	Receipts during the year	Total Receipts Cr.
	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
To Lines open for traffic	4,98,000	2,52,000	7,50,000	By 5% Pref. shares of Rs. 100 each	2,50,000	50,000	3,00,000
" Lines not open for traffic	Nil	Nil	Nil	" Equity shares of Rs. 10 each	3,00,000	1,00,000	4,00,000
" New lines	Nil	Nil	Nil	" Share Premium	1,20,000	40,000	1,60,000
" Lines under construction	24,000	12,000	36,000	" Loans	Nil	Nil	Nil
" Lines leased	4,06,000	—	4,06,000	" 6% Debentures	2,00,000	—	2,00,000
" Lines jointly owned	Nil	Nil	Nil	" Discount on Shares/ Debentures	Nil	Nil	Nil
" Lines jointly leased	Nil	Nil	Nil	Total Receipts	8,70,000	1,90,000	10,60,000
" Rolling Stock	1,65,000	70,000	2,35,000	By Balance of Capital A/c	2,23,000	1,44,000	3,67,000
" Manufacturing & Repairs	Nil	Nil	Nil				
" Horses, Road Vehicles etc.	Nil	Nil	Nil				
Total Expenditure	10,93,000	3,34,000	14,27,000		10,93,000	3,34,000	14,27,000

Revenue Account
for the year ended 31st March 2009

Dr.	Rs.		Cr. Rs.
To Rent and Taxes	90,000	By Passengers carried	12,50,000
" Maintenance of Ways	5,10,000	" Merchandise	5,40,000
" Locomotive Power	8,82,000	" Parcels	1,60,000
" Traffic Expenses	3,50,000	" Mails	1,45,000
" Carriage and Wagon Repairs	1,32,000	" Minerals	80,000
" Compensation (Accidental losses)	6,000		
" Net Revenue A/c Balance Transferred	2,05,000		
	21,75,000		21,75,000

Net Revenue Account
for the year ended 31st March 2009

Dr.	Rs.		Cr. Rs.
To Rent on leased lines	36,000	By Balance b/d	55,000
" Interest on Debentures	12,000	" Balance from Revenue A/c	2,05,000
" Balance carried to General Balance Sheet	2,12,600	" General Interest	600
	2,60,600		2,60,600

Note :

In the absence of information, General Revenue Account and Net Revenue Accounts are prepared. Statutory forms of Railway Companies Account by preparing Revenue Receipts and Expenditure of the whole undertaking is not followed here.

.... Railway
General Balance Sheet
as at 31st March 2009

Liabilities	*Rs.*	*Assets*	*Rs.*
Total amount received as per Capital A/c	10,60,000	Total Capital Expenditure as per Capital A/c	14,27,000
Amount due to Bankers	Nil	Cash at Bank and in hand	1,28,600
Temporary Loans and Calls paid in advance	Nil	Cash on deposit on interest	Nil
Llyod's Bond	Nil	Investment in consols and Government Securities	Nil
Unpaid Interest and Dividend	Nil	Investment in Stock and Share	Nil
Amount due to other Companies	18,000	Investment in Superannuation Fund and other P. F.	Nil
Superannuation and other Provident Funds	1,10,000	Stock of Stores and Materials	25,000
Acounts Payable (S. Credited)	14,500	Outstanding Traffic A/c	12,000
Liabilities Accrued	Nil	Amount due by other Companies	28,000
Miscellaneous A/cs	Nil	Amount Receivable	Nil
Special Items	Nil	Miscellaneous Accounts	Nil
Fire Insurance Fund	2,05,500	Suspense A/c (if any)	Nil
Depreciation Fund	Nil	Special items	Nil
General Reserve Fund	Nil		
Balance of Net Revenue Account	2,12,600		
	16,20,600		16,20,600

10.7 SUMMARY

A statutory company definition is defined as a company that is created by a Special Act of the Parliament and it provides services of value to the public. A statutory company is defined as a company that is created by a Special Act of the Parliament. It is a company that provides services of value to the public. A statutory company can be approved by either the Central or State Legislature Statutory Company. A statutory company is usually created with the intention of serving people rather than the traditional business goal of creating profits. Despite the fact that statutory companies have limited liability, they are not always required to utilize the limited title. They are required, however, to provide annual reporting to the Legislature-Parliament. A few well-known statutory companies include the following:

10.8 GLOSSARY

- Depreciation- It means gradual decrease in the value of fixed assets due to wear and tear.
- Compound Interest Method-It is also known as Modified Sinking Fund Method.

- Straight Line Method-Under this method, an allowance is made in each year in respect of depreciation .of fixed assets-such an amount which is arrived at by dividing 90% of the original cost by the period of its prescribed life.
- Risk of obsolescence – Risk due to change in technology

10.9 SELF ASSESSMENT QUESTIONS

Q1. Discuss the financial provisions contained in the 6th and 7th schedule of the electricity supply Act.

Ans. ____

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Q2. What is operating expenses?

Ans. ____

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Q3. What is operating revenues?

Ans. ____

____

____

Q4. What is capital expenditure?

Ans.

10.10 LESSON END EXERCISE

1. Give the format of statement of share and loan capital.
2. Prepare the statement of operating expenses with imaginary figures.
3. Prepare the statement of provision for depreciation with imaginary figures.

10.11 SUGGESTED READUNGS

- Jain, S.P and Narang, K.L. (2014). Advanced Accountancy-Vol-II. Kalyani Publisher, New Delhi.
- Gupta, Sashi, K. (2015). Management Accounting. Kalyani Publisher, New Delhi.
- Gupta, Sashi, K. and Mehra, A. (2015). Contemporary Issues in Accounting. Kalyani Publisher, New Delhi.
- Gupta, Sashi, K. (2015). Financial Management. Kalyani Publisher, New Delhi.

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CONSOLIDATED FINANCIAL STATEMENTS

M.Com II Sem.	**Advanced Accounting**	**Unit-III**
M.Com – C 211		**Lesson No. 11**

STRUCTURE:

11.1 INTRODUCTION

The creation of the relationship of holding and subsidiary companies is a form of combination. The procedure involves acquisition of shares in the absorbed company, and not its assets with or without liabilities. The separate legal entity of the absorbed company is, therefore, not disturbed. In other words, the subsidiary company continuous its business as usual because acquisition of controlling interest by another company does not mean its liquidation.

11.2 OBJECTIVES

After going through this lesson you should be able to understand the meaning, objectives, merits, demerits and distinction between holding company and subsidiary company.

11.3 MEANING OF HOLDING COMPANY

A holding company is one which may acquire either the whole or the majority of the shares of another company so as to have controlling interest in such a company or companies. The controlling company is known as the 'holding company' and the so controlled company or the company whose shares have been acquired is known as *'subsidiary company'* and both together are known as 'group of company'. Holding companies are able to nominate the majority of the directors of subsidiary company. The company gets such right which it purchase more than fifty percent shares of another company. So, the holding company is one which controls one or more other companies either by means of holding more than fifty percent shares in that company or companies or by having power to appoint the whole or majority of the directors of those companies. A company controlled by holding company is known as subsidiary company.

11.4 LEGAL DEFINITION

A holding company is better defined in the context of the definition of a subsidiary company.

Section 4 of the Companies Act, 1956 defines a subsidiary company. According to this section, (1) a company shall be deemed to be a subsidiary company of another if and only if:

"(a) that other company controls the composition of its Board of Directors; or (b) that other:

(i) when the first mentioned company is an existing company in respect of which the holders of preference shares issued before the commencement of this Act have the same voting rights in all respects as the holders of equity shares, exercises or controls more than half of the total voting power of such company;

(ii) when the first mentioned company is another company, holds more than half in nominal value of its equity share capital; or (c) the company is a subsidiary of any company which is that other company's subsidiary".

For example, company S is a subsidiary of company H and company R is a subsidiary of company S. Company R becomes a subsidiary of company H, by virtue of clause (c) above. Further, if company W is a subsidiary of company R, company W will also be a subsidiary of company S and consequently also of company H.

Subsidiary Company : From Section 4 (as reproduced ahove it is clear that a company is a subsidiary of a holding company in any of the following three cases:

1. When the holding company controls the composition of the Board of Directors of the Subsidiary company i.e., the holding company is able to appoint or dismiss the majority of directors of the subsidiary company.
2. Where the holding company holds more than 50% in nominal value of the equity share capital of the subsidiary company i.e., the holding company holds the majority of voting power in the subsidiary company.
3. When a subsidiary company is a holding company of another subsidiary company, the original holding company is also a holding company of that other subsidiary company.

11.5 WHOLLY OWNED AND PARTLY OWNED SUBSIDIARIES

A wholly owned subsidiary company is one in which all the shares with voting rights of 100% are owned by the holding company whereas in a partly owned subsidiary, only the majority of shares (i.e. more than 50%) are owned by the holding company.

In a wholly owned subsidiary, there -is no minority interest because all the shares with voting rights are held by the holding company. On the other hand, in a partly owned subsidiary company, there is a minority interest because less than 50% shares with voting rights are held by outsiders other than the holding company.

Section 42 of the companies Act, 1956 prohibits a subsidiary company from holding shares in the holding company but a subsidiary company may continue to be a member of its holding company if it was a member thereof at the commencement of the Act or before becoming a subsidiary company.

AS-21 on Consolidated Financial Statements gives the following definitions:

A subsidiary is an enterprise that is controlled by another enterprise (known as the parent).

A parent is an enterprise that has one or more subsidiaries.

A group is a parent and all subsidiaries.

Thus, AS-21 calls holding company, a parent company.

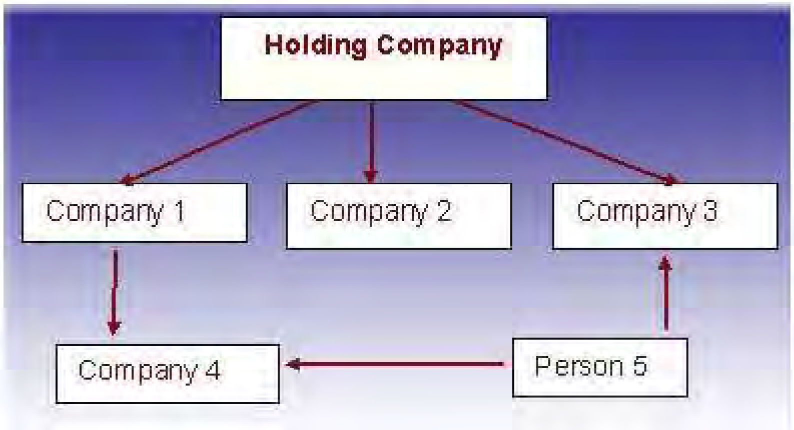
11.6 OBJECTIVES OF HOLDING COMPANY

The main objectives of holding company are

1. To promote combination movement so that competition may be eliminated i.e., bringing a number of companies under one control.
2. To eliminate the middlemen.
3. To economies in production and management

11.7 DIFFERENCE BETWEEN HOLDING COMPANY AND SUBSIDIARY COMPANY

Holding Company : When a company acquires controlling interest in the affairs of another company, it is known as the holding company. **Holding company** does not have any business operations bit it owns assets. **Holding company** controls the composition of board of directors due to its controlling capacity. The Companies Act identifies some points about holding company and these points are as follows:



- Its assets may consist in whole or in part of shares in another company
- Holding companies' shares and other interests may be held either directly or through a nominee.
- Holding companies' interest should be in the form of holding more than fifty percent of shares or voting rights in that other company.
- Holding companies' voting right gives power directly or indirectly to appoint the majority of the directors in that other company otherwise than by virtue of the provision of a trust deed.

Subsidiary Company: Subsidiary company is a company that more than fifty percent of issued share capital or voting power is held by another company or the majority of directors can be appointed by another company. A **subsidiary company** may be a public limited or private limited company. Where the shares of such a company are held as security by a company the ordinary business of which is lending of money or where the majority of directors can be appointed by a company by virtue of powers contained in a debenture trust-deed, the former company will not be deemed to be a **subsidiary company** of the latter.

11.8 MERITS OF HOLDING COMPANIES

The following are the main advantages of holding companies:

1. Subsidiary companies maintain their goodwill due to having separate identities.
2. The fruits of monopoly or near monopoly may be enjoyed as the public may not be aware of the existence of combination. Hence, no resentment in the minds of the people.
3. The holding companies may require to invest a comparatively small amount in order to have control on the subsidiaries companies.
4. Subsidiary companies maintain their separate identities which make it possible to carry forward losses for income tax purposes.
5. The financial position and profitability of each undertaking is known as these companies have to prepare their own accounts.
6. It is easy to give up the control of the holding company simply by disposing of the shares in the subsidiary companies.
7. Holding company may be able to secure economies in production and management.

11.9 DEMERITS OF HOLDING COMPANIES

Following are the main disadvantages of holding companies:

1. Fraudulent manipulation of accounts is possible especially if the accounts of various companies are made up to different dates.
2. Inter company transactions are often entered at unduly low prices in order to suit the holding companies.
3. There is the danger of oppression of minority shareholders.
4. Accounting difficulties may arise inappraising the financial position of companies due to inter-company transactions done on too high or too low prices.
5. The true financial position of the subsidiary companies may not be known to the shareholders of the holding company.

6. The creditors and outside shareholders may not be aware of the true financial position of the subsidiary companies.

7. Officers or directors (of the choice of holding company) at undue high remuneration may have to be appointed in the subsidiary companies.

11.10 SUMMARY

To conclude we can say that a holding company is one which holds either whole or majority of the shares of another company or control the management of the other company, and the other company is called its subsidiary. These subsidiaries have their separate existence and are managed by independent governing boards (in case of public enterprises) and Holding Company (in case of commercial enterprises). In India, the organisation of the Steel Authority of India Ltd., the Coal Authority of India Ltd., the General Insurance Corporation of India and the State Trading Corporation of India as holding companies (in public enterprises) are the instances of this form. A holding company is able to exercise control over the management of other companies by virtue of its share ownership. According to Bon-bright and Menons "The holding company is often described as a super corporation which, by virtue of its share ownership and hence voting right in other corporations, is in a position to exercise control or materially influence the management of those other corporations known as subsidiaries"

11.11 GLOSSARY

- **Holding Company**- A holding company is one which directly or indirectly acquires either all or more than half the number of Equity shares in one or more companies so as to secure a controlling interest in such companies, which are then known as subsidiary companies

- **Capital Profit**- Balance of profit and loss a/c and reserves on or before the date of purchase of shares by the holding company.

11.12 SELF ASSESSMENT QUESTIONS

Q 1. Write a short note on AS 21 on consolidated financial statements.

Q.2 Give the legal definition of holding company.

11.13 LESSON END EXERCISE

Q.1 What do you mean by holding company? Also explain the various objectives of holding company?

Q.2 What do you mean by holding company? Explain the merits and demerits of holding company ?

11.14 SUGGESTED READINGS

- M.C Shukla and Grewal, "Advanced Accounts-II", S.Chand, New Delhi.
- Jain,S.P and Narang, K.L. "Advanced Accounts-II", Kalyani Publisher, New Delhi
- Maheshwari,S.N "Advanced Accounts-II", Vikash Publisher, New Delhi

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CONSOLIDATED FINANCIAL STATEMENTS

M.Com II Sem.	Advanced Accounting	Unit-III
M.Com – C 211		Lesson No. 12

STRUCTURE

12.1 Introduction

12.2 Objectives

12.3 Rationale of Holding Company

12.4 Accounts of Holding Company

12.5 Consolidated Balance Sheet and Profit and Loss Account

12.6 Minority Interest

12.7 Cost of Control/ Goodwill/Capital Reserve

12.8 Pre-acquisition/Capital Profits

12.9 Revenue Profit

12.10 Summary

12.11 Glossary

12.12 Self Assessment Questions

12.13 Lesson End Exercise

12.14 Suggested Readings

12.1 INTRODUCTION

Section 4 of the companies Act, 1956 defines a subsidiary company. A company is a subsidiary of another if and only if – a) That other company controls the composition of its Board of Directors; or b) That other – i) Where the first mentioned company is an existing company in respect of which the holders of Preference shares issued before the commencement of this Act have the same voting rights in all respect as the holders of Equity shares exercises or controls more than half of the total voting power of such company. ii) Where the first mentioned company is any other company, holds more than half in nominal value of its Equity share Capital so or iii) The company is a subsidiary of any company which is that other company's subsidiary.

12.2 OBJECTIVES

After going through this lesson, you should be able to understand the rationale of holding companies.

12.3 RATIONALE OF HOLDING COMPANIES

Rationale of Holding Companies is that:

(a) It allows better quality decisions to be taken at all levels. In case of public enterprises the Government to concentrate on macro policy,, the holding company on corporate policies and strategies and the operating levels on implementation within the framework of established strategies.

(b) It leads to a better utilisation of financial and other reserves by pooling the reserves of group of enterprises like finance, R & D, marketing and human resources. The holding company is well suited to the task of rationalisation of public sector through mergers, vertical integration, inter-group transfers and allocation of social costs.

(c) The management of holding company could promote commercial and managerial culture rather than bureaucratic systems.

(d) By grouping of enterprises into holding companies a large number could be reduced to manageable levels from the point of co-ordination and span of control. It provides enterprises scope to share and undertake relevant R & D work to update technology in order to become more competitive. It could be a strategy to turn around the sick public enterprises.

(e) The holding company is able to concentrate on corporate planning, acquisition and update technology and building of corporate culture an sound business principles.

12.4 ACCOUNTS OF HOLDING COMPANY

A holding company is required to attach certain documents relating to its subsidiaries. The provisions relating to this have been laid down in Section 212 of the Companies Act. Section 212 reads as under:

(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 or of such subsidiaries, as the case maybe:

(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 Directors;

(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) (1) 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 sub-section (1) shall be made out in accordance with requirements of this Act— - (i) as at the end of the 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 where the financial year of the subsidiary does not coincide with that of the holding company.

(b) The profit and loss account and the reports of the Board of directors and .of the auditors, referred to in clauses (b), (c) and (d) of sub-section (1), shall be made out, in accordance with requirements of this Act, for the financial year of the subsidiary referred to' in clause (a). (c) Where the financial year of the subsidiary does not coincide with that of the holding company, the financial year aforesaid of the subsidiary shall not end on a day which proceeds the day on which the holding company's financial year ends by more than six months. (d) Where the financial year of a subsidiary is shorter in duration than that of its holding company, references to the financial year of the subsidiary in clauses (a), (b) and (c) shall be constructed as references to two or more financial years 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 sub-section (1) shall specify— (a) the extent of the holding company's interest in the subsidiary at the end of the financial years or of the last of the financial years of the subsidiary referred to in sub-section (2). (b) the net aggregate amount, so far as it concerns members of the holding company and is not dealt with in the company's accounts of the subsidiary's 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 became the holding company's subsidiary; (c) the net aggregate amount of the profits of the subsidiary after deducting the 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 became the holding company's subsidiary; so far as those profits are dealt with, the provision is made for those losses in the company's accounts. (4) Clauses (b) and (c) of sub-section (3) shall apply only to profits and losses of the subsidiary which may properly be treated in the holding company's accounts as revenue profits or losses, and the profits or losses attributable to shares in 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 were acquired by the company or any of its subsidiaries, except that they may be 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 losses are to be treated as profits or losses for the said period, the profit or loss for any financial year of the subsidiary may, if it is not practicable to apportion it with reasonable accuracy by reference to the facts, be treated as accruing from day to day during that year and be apportioned accordingly.

(5) Where the financial year or years of a subsidiary referred to sub-section (2) 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 holding company's interest in the subsidiary between the end of the financial year or of the last of the financial years of the subsidiary and the end of the holding company's financial year; (b) details of any material changes which have occurred between the end of the financial year or 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 moneys borrowed by it for any purpose other than for meeting current liabilities.

(6) If for any reason, the Board of Directors 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 clauses (e), (f) and (g) of sub-section (1) shall be signed by the persons by whom the balance sheet 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 the company, direct that in relation to any subsidiary, the provisions 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 sub-section (6) of section 209 fails 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; Provided that in any proceeding against a person in respect of an offence under this section,

it shall be a defense to prove that a competent and reliable person was charged with the duty of seeing that the provisions of this section were complied with and was in a position to discharge that duty: Provided further that no person shaH he sentenced to imprisonment for any such offence unless it was committed willfully. (10) If any person, not being a person referred to in sub-section (6) of Section 209 having been charged by the Board of Directors as the case may be, with the duty of seeing that the provisions of this section are compiled with, makes default in doing so, 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.

Provided that no person punished shall be sentenced to imprisonment for any such offence unless it was committed willfully."

Illustration 12.1 A Ltd., B Ltd. and C Ltd. are subsidiaries of H Ltd. H Ltd.'s accounts for the year ending 31st March, 2008 have been prepared. In respect of the income from the subsidiaries H Ltd. accounts only for dividend, if any, received from.

Particulars in respect of the subsidiaries are:

	A Ltd.	*B Ltd.*	*C Ltd.*
Equity Share Capital of Rs. 100 each on date of respective Balance Sheets (Rs.)	10,00,000	15,00,000	20,00,000
Financial year ends on	31st March	31st Dec.	31st Oct.
Shares held by H Ltd. on 31-3-2008	8,000	9,000	12,000
Shares purchased by H Ltd. from 1-4-2007 to 31-3-2008 [redacted]	Nil	Nil	Nil
Dividend received in 2007-08 by H Ltd. in respect of last year from (Rs.)	—	—	1,80,000
Dividend received in 2007-08 by H. Ltd. in respect of earlier years (Rs.)	1,60,000	—	—
Total divisible profit for the last year (Rs.)	3,00,000	4,00,000	5,00,000
Total undistributed profits for earlier years since they became subsidiaries' of H. Ltd. (Rs.)	8,00,000	9,00,000	15,00,000

B Ltd. purchased fixed assets for Rs. 2,00,000 and lent an amount of Rs. 1,00,000 upto 3 1-3- 2008 since the last closing. C Ltd. purchased investments for Rs. 1,25,000 and borrowed Rs. 1,00,000 upto 31-3-2008 since the last closing.

Prepare the statements pursuant to Section 212 of the Companies Act, 1956 to be furnished long with accounts of H Ltd. for the year ended 31st March, 2008.

SOLUTION

Statement in accordance with Section 212 of the Companies Act, 1956 relating to the subsidiary companies for the year ending 31st March, 2008.

	A Ltd.	*B Ltd.*	*C Ltd.*
1. Financial year of the subsidiary companies ending on	31-3-2008	31-12-2007	31-10-2007
2. (a) Number of shares of subsidiary companies held at the end of the financial year on 31-3-2008	8,000	9,000	12,000 [redacted]
(b) Extent of holding in the subsidiary companies [redacted]	80% $\left(\frac{8,000}{10,000} \times 100\right)$	60% $\left(\frac{9,000}{15,000} \times 100\right)$	60% $\left(\frac{12,000}{20,000} \times 100\right)$
3. Changes in the interest of H Ltd. between the end of the financial year of the subsidiary and the end of the financial year (31-3-2008) of H Ltd.	[redacted]	[redacted]	[redacted]
(a) Number of shares	Nil	Nil	Nil
(b) Extent of holding	Nil	Nil	Nil
4. Net aggregate profit of the subsidiary companies so far as it concerns the members of H Ltd.	[redacted]		[redacted]
(a) Not dealt with in the accounts of H Ltd. for the year ending 31-3-2008	Rs.	Rs.	Rs. [redacted]
[redacted] (i) for subsidiary companies' financial year ending as above in (1)	2,40,000 (80% of 3,00,000)	2,40,000 (60% of 4,00,000)	1,20,000 (60% of 2,00,000 i.e. 5,00,000 less 3,00,000 total dividend given by C Ltd.)
[redacted]	[redacted]	[redacted]	

(ii) for earlier years of the subsidiary since it became subsidiary of H Ltd.	4,80,000 80% of 6,00,000 (i.e. 8,00,000 less 2,00,000 total dividend given by A Ltd. in respect of earlier years)	5,40,000 (60% of 9,00,000)	9,00,000 (60% of 15,00,000)
(b) Dividend received dealt with in the accounts of H Ltd. for the year ending 31-3-2008			
(i) for the subsidiary's financial year as in (1) above	—	—	1,80,000
(ii) for earlier years of the subsidiary since it became subsidiary of H. Ltd.	1,60,000	—	—
5. Material changes between the end of the financial year of the subsidiary and 31-3-2008			
(i) Fixed assets (purchase)	—	2,00,000	—
(ii) Investments (purchase)	—	—	1,25,000
(iii) Amount lent by subsidiary	—	1,00,000	—
(iv) Amount borrowed by subsidiary	—	—	1,00,000

Working Notes :

Calculation of Extent of Holding in the Subsidiaries

	A Ltd.	*B Ltd.*	*C Ltd.*
Share Capital (Rs.)	10,00,000	15,00,000	20,00,000
Number of shares having paid up value of Rs. 100 each	10,000	15,000	20,000
	$\left(\frac{\text{Rs. } 10,00,000}{\text{Rs. } 100}\right)$	$\left(\frac{\text{Rs. } 15,00,000}{\text{Rs. } 100}\right)$	$\left(\frac{20,00,000}{\text{Rs. } 100}\right)$
Shares held by H Ltd.	8,000	9,000	12,000
Extent of Holding by H Ltd.	80%	60%	60%
	$\left(\frac{8,000}{10,000} \times 100\right)$	$\left(\frac{9,000}{15,000} \times 100\right)$	$\left(\frac{12,000}{20,000} \times 100\right)$

Financial Year of Holding Company and Subsidiary. In this regard, Section 213 of the Companies Act, 1956, reads as below:

(1) Where it appears to the Central Government desirable for a holding company or holding company's subsidiary, to extend its financial year so that the subsidiary's financial year may end with that of the holding company, and for that purpose to postpone the submission of the relevant accounts to a general meeting, the Central Government

may, on the application or with the consent of the Board of Directors of the company whose financial year is to be extended, direct that in the case of that company the submission of accounts to a general meeting, the holding of an annual general meeting or the making of an annual return, shall not be required to be submitted, held or made, earlier than the dates specified in the direction, notwithstanding anything to the contrary in this Act or in any other Act for the time being in force.

(2) The Central Government shall, on the application of the Board of Directors of a holding company or a holding company's subsidiary, exercise the powers conferred on that Government by sub-secti6n (1) if it is necessary so to do, in order to secure that the end of the financial year of the subsidiary does not precede the end of the holding company's financial year by more than six months, where that is not the case at the commencement of this Act, or at the date on which the relationship of holding company and subsidiary comes into existence where that date is later than the commencement of this Act."

Rights of Holding Company's Representatives and Members. With regard to the rights of holding company's representatives and members, Section 214 of the Companies Act, 1956, reads as follows '(1) A holding company may, by resolution, authorise representatives named in the resolution to inspect the books of account kept by any of its subsidiaries, and the books of account of any such subsidiary shall be open to inspection by those representatives at any time during business hours.""(2) The rights conferred by section 235 upon members of a company may be exercised, in respect of any subsidiary, by members of the holding company as if they alone were members of the subsidiary."

Under Section 235, members of the holding company can apply for investigation of affairs of the subsidiary company.

Requirements of Schedule VI. The Balance Sheet of holding company must disclose, in the prescribed form of Balance Sheet as per Schedule VI, the following items in relation to its subsidiary or subsidiaries:

On the Assets Side

(1) Under Investments

Investments in shares, debentures or bonds of subsidiary companies.

(2) Under Loans and Advances: - Advances and loans to subsidiaries.

On the Liabilities Side

(1) Under Secured Loans: Loans and advances from subsidiaries.

(2) Under Unsecured Loans: Loans and advances from subsidiaries.

(3) Under Current Liabilities and Provisions: Subsidiary companies.

12.5 CONSOLIDATED BALANCE SHEET AND PROFIT & LOSS ACCOUNT

- **Consolidated Balance Sheet**

In India, although a holding company is not required by law to prepare a Consolidated Balance Sheet but preparation of Consolidated Balance Sheet is of much help to the holding company to show the clear picture. Therefore, in addition to the "legal" Balance Sheet as prescribed in Schedule VI, the holding company may also publish a Consolidated Balance Sheet in which the assets and liabilities of all the subsidiaries are given along with its own assets and liabilities as the Balance Sheet of a head office incorporates the assets and liabilities of its branches.

Shareholders of a holding company are interested in knowing the affairs of the subsidiary company as part of their money given to the holding company is invested in the subsidiary company. So, it becomes safe for directors of the holding company to disclose to the shareholders of the holding company the extent to which they are entitled to the net assets of the subsidiary company. In short, the purpose of consolidated financial statements is to present primarily for the benefit of shareholders and creditors of the parent company, financial information about the economic activities of the group as a whole e.g., economic resources controlled by the group, the obligations of the group and results the group achieves. By way of Consolidated Balance Sheet, the investments of the holding company in the subsidiary company are replaced by net assets of the subsidiary company.

Note: In case if the holding company acquires whole of the shares of subsidiary company, then all assets and liabilities of the subsidiary company becomes the assets and liabilities of the holding company. While preparing a Consolidated Balance Sheet, investment of the holding company in the subsidiary-should be replaced by the assets and liabilities of the subsidiary company if all the shares of the subsidiary company have been purchased by the holding company. Share capital of the subsidiary company is not taken in the consolidated balance sheet because it gets itself adjusted in the investment in shares of the subsidiary company acquired by the holding company.

- **CONSOLIDATION OF PROFIT & LOSS ACCOUNTS:**

Apart from the usual items of gains, incomes, losses and expenses which will appear in the loss accounts of both the holding and the subsidiary companies and which will therefore ---- some adjustments will be required. The following are the most important:-

1. The profit of the subsidiary company arising before the date of acquisition of shares in the subsidiary company and belonging to the holding company should be debited to the consolidated Profit and Loss Account and credited to Capital Reserve or Goodwill as the case may be. In case there is a loss, the Consolidated Profit and Loss Account will be credited and Capital Reserve or goodwill debited.

2. In respect of the proportion of the profits of the subsidiary company which belongs to the minority shareholders, their account should be credited by debit to the Consolidated Profit and Loss Account. In case of loss, the Minority Shareholders, Suspense Account should be debited and the Consolidated Profit and Loss Account credited.

3. All items internal to the holding and subsidiary companies should be eliminated. If the subsidiary company has passed entries for proposed dividend and the holding company has also taken credit for its share of the dividends, there will be a cancellation from both sides of the Consolidated Profit and Loss Account. If the proposed dividend has not been passed through the holding company's books, the debit in respect of proposed dividend will be reduced by the holding company's share in the Consolidated Profit and Loss Account; the corresponding liability in the Balance Sheet will also be reduced.

4. Reserve for unrealised profit in respect of inter -company transactions relating to goods will have to be created by debit to the Consolidated Profit and Loss Account and credit to Stock Reserve Account.

The transfer of goods between the holding company and the subsidiary company should be eliminatd from both sides of the Consolidated Profit and Loss Account.

5. Debenture interest or dividends received by the holding company from the subsidiary will have to be eliminated from both sides of the Consolidated Profit and Loss Account.

   No adjuestment is required in respect of tax on dividends or on interest on debentures paid by the subsidiary company to the holding company. In case of interest outstanding or accruing, care should be taken to see that both the holding and subsidiary companies pass entries. Then the debenture interest will be cancelled from both sides of the Consolidated Profit and Loss Account, so far as it relates to the debentures held by the holding company.

6. In case Cumulative Preference Shares are held by outsiders and in case the dividend --- arrear, such arrear may be shown by way of a note in the Consolidated balance ----- alternatively, the amount due by way of dividends should be debited to the Consolidated Profit and Loss Account and credited to the Minority Shareholders Account and ---- a liability in the consolidated Balance Sheet.

12.6 MINORITY INTEREST

When some of the shares of the subsidiary company are held by outsiders (i.e., other than the holding company), their interest is in the subsidiary company is known as minority interest and is shown on the liabilities side of the consolidated Balance Sheet. The share of the outsiders in the subsidiary company is called minority interest because they are having less than 50% of shares of the subsidiary company.

The minority interest is calculated as follows:

Face value of shares held by outsiders	xxx
Add: Proportionate share of the capital profit	xxx
Add: Proportionate share of the capital profit	xxx
Less: Proportionate share of subsidiary company's losses	xxx
Proportionate decrease in the value of the assets of the subsidiary company	xxx
Value of Minority Interest	**xxx**

If preference shares are held by outsiders, the paid-up value of such shares together with dividend thereon (if there are profits) is also added to the value of the minority interest or shown separately. Proportionate share of the subsidiary company's profit and reserves belonging to the outsiders is calculated keeping in view the value of equity shares held by them and the value, of the preference shares held is not considered because profits and reserves belong to equity shareholders and not to preference shareholders. Having shown the amount of the minority interest in the consolidated Balance Sheet as a liability, all the assets and liabilities of the subsidiary company are merged up with those of the holding company thereby eliminating investment in shares of the subsidiary company.

12.7 COST OF CONTROL/GOODWILL OR CAPITAL RESERVE

If the price paid for the purchase of shares of the subsidiary company by the holding company is more than the paid-up value of the shares, the excess amount paid represents payment for goodwill or cost of acquiring control of the subsidiary company if there exist no reserves or profit or loss balance in the subsidiary company on the date of acquisition of shares of the subsidiary company. On the other hand, if the shares are purchased at a price which is less than the paid-up value of the shares, the less amount paid represents capital reserve or profit. Thus, if 10,000 shares of Rs. 10 each are purchased at Rs. 1,10,000, the excess amount of Rs. 10,000 (i.e., Rs. 1,10,000 — Rs. 100,000) is goodwill and will be shown in Consolidated Balance Sheet as goodwill on the assets side. On the other hand, if the price paid for 10,000 shares is Rs. 80,000, the less amount of Rs. 20,000 is capital profit and will be shown on the liabilities side as capital reserve.

12.8 PRE-ACQUISITION (OR CAPITAL) RESERVES AND PROFITS

The balance of reserves and profits of the subsidiary company on or before the date of the purchase of shares by the holding company is treated as capital profits. The outsiders' share of such reserves and profits is added to the minority interest as pointed out earlier and the balance of such reserves and profits are capital profits of the holding company and are shown as capital reserve in the Consolidated Balance Sheet. In case of cost of control or goodwill, share of such profits belonging to the holding company is adjusted to goodwill and reduces the cost of control or goodwill.

Similarly, losses of the subsidiary company such as debit balance of profit and loss account, preliminary expenses, discount on issue of shares and debentures, underwriting commission etc. shown in the Balance Sheet on the date of the purchase of shares are divided into two parts i.e., share of the minority shareholders and share of the holding company. Share of the outsiders is deducted from the amount of the minority interest and share of the holding company is added to the cost of control or goodwill or reduced from capital profit which has become available on purchase of shares of the subsidiary company at a price lower than the paid-up value.

12.9 REVENUE (OR POST-ACQUISITION) PROFITS

Any profit of the subsidiary company earned after the date of the purchase of shares by the holding company are treated as revenue profits. Holding company's share of such profits is added to the profits of the holding company and share of such profits belonging to the minority shareholders is added to the amount of the minority interest. Thus, to decide whether profits and reserves of the subsidiary company are capital profits or revenue profits, date of purchase by the holding company is the deciding factor. Profits or reserves shown in the Balance Sheet of the subsidiary company on or before the date of purchase of shares are treated as capital profits and profits earned by the subsidiary company after the purchase of shares by the holding company are called revenue profits.

12.10 SUMMARY

Rationale of Holding Companies is that: It allows better quality decisions to be taken at all levels. In case of public enterprises the Government to concentrate on macro policy,, the holding company on corporate policies and strategies and the operating levels on implementation within the framework of established strategies. It leads to a better utilisation of financial and other reserves by pooling the reserves of group of enterprises like finance, R & D, marketing and human resources. The holding company is well suited to the task of rationalisation of public sector through mergers, vertical integration, inter-group transfers and allocation of social costs. The management of holding company could promote commercial and managerial culture rather than bureaucratic systems. By grouping of enterprises into holding companies a large number could be reduced to manageable levels from the point of co-ordination and span of control. It provides enterprises scope to share and undertake relevant R & D work to update technology in order to become more competitive. It could be a strategy to turn around the sick public enterprises. The holding company is able to concentrate on corporate planning, acquisition and update technology and building of corporate culture an sound business principles.

12.11 GLOSSARY

- Revenue Profit— Balance of profit and loss a/c and reserves after the date of purchase of shares by the holding company.
- Minority Interest- Outsiders interest in the subsidiary company.
- Capital Profit- Profit earned on or before the date of purchase of shares by holding company
- Post-acquisition Profit- Profit earned on or before the date of purchase of shares by holding company

12.12 SELF ASSESSMENT QUESTIONS

Q.1 What is capital profit?

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Q.2 What is revenue profit?

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12.13 LESSON END EXERCISE

Q.1 What is minority interest? How it is calculated?

Q.2 Give the conceptual framework of holding company. Also discuss the advantages and dis-advantages of holding companies.

12.14 SUGGESTED READINGS

- M.C Shukla and Grewal, "Advanced Accounts-II", S.Chand, New Delhi.
- Jain,S.P and Narang, K.L. "Advanced Accounts-II", Kalyani Publisher, New Delhi
- Maheshwari,S.N "Advanced Accounts-II", Vikash Publisher, New Delhi

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CONSOLIDATED FINANCIAL STATEMENTS

M.Com II Sem.	**Advanced Accounting**	**Unit-III**
M.Com – C 211		**Lesson No. 13**

STRUCTURE:

13.1 INTRODUCTION

Dividends are payments made by a corporation to its shareholder members. It is the portion of corporate profits paid out to stockholders. When a corporation earns a profit or surplus, that money can be put to two uses: it can either be re-invested in the business (called retained earnings), or it can be distributed to shareholders. There are two ways to distribute cash to shareholders: share repurchases or dividends. Many corporations retain a portion of their earnings and pay the remainder as a dividend.

13.2 OBJECTIVES

After going through this lesson you should be able to understand the advanced treatment of dividend.

13.3 FORMS OF PAYMENT OF DIVIDEND

A dividend is allocated as a fixed amount per share. Therefore, a shareholder receives a dividend in proportion to their shareholding. For the joint stock company, paying dividends is not an expense; rather, it is the division of after tax profits among shareholders. Retained earnings (profits that have not been distributed as dividends) are shown in the shareholder equity section in the company's balance sheet - the same as its issued share capital. Public companies usually pay dividends on a fixed schedule, but may declare a dividend at any time, sometimes called a special dividend to distinguish it from the fixed schedule dividends.

Cooperatives, on the other hand, allocate dividends according to members' activity, so their dividends are often considered to be a pre-tax expense.

Dividends are usually paid in the form of cash, store credits (common among retail consumers' cooperatives) and shares in the company (either newly created shares or existing shares bought in the market.) Further, many public companies offer dividend reinvestment plans, which automatically use the cash dividend to purchase additional shares for the shareholder.

The word "dividend" comes from the Latin word "*dividendum*" ("thing to be divided").

Cash dividends (most common) are those paid out in currency, usually via electronic funds transfer or a printed paper check. Such dividends are a form of investment income and are usually taxable to the recipient in the year they are paid. This is the most common method of sharing corporate profits with the shareholders of the company. For each share owned, a declared amount of money is distributed. Thus, if a person owns 100 shares and the cash dividend is GBP £0.50 per share, the holder of the stock will be paid GBP £50. Dividends paid are not classified as an expense, but rather a deduction of retained earnings. Dividends paid does not show up on an Income Statement but does appear on the Balance Sheet.

Stock or scrip dividends are those paid out in the form of additional stock shares of the issuing corporation, or another corporation (such as its subsidiary corporation). They are usually issued in proportion to shares owned (for example, for every 100 shares of stock owned, a 5% stock dividend will yield 5 extra shares). If the payment involves the issue of new shares, it is similar to a stock split in that it increases the total number of shares while lowering the price of each share without changing the market capitalization, or total value, of the shares held. (See also Stock dilution.)

Property dividends or dividends ***in specie*** (Latin for "in kind") are those paid out in the form of assets from the issuing corporation or another corporation, such as a subsidiary corporation. They are relatively rare and most frequently are securities of other companies owned by the issuer, however they can take other forms, such as products and services.

Interim dividends are dividend payments made before a company's annual general meeting (AGM) and final financial statements. This declared dividend usually accompanies the company's interim financial statements.

Other dividends can be used in structured finance. Financial assets with a known market value can be distributed as dividends; warrants are sometimes distributed in this way. For large companies with subsidiaries, dividends can take the form of shares in a subsidiary company. A common technique for "spinning off" a company from its parent is to distribute shares in the new company to the old company's shareholders. The new shares can then be traded independently.

13.4 RELIABILITY OF DIVIDENDS

Two metrics are commonly used to examine a firm's dividend policy. *Payout ratio* is calculated by dividing the company's dividend by the earnings per share. A payout ratio greater than 1 means the company is paying out more in dividends for the year than it earned.

Dividend cover is calculated by dividing the company's cash flow from operations by the dividend. This ratio is apparently popular with analysts of income trusts in Canada. Dividends are payments made by a corporation to its shareholder members. It is the portion of corporate profits paid out to stockholders.

- **Dividend dates**

Any dividend that is declared must be approved by a company's Board of Directors before it is paid. For public companies, there are four important dates to remember regarding dividends. These are discussed in detail with examples at the Securities and Exchange Commission site

1. **Declaration date** is the day the Board of Directors announces its intention to pay a dividend. On this day, a liability is created and the company records that liability on its books; it now owes the money to the stockholders. On the declaration date, the Board will also announce a date of record and a payment date.

2. **In-dividend date** is the last day, which is one trading day before the *ex-dividend date*, where the stock is said to be *cum dividend* ('with [**in**cluding] dividend'). In other words, existing holders of the stock and anyone who buys it on this day will receive the dividend, whereas any holders selling the stock lose their right to the dividend. After this date the stock becomes *ex dividend*.

3. **Ex-dividend date** (typically 2 trading days before the *record date* for U.S. securities) is the day on which all shares bought and sold no longer come attached with the right to be paid the most recently declared dividend. This is an important date for any company that has many stockholders, including those that trade on exchanges, as it makes reconciliation of who is to be paid the dividend easier. Existing holders of the stock will receive the dividend even if they now sell the stock, whereas anyone who now buys the stock will not receive the dividend. It is relatively common for a stock's price to decrease on the ex-dividend date by an amount roughly equal to the dividend paid. This reflects the

decrease in the company's assets resulting from the declaration of the dividend. The company does not take any explicit action to adjust its stock price; in an efficient market, buyers and sellers will automatically price this in.

4. **Book Closure Date** Whenever a company announces a dividend pay-out, it also announces a date on which the company will ideally temporarily close its books for fresh transfers of stock.

5. **Record Date** Shareholders registered in the **stockholders of record** on or before the **date of record** will receive the dividend. Shareholders who are not registered as of this date will not receive the dividend. Registration in most countries is essentially automatic for shares purchased before the ex-dividend date.

6. **Payment Date** is the day when the dividend cheques will actually be mailed to the shareholders of a company or credited to brokerage accounts.

- **Dividend-reinvestment**

Some companies have dividend reinvestment plans, or DRIPs, not to be confused with scrips. DRIPs allow shareholders to use dividends to systematically buy small amounts of stock, usually with no commission and sometimes at a slight discount. In some cases, the shareholder might not need to pay taxes on these re-invested dividends, but in most cases they do.

1. Dividend Taxation

In many countries, such as the U.S.A. and Canada, income from dividends is taxed, albeit at a lower rate than ordinary income. Though in most cases, the lower tax rate is due to profits being taxed initially as Corporate tax.

2. Australia and New Zealand

In Australia and New Zealand, companies also forward franking credits or imputation credits to shareholders along with dividends. These franking credits represent the tax paid by the company upon its pre-tax profits. One dollar of company tax paid generates one franking credit. Companies can forward any proportion of franking up to a maximum amount that is calculated from the prevailing company tax rate: for each dollar of dividend paid, the maximum level of franking is the company tax rate divided by

(1 - company tax rate). At the current 30% rate, this works out at 0.30 of a credit per 70 cents of dividend, or 42.857 cents per dollar of dividend. The shareholders who are able to use them offset these credits against their income tax bills at a rate of a dollar per credit, thereby effectively eliminating the double taxation of company profits. This system is called dividend imputation.

3. UK

The UK's taxation system operates along similar lines to Australia and New Zealand: when a shareholder receives a dividend, the basic rate of income tax is deemed to already have been paid on that dividend. This ensures that double taxation does not take place, however this creates difficulties for some non-taxpaying entities such as certain trusts, charities and pension funds which are not allowed to reclaim the deemed tax payment and thus are in effect taxed on their income.

4. India

In India, companies declaring or distributing dividend, are required to pay a Corporate Dividend Tax in addition to the tax levied on their income. Dividend received is exempt in the hands of the shareholder's, in respect of which Corporate Dividend Tax has been paid by the company.

- **Effect on stock price**

After a stock goes ex-dividend (i.e.. the financial obligation for the company to pay the dividend to the holder), the stock price should drop.

To calculate the amount of the drop, the traditional method is to view the financial effects of the dividend from the perspective of the company. Since the company has paid say £x in dividends per share out of its cash account on the left hand side of the balance sheet, the equity account on the right side should decrease an equivalent amount. This means that a £x dividend should result in a £x drop in the share price.

A more accurate method of calculating this price is to look at the share price and dividend from the after-tax perspective of a share holder. The after-tax drop in the share price (or capital gain/loss) should be equivalent to the after-tax dividend. For example, if the tax of capital gains Tcg is 35%, and the tax on dividends Td is 15%, then a £1 dividend is equivalent to £0.85 of after tax money. To get the same financial benefit from a capital loss, the after tax capital loss value should equal £0.85. The pre-tax capital loss would be £0.85/(1-Tcg) = £0.85/(1-35%) = £0.85/65% = £1.30. In this case, a dividend of £1 has led to a larger drop in the share price of £1.30, because the tax rate on capital losses is higher than the dividend tax rate.

Finally, security analysis that does not take dividends into account may mute the decline in share price, for example in the case of a Price–earnings ratio target that does not back out cash; or amplify the decline, for example in the case of Trend following.

13.5 ADVANCED TREATMENT OF DIVIDEND

Dividends may be received out of capital or revenue profits of the subsidiary company. Dividends received by the holding company from the capital profits of the subsidiary company are credited to Investment in Shares of the Subsidiary Account thereby reducing the cost of control or increasing capital reserve. On the other hand, dividends received out of the revenue profits (i.e., post-acquisition profits) are treated as income and credited to Profit and Loss Account by the holding company. If dividend declared partly out of capital profits (i.e., pre-acquisition profits) and partly out of revenue profits (i.e., post-acquisition profits), the dividend received is divided into two parts in proportion to its declaration out of capital profits and revenue profits. The dividend pertaining to the first part (i.e., capital profits) is credited to Investment Account reducing the cost of control or increasing the capital reserve and dividend pertaining to the second part (i.e., revenue profits) is credited to Profit and Loss Account.

It may be noted that in the absence of information whether dividend has been declared out of pre-acquisition or post-acquisition profits, it is assumed that dividend is out of profits for the year for which the dividend is declared.

13.6 TREATMENT OF PROPOSED DIVIDEND

If the proposed dividend appears in the Balance Sheet of subsidiary company, holding company's share of such dividend will appear with the Profit and Loss Account balance in the consolidated Balance Sheet and share of such dividend belonging to minority shareholders will be added to the minority interest. Proposed dividend need not be shown in the consolidated Balance Sheet because it has been added to the minority interest and

Profit and Loss Account balance of the holding company.

If proposed dividend is not given in the Balance Sheet of the subsidiary company or directors of this company have not appropriated the profits for proposed dividend, then the following procedure is followed:

(i) Calculate the cost of control and minority interest etc. in the usual manner without any adjustment for proposed dividend.

(ii) Deduct from minority interest its share of proposed dividend and show the same as a separate item in the Consolidated Balance Sheet.

13.7 TREATMENT OF INTERIM DIVIDEND

Interim dividends are those dividends which are declared by the company in between two annual general meetings. The amount of interim dividend paid by subsidiary company during the accounting year is to be added to revenue profits of the subsidiary company before distribution among holding company and minority shareholders. Afterwards holding company's share will be deducted from the profits of the holding company and minority share from the minority interest, Interim dividend will not be shown anywhere in the Consolidated Balance Sheet.

Unclaimed dividend appearing in the Balance Sheet of the Subsidiary Company will be added in full to the total of minority interest.

13.8 BONUS SHARES

Bonus paid to the shareholders can be either cash honus or capital bonus. A company gives cash bonus to its shareholders only when it has larger reserves and sufficient cash to pay bonus. It is also seen that the payment of cash bonus does not affect the working capital of the company. On the other hand, capital bonus en the company wants to share the accumulated reserves'with the shareholders but it is not in a position to pay cash bonus because it adversely affects the working capital of the company. Capital bonus is given by making partly paid shares as fully paid without getting cash from the shareholders or it is given by the of free fully paid shares know as bonus shares.

Basic Characteristics of Bonus Shares

(a) Bonus shares can he issued to the existing members only.

- **Conditions for Issue of Bonus Shares**

(a) The bonus issue is not made unless the partly paid shares, if any, are made fully paid-up.

(b) The company has not defaulted in payment of interest or principal in respect of fixed deposits and interest on existing debentures or principal on redemption.

(c) 'I'he company has sufficient reason to believe that it has not defaulted in respect of payment of statutory dues of the employees such as contribution to provident fund, gratuity, bonus etc.

(d) A company which announces its bonus issue after the approval of the Board of Directors must implement the proposal within a period of six months from the date of such approval and shall not have the option of changing the decision.

  - The articles of association of the company shall contain a provision for capitalisation of reserves; ete.
  - If there is no such provision in t.he articles the company shall pass a resolution at its general body meeting making provisions in the articles of association for capitalisation.

- **Circumstances for Issue of Bonus Shares**

Following circumstances warrant the issue of bonus shares:

(i) When a company has accumulated large reserves (whether capital or revenue) and it wants to capitalise these reserves by issuing bonus shares.

(ii) When the company is not in a position to give cash bonus because it adversely affects its working capital.

(iii) When the value of fixed assets far exceeds the amount of the capital.

(iv) When the higher rate of dividend is not advisable for the distribution of the accumulated reserves because shareholders will demand the same rate of dividend in future which the directors may not be able to give. To obviate this difficulty, bonus shares are issued to facilitate the payment of the regular dividend from year to year.

v) When there is a big difference between the market value and paid up value of shares of the company i.e. market; value of shares far exceeds the nominal value of shares.

A company issuing bonus shares is better placed in the market. There is a sharp rise in the prices of equity shares following the declaration of bonus issue.

(v) When there is a big difference between the market value and paid up value of shares of the company i.e., market value of shares far exceeds the nominal value of shares.

A company issuing bonus shares is better placed in the market. There is a sharp rise in the prices of equity shares fonowing the declaration of bonus issue.

Provisions of the Companies Act Regarding Issue of Bonus Shares

According to Section 52 of the Companies Act, 2013 the Securities Premium Reserve may be applied in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares. Section 55 provides that the Capital Redemption Reserve Account may be applied by the company in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares. As per Section 63 of the Companies Act, 2013, a cornpany may issue fully paid bonus shares to its members in any manner out of

(i) its free reserves;

(ii) the securities premium account; or

(iii) the capital redemption reserve account.

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

SEBI (i.e., Securities and Exchange Board of India) Guidelines for Issue of Bonus Shares

Bonus issues are regulated by guidelines, 2003 issued hy SEBI and came into force w.e.f. 27-1-2003. The text of these guidelines is given as follows:

(i) These guidelines are applicable to existing listed companies who shall forward a certificate duly signed by the issuer and duly counter signed by its satutory auditor or by a company secretary in practice to the effect that the terms and conditions for issue of bonus shares as laid down in these guidelines have been complied with.

(ii) Issue of bonus shares after any public/rights issue is subject to the condition that no bonus issue shall be made which will dilute the value or right of the holders of debentures, convertible fully or partly. In other words, no company shall, pending conversion of FCDs/PCDs, issue any shares by way of bonus unless similar benefit is extended to the holders of such FCDs/PCDs, through reservation of shares in proportion to such convertible part of FCDs or PCDs. The shares so reserved may be issued at the tinle of conversion(s) of such debentures on the same terms on which the bonus issues vvere .made.

(iii) The bonus issue is made out of the free reserves built out of the genuine profits or securities premium reserve collected in cash only.

(iv) Reserves created by revaluation of fixed assets are not capitalised.

(v) The declaration of bonus issue, in lieu of dividend, is not made.

(vi) The bonus issue is not made unless the partly-paid shilres. if any existing, are made fully paid-up.

(vii) The company-

1. has not defaulted in payment of interest or principal in respect of fixed deposits and interest on existing debentures or principal on redemption thereof, and

2. has sufficent reason to believe that it has not defaulted in respect of the payment of statutory dues of the employees such as contribution to provident fund, gratuity, bonus etc.

viii) A company which announces its bonus issue aftcr the approval of the Board of Directors must implement the proposals within a period of six months from the date of such approval and shall not have the option of changing the decision.

ix) There should be a provision in the Articles of Association of the company for capitalisation of reserves, etc. and if not, the company shall pass a Resolution at its General Body Meeting making provisions in the Articles of Association for capitalisation.

x) Consequent to the issue of bonus shares if the subscribed and paid-up capital exceed the authorised share capital, a Resolution shall be passed by the company at its General Body Meeting for' increasing the authorised capital.

Free Reserves that can be Used for Issue of Bonus Shares

1. Surplus Account (i.e., credit balance of Profit and Loss A/c carried forward).

2. General reserve.

3. Dividend equalisation reserve.

4. Realised capital profits and reserves arising from profit on sale of fixed assets received in cash.

5. Balance ill debenture redemption reserve after redemption of debentures.

6. Capital Redemption Reserve Account created at the time of redemption of redeemable preference shares out of the profits.

7. Securities Premium Reserve Account collected in cash only.

   It may be remembered that both the above accounts can be utilised only for issuing fully paid bonus shares and not for making partly paid shm:es fully paid shares.

Reserves (i.e., not Free Reserves) not Available for issue of Bonus Shares

1. Capital reserve arising due to revaluation of assets.

2. Securities premium reserve arising on issue of shares on amalgamation or take over.

3. Investment allowance reserve/Development rebate reserve before expiry of 8 years of creation.

4. Balance in Debenture Redemption Reserve Account before redemption takes place.

5. Surplus arising from a change in the method of charging depreciation.

Accounting Treatment

(A) If the bonus is utilised by making existing partly paid shares fully paid shares, the entries will be as follows;

(1)	Surplus Account	Dr.
	or General Reserve Account	Dr.
	or Capital Profit Account	Dr.
	To Bonus to Shareholders Account	
	(Being amount transferred for bonus payable to shareholders) ;	
(2)	Share Final Call Account	Dr.
	To Share Capital Account	
	(Being final call due on shares)	
(3)	Bonus to Shareholders Account	Dr.
	To Share Final Call Account	
	(Being bonus to shareholders utihsed to make the final call paid-up)	

(B) If the payment of bonus is made by the issue of free fully paid bonus shares, the following Journal Entries will be recorded;

(1)	Surplus Account	Dr.
	or General Reserve Account	Dr.
	or Capital Redemption Reserve Account	Dr.
	or Securities Premium Reserve Account	Dr.
	or Capital Reserve Account	Dr.
	or Any Other Reserve Account	Dr.

To Bonus to Shareholders Account

(Being arnount transferred for issue of bonus shares)

(2) Bonus to Shareholders Account Dr.

To Share Capital Account

To Securities Premium Reserve Account (if bonus shares are

(Being issue of bonus shares) issued at a premium)

From the entries given above, it is clear that issue of bonus shares represents the addition to share capital of the company, but shareholders' fund remains unchanged because reserves are decreased by a responding amount.

While preparing the balance sheet of the company after the issue of bonus shares, the number of shares led as bonus shares and the source from which such shares are issued must be disclosed in the balance sheet.

After the issue of bonus shares, other things remaining the same, the price of shares will come down. total value of shares held by a shareholder will rernain unaltered. For example, suppose. A held 100 shares before issue of bonus shares when the market value of a share was ₹ 30. Suppose the company shares a bonus issue of one share for every 2 shares held; the shareholder in the example will get 50 us share8. His total holding will be 150 shares. The value of a share will come down to ₹ 20 i.e. ₹ 30 $\left(-\frac{1.00}{3.00}\right)$. Thus, total value of his holding will be ₹ 3,000 (150 × ₹ 20) i.e. value which was before the share of bonus shares. i.e ₹ 100 shares @ ₹ 30. It is because net assets available for shareholder are not red by issue of bonus shares.

The issue of bonus shares can be profitable to shareholders if the company maintains the rate of dend per share after the issue of bonus shares as before. After the issue of bonus shares, shareholders start getting more dividend as they are in possession of increased number of shares.

The imhalance between the lower amount of paid-up capital and the higher arnount. of net worth which an account of accumulated reserves can he corrected by capitalising reserves by issuing bonus shares. By issue of bonus shares the paid-up share capital will increase and will become representative capital in tion to the earning capacity. It. will curb speculation in the prices of shares and as a result prices of res of the company will stabilise. It can be made dear by taking the following example, Suppose a company has the following sumrnarised Balance Sheet:

	₹		₹
Capital	25,00,000	Net Assets	50,00.000
rerves,	25,00,000		
	50,00,000		50.00,000

Suppose further that the company earns ₹ 6,25,000 per year. A superficial view will show that the company earns 25% on its capital i.e. $\frac{\text{₹ } 6{,}25{,}000 \text{ (Profits)}}{\text{₹ } 25{,}00{,}000 \text{(Share Capital)}} \times 100$. This may give the feeling that company's rate of earning is very high and customers are being exploited. But if reserves of ₹ 26,00.000 capitalised by issue of bonus shares, the feeling of high rate of earning will be washed away because of earning will be only 12.5%

$$\text{(i.e., } \frac{\text{₹ } 6{,}25{,}00 \text{ (Profits)}}{\text{₹ } 25{,}00{,}000 \text{ (Share Capital)}} \times 100^{\cdot}$$

ILLUSTRATION 13.1 – Balance Sheet of Do Well. Ltd. as on 31st March, 2016 was as follows:

1. Equity and Liabilities	₹
(1) *Shareholders' Funds*	
(a) Share Capital :	
Equity Shares of ₹ 10 each	2,00,000
(b) Reserves and Surplus :	
Surplus Account	1,20,000

(2) *Non current Liabilities*	
6% Debentures	1,20,000
(2) *Current Liabilities*	
Creditors	60,000
Proposed Dividend	20,000
Total Equity and Liabilities	5,20,000
II. Assets	
(1) *Non-current Assets*	
Fixed Aslsets : Freehold Property	1,00,000
(2) *Current Assets*	
Stock	1,20,000
Debtors	80,000
Balance at Bank	2,20,000
Total Assets	5,20,000

At the annual general meeting held on 18th April, 2016 it was resolved:

(i) To declare dividend of 10% for the accounting year ended on 31st March, 2016,

(ii) To issue one bonus share for every 4 shares held out of Surplus Account.

(iii) To give existing shareholders the option to purchase for cash one share for ₹ 15 for every 4 shares held prior to the bonus distribution. This option was accepted by all the shareholders. (On this no bonus share will be given)

(iv) To redeem the debentures at a premium of 3%.

Assuming that the authorised share capital is enough and dividends have been paid in full, pass necessary Journal. Entries. Ignore dividend distribution tax.

SOLUTION

JOURNAL ENTRIES

			₹	₹
(1)	Proposed Dividend A/c	Dr.	20,000	
	To Dividend Payable A/c			20,000
	(Being dividend declared)			
(2)	Dividend Bank A/c	Dr.	20,000	
	To Bank A/c			20,000
	(Being amount transferred to Dividend Bank Account)			
(3)	Dividend Payable A/c	Dr.	20,000	
	To Dividend Bank A/c			20,000
	(Being dividend paid)			
(4)	Surplus A/c	Dr.	50,000	
	To Bonus to Shareholders A/c			50,000
	(Being bonus declared for shareholders)			
(5)	Bonus to Shareholders A/c	Dr.	50,000	
	To Equity Share Capital A/c			50,000
	(Being 5,000 bonus shares allotted to shareholders)			
(6)	Bank A/c	Dr.	75,000	
	To Equity Capital A/c			50,000
	To Securities Premium Reserve A/c			25,000
	(Being 5000 equity shares of ₹ 10 each issued at premium of ₹ 5 per share)			
(7)	Securities Premium Reserve A/c	Dr.	3,600	
	To Premium on Redemption of Debentures A/c			3,600
	(Being Premium on Redemption of debentures provided)			
(8)	6% Debentures A/c			
	Premium on Redemption of Debentures A/c			
	To Bank A/c			
	(Being redemption of debentures)			

ILLUSTRATION 13.2 - Following figures have been extracted from the books of ABC Ltd. as at 31-3-2016 :

	₹
Authorised Capital:	
50,00,000 Equity Shares off ₹ 10 each	5,00,00,000
Issued and Subscribed Capital:	
45,00,000 Equity Shares off ₹10 each, fully paid up	4,50,00,000
Reserves and Surplus:	
General Reseve	50,00,000
Surplus Account	1,10,00,000
Capital Reserves	30,00,000
Securities Premium Reserve	15,00,000
14% Partly Convertible Debentures of ₹ 100 each	1,25,00,000

The company decided to capitalise its reserves by way of bonus issue at the rate of one share for every 4 shares held. Capital reserves include ₹ 20,00,000 profit on sale of fixed assets. It may be assumed that securities premium reserve has been realised in cash. 40% of 14% debentures are convertible into equity shares of ₹ 10 each fully paid on 30th September, 2016.

Show the necessary Journal Entries in the books of the company and prepare the extract of the Balance Sheet immediately after the bonus ‘issue but before conversion of debentures.

SOLUTION

ACB Ltd.

JOURNAL ENTRIES

			₹	₹
	Capital Reserve Account Dr. Securities Premium Reserve Account Dr. General Reserve Account Dr. Surplus Account Dr. To Bonus to Shareholders Account (Being bonus issue @ 1 share for every 4 shares held by utilising various reserves as per Board's resolution dated.....) .		20,00,000 15,00,000 50,00.000 27,50,000	 1,12,50,000
	Bonus to Shareholders Account Dr To Equity Share Capital Account (Being issue of 11,25,000 bonus shares of ₹ 10 each fully paid up to be distributed in the ratio of 1 bonus share for every 4 shares held)		1,12,50,000	 1,12,50,000

BALANCE SHEET (EXTRACT)

as on........ (after Bonus Issue)

	₹
Authorised Capital	
62,50,000 Equity Shares of ₹ 10 each	6,25,00,000
Issued and Subscribed Capital	
56,25,000 Equity Shares of ₹ 10 each, fully paid up (Out of the above 11,25,000 equity shares of ₹ 10 each have been issued as fully paid bonus shares out of Capital Reserve Account ₹ 20,00,000, Securities Premium Reserve Account ₹ 15,00,000, General Reserve ₹ 50,00,000 and Surplus Account ₹ 27,50,000)	5,62,50,000

Reserves and Surplus :	
Capital Reserves	10,00,000
Surplus Account	82,50,000
Secured Loan:	
14% Partly Convertible Debentures of ₹ 100 each	1,25,00.000

Notes:

(1) It is assumed that the company will pass necessary resolution at its general body meeting for increasing the authorised capital. Figure of increased authorised capital may be as follows:

	₹
Existing number of equity shares as authorised	50,00,000
Add : issue of bonus shares to equity shareholders	11,25,000
Number of bonus shares to be issued to debenlureholders for	
conversion $\left(\frac{₹\ 1,25,00,000 \times 40\%}{4 \times ₹\ 10}\right)$	1,25,000
	62,50,000

(2) Entries for bonus shares to be issued to debentureholders will be made when debentures will be converted. No. of shares to be issued to debenture holders is calculated as follows:

	₹
Partly convertible debentures	1,25,00,000
Portion to be converted 40% $\left(₹\ 1,25,00,000 \times \frac{40}{100}\right)$	50,00,000
Ratio of bonus issue 1 : 4 $\left(₹\ 50,00,000 \times \frac{1}{4}\right)$	12,50,000
No. of bonus shares @ ₹10 each (₹12,50,000 ÷ 10)	1,25,000

(b) Bonus shares are issued as fully paid i.e. partly paid bonus shares cannot be issued.

(c) The right of bonus shares cannot be renuDciatl'd.

13.9 SUMMARY

Some believe that company profits are best re-invested back into the company: research and development, capital investment, expansion, etc. Proponents of this view (and thus critics of dividends per se) suggest that an eagerness to return profits to shareholders may indicate the management having run out of good ideas for the future of the company. Some studies, however, have demonstrated that companies that pay dividends have higher earnings growth, suggesting that dividend payments may be evidence of confidence in earnings growth and sufficient profitability to fund future expansion.

Taxation of dividends is often used as justification for retaining earnings, or for performing a stock buyback, in which the company buys back stock, thereby increasing the value of the stock left outstanding.

When dividends are paid, individual shareholders in many countries suffer from double taxation of those dividends:

1. the company pays income tax to the government when it earns any income, and then

2. when the dividend is paid, the individual shareholder pays income tax on the dividend payment.

In many countries, the tax rate on dividend income is lower than for other forms of income to compensate for tax paid at the corporate level.

Capital gains should not be confused with dividends. Capital gains assumes an increase in a stock's value. Dividend is merely parsing out a share of the profits, and is taxed at the dividend tax rate. If there is an increase of value of stock, and a shareholder chooses to sell the stock, the shareholder will pay a tax on capital gains (often taxed at a lower rate than ordinary income). If a holder of the stock chooses to not participate in the buyback, the price of the holder's shares could rise (as well as it could fall), but the tax on these gains is delayed until the actual sale of the shares. Certain types of specialized investment companies (such as a REIT in the U.S.) allow the shareholder to partially or fully avoid double taxation of dividends.

Shareholders in companies that pay little or no cash dividends can reap the benefit of the company's profits when they sell their shareholding, or when a company is wound down and all assets liquidated and distributed amongst shareholders. This, in effect, delegates the dividend policy from the board to the individual shareholder. Payment of a dividend can increase the borrowing requirement, or leverage, of a company.

13.10 GLOSSARY

- Dividend- Part of profit distributed among shareholders
- Interim dividend- Dividend declared by company in between two annual general meeting
- Contingent Liabilities-These are the liabilities which may or may not occur and are shown as a foot note in the balance sheet.

13.11 SELF ASSESSMENT QUESTIONS

Q.1 What do you mean by dividend?

____

____

____

Q.2 What is proposed dividend?

____

____

____

13.12 LESSON END EXERCISE

Q.1 What do you mean by dividend? How dividends are treated in the consolidated balance sheet?

Q.2 Discuss the treatment of proposed dividend and interim dividend in the consolidated balance sheet with suitable examples.

13.13 SUGGESTED READINGS

- M.C Shukla and Grewal, "Advanced Accounts-II", S.Chand, New Delhi.
- Jain, S.P and Narang, K.L. "Advanced Accounts-II", Kalyani Publisher, New Delhi
- Maheshwari, S.N "Advanced Accounts-II", Vikash Publisher, New Delhi

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CONSOLIDATED FINANCIAL STATEMENTS

M.Com II Sem.	Advanced Accounting	Unit-III
M.Com – C 211		Lesson No. 14

STRUCTURE:

14.1 INTRODUCTION

Goodwill has been said to be attraction force which brings in customers. Thus, to determine the nature of goodwill in a particular case, it is necessary to consider the types of business and the type of customers which such a business is inherently likely to attract as well as surrounding circumstances of each case. Goodwill of a business is a composite thing referable in part to its locality, in part of the way in which it is conducted and the personality of those who conduct and in part to the likelihood of competition. According to Braden and Allyn, "Goodwill is an intangible asset compounded from a variety of successful business quality and profitable product, efficient production methods, an outstanding reputation, plus the expectation that these ingredients, will continue to produce an about normal rate of return fro an indefinite period of time."

14.2 OBJECTIVES

After going through this lesson you, should be able to understand the treatment of goodwill already appearing in the balance sheet of subsidiary company, elimination of common transactions, treatment of fictitious assets, treatment of unrealised profit, treatment of contingent liabilities, treatment of bonus issue and revaluation of assets.

14.3 TREATMENT OF GOODWILL ALREADY APPEARING IN THE BOOKS OF THE SUBSIDIARY COMPANY

Goodwill appearing in the Balance Sheet of the subsidiary company will be shown alongwith goodwill (if any) of the holding company. In case there is capital reserve, it will be adjusted in capital reserve on consolidation.

Illustration 14.1- (Simple) From the balance sheets given below prepare a Consolidated Balance Sheet of A. Ltd. and its subsidiary company B. Ltd.

BALANCE SHEETS

as on 31st March, 2008

Liabilities	*A. Ltd.* Rs.	*B. Ltd.* Rs.	*Assets*	*A. Ltd.* Rs.	*B. Ltd.* Rs.
Share Capital :			Land & Building	6,40,000	2,00,000
Shares of Rs. 10 each	25,00,000	6,00,000	Machinery	12,60,000	3,40,000
General Reserve	3,60,000	1,20,000	Furniture	1,40,000	60,000
Profit and Loss A/c	2,40,000	1,80,000	40,000 shares in B. Ltd.	5,00,000	
Trade Creditors	3,50,000	1,00,000	Stock in hand	4,10,000	2,50,000
[redacted]			Debtors [redacted]	3,80,000	1,00,000
			Bank Balance	1,20,000	50,000
	34,50,000	10,00,000		34,50,000	10,00,000

At the date of acquisition of A Ltd. of its holding of 40,000 shares in B. Ltd., the latter company had undistributed profits and reserves amounting to Rs. 1,00,000, none of which has been distributed since then.

SOLUTION [redacted]

CONSOLIDATED BALANCE SHEET OF A. LTD. AND ITS SUBSIDIARY B. LTD. [redacted]

as on 31st March, 2008

Liabilities	Rs.	Rs.	*Assets*	Rs.	Rs.
Share Capital :			Goodwill	(3)	33,333
2,50,000 shares of Rs. 10 each			Land & Building :		
fully called up and paid up		25,00,000	A. Ltd. [redacted]	6,40,000	
Minority Interest (4)		3,00,000	B. Ltd.	2,00,000	
General Reserve		3,60,000			8,40,000
Profit and Loss Account :			Machinery :		[redacted]
Balance as per A Ltd.'s			A. Ltd.	12,60,000	
Balance Sheet	2,40,000		B. Ltd.	3,40,000	
Add : Profit of [redacted]					16,00,000
B. Ltd. (2)	1,33,333				
		3,73,333	Furniture :		
Trade Creditors : [redacted]			A. Ltd.	1,40,000	
A. Ltd.	3,50,000		B. Ltd.	60,000	
B. Ltd.	1,00,000				2,00,000
[redacted]		4,50,000	Stock in Hand :		
			A. Ltd.	4,10,000	
			B. Ltd.	2,50,000	
					6,60,000
			Debtors :		
			A. Ltd.	3,80,000	
			B. Ltd.	1,00,000	
					4,80,000
			Bank Balance :		
			A. Ltd.	1,20,000	
			B. Ltd.	50,000	
					1,70,000
		39,83,333			39,83,333

Working Notes : [redacted]

	Rs.
(1) ***Calculation of Capital (or Pre-acquisition) Profits***	
[redacted] Balance of General Reserve and Profits and Loss of B. Ltd. on the date of acquisition of shares by the holding company [redacted]	1,00,000

[redacted]	Holding Company's share is 2/3 because 40,000 shares out of 60,000 shares of B. Ltd. have been acquired by it ($i.e.,$ Rs. $1,00,000 \times \frac{2}{3}$) [redacted]	66,667
	Outsiders' share is 1/3 because 20,000 shares out of 60,000 shares are held by them ($i.e.,$ Rs. $1,00,000 \times \frac{1}{3}$)	33,333
		1,00,000

(2) ***Calculation of Revenue Profit (i.e., Profits after Acquisition of Shares)***

	General Reserve Rs.	*P & L A/c* Rs.	*Total* Rs.
Balance as given in B Ltd.'s B/S	1,20,000	1,80,000	3,00,000
Less : Reserves on the date of the acquisition *of shares treated as capital profits*	1,00,000	—	1,00,000
	20,000	1,80,000	2,00,000
Holding Company's Share — 2/3	13,333	1,20,000	1,33,333
Outsiders' Share—1/3	6,667	60,000	66,667

(3) ***Calculation of Goodwill or Cost of Control***

	Rs.	Rs.
Amount paid for 40,000 shares in B. Ltd.		5,00,000
Less : Face value of 40,000 shares of Rs. 10 each	4,00,000	
Holding Company's share of capital profits as calculated in (1) above	66,667	
		4,66,667
Cost of Control or Goodwill		33,333

(4) ***Calculation of Minority Interest***

	Rs.
Face value of 20,000 shares of Rs. 10 each held by outsiders	2,00,000
Add : 1/3 share of capital profit as calculated in (1) above	33,333
1/3 share of revenue profits as calculated in (2) above	66,667
	3,00,000

14.4 ELIMINATION OF COMMON TRANSACTIONS

While preparing Consolidated Balance Sheet, common transactions appearing in both the Balance Sheets of the holding company and the subsidiary company should be eliminated. Such transactions may be:

1. Goods sold on credit by the holding company to the subsidiary company or vice versa will appear as debtors in the Balance Sheet of the company selling goods and as creditors in the Balance Sheet of the company purchasing goods.

2. Bills drawn by one company and accepted by the other company are eliminated while preparing Consolidated Balance Sheet but bills discounted and endorsed will continue

to appear as a liability because the company, which has accepted such bills, will have to make the payment to an outsider (i.e., bank) on the due date.

3 Loans advanced by the holding company to the subsidiary company or vice versa appears as an asset in the Balance Sheet of the company which gives such loans and as a liability in the Balance Sheet of the company that takes these loans.

4. Debentures issued by one company and held by the other company.

14.5 TREATMENT OF FICTITIOUS ASSETS

In case if any fictitious assets (i.e. preliminary expenses, discount on issue of shares and debentures, underwriting commission etc.) are given on the assets side of the Balance Sheet of the subsidiary company, then these items must be deducted from the capital profits (or added to the capital loss) before distributing the same among the holding company and minority shareholders.

14.6 TREATMENT OF UNREALISED PROFIT

At the time when the goods are sold at a profit by the subsidiary company to the holding company or by the holding company to the subsidiary company remain unsold at the close of the financial year, the profit charged by the company on unsold goods remains unrealised. In such a case, it is not proper to credit the Profit and Loss Account with such unrealised profit. So, a stock reserve is created and, profit is reduced by the unrealised profit. For example, H Ltd. purchased from S Ltd. goods of the value of Rs. 50,000 on which S Ltd. has charged a profit of 25% on cost and goods worth Rs. 20,000 remained unsold at the end of the financial year. Unrealised profit in this case will be Rs. 4,000 (i.e.. 125 x Rs. 20,000). While preparing a Consolidated Balance Sheet, Stock Reserve of Rs. 4,000 will be deducted from stock on the assets side and the balance of Profit and Loss Account of the holding company will be reduced by Rs. 4,000 on the liabilities side.

Illustration 14.2- (Inter Company Owings, Stock Reserve & Fictitious Assets). From the Balance Sheet and information given below, prepare Consolidated Balance Sheet.

Additional Information:

BALANCE SHEET
as at 31st March, 2008

	H. Ltd.	*S. Ltd.*		*H. Ltd.*	*S. Ltd.*
	Rs.	Rs.		Rs.	Rs.
Share Capital :			Fixed Assets	4,00,000	60,000
Shares of Rs. 10			Stock	3,00,000	1,20,000
each fully paid	5,00,000	1,00,000	Debtors	75,000	85,000
Profit & Loss	2,00,000	60,000	Bills Receivable	20,000	—
Reserves	60,000	40,000	Shares in S Ltd.		
Bills Payable	—	15,000	7,500 at cost	75,000	—
Creditors	1,10,000	60,000	Preliminary Expenses	—	10,000
	8,70,000	2,75,000		8,70,000	2,75,000

(1) The bills accepted by S. Ltd. are all in favour of H Ltd.

(2) The stock of H Ltd. includes Rs. 25,000 bought from S Ltd. at a profit to the latter of 20% of sales.

(3) All the profit of S Ltd. has been earned since the shares were acquired by H Ltd. but there 'was already the reserve of Rs. 40,000 at that date.

SOLUTION

CONSOLIDATED BALANCE SHEET OF H. LTD. & ITS SUBSIDIARY S. LTD.
as at 31st March, 2008

Liabilities	Rs.	Rs.	*Assets*	Rs.	Rs.
Share Capital :			Fixed Assets :		
50,000 shares of			H Ltd.	4,00,000	
Rs. 10 each fully			S Ltd.	60,000	
paid-up		5,00,000			4,60,000
Minority Interest (4)		47,500			
Capital Reserve (3)		22,500	Stock :		
Reserves		60,000	H Ltd.	3,00,000	
Profit and Loss Account :			S Ltd.	1,20,000	
H Ltd.	2,00,000			4,20,000	
S. Ltd.			*Less* : Stock		
$\left(\frac{75}{100} \times \text{Rs. } 60{,}000\right)$	45,000		Reserve (*i.e.,*		
	2,45,000		Unrealised		
Less : Unrealised Profit			Profit		
as per contra	5,000				
		2,40,000	$\left(\frac{20}{100} \times \text{Rs. } 25{,}000\right)$	5,000	
Bills Payable :					
S Ltd.	15,000				4,15,000

Less : Held by H Ltd.	15,000		Debtors :		
		Nil			
Creditors :			H Ltd.	75,000	
H Ltd.	1,10,000		S Ltd.	85,000	
S Ltd.	60,000				1,60,000
		1,70,000	Bills Receivable :		
			H Ltd.	20,000	
			Less : Mutual Owing	15,000	
					5,000
		10,41,000			10,41,000

Working Notes :

		Rs.
	Total shares of the subsidiary company	10,000
	Shares held by the holding company	7,500
	Proportion of shares held by the holding company $\left(\frac{7,500}{10,000}\right)$	$\frac{3}{4}$
	Shares held by the outsiders (10,000 – 7,500)	2,500
	Proportion of shares held by the outsiders $\left(\frac{2,500}{10,000}\right)$	$\frac{1}{4}$
(1)	***Analysis of Capital Profit***	Rs.
	Balance of General Reserve on the date of acquisition	40,000
	Less : Preliminary Expenses	10,000
		30,000
	Less : Monority Interest (1/4)	7,500
	Share of Holding Company	22,500
(2)	***Analysis of Revenue Profit***	Rs.
	Profit earned after acquisition	60,000
	Less: Minority Interest (1/4)	15,000
	Share of Holding Company	45,000

(3)	***Calculation of Cost of Control or Capital Reserve***	Rs.	Rs.
	Amount paid for 7,500 shares in S Ltd.		75,000
	Less : Paid-up value of 7,500 shares for Rs. 10 each	75,000	[redacted]
	3/4 share of Rs. 30,000 Reserves of S Ltd. treated as capital profit because these existed on the date of purchase of shares in S Ltd.	22,500	
			97,500
	Capital Reserve		22,500
(4)	***Calculation of Minority Interest***		Rs.
	Paid-up value of 2,500 shares held by the outsiders		25,000
	Add : 1/4 share of Reserves of S Ltd. (*i.e.*, Rs. 30,000 × 1/4)		7,500
	1/4 share of Profit of S Ltd. (*i.e.*, Rs. 60,000 × 1/4)		15,000
	Minority Interest		47,500

ILLUSTRATION 14.3 *(Loss in Profit & Loss A/c, Inter Company Owings & Stock Reserve).* The following Balance Sheets are presented to you as on 31st March, 2008.

Liabilities	*H Ltd.*	*S Ltd.*	*Assets*	*H Ltd.*	*S Ltd.*
	Rs.	Rs.		Rs.	Rs.
Share Capital :			Fixed Assets	3,03,000	2,00,000
Shares of Rs. 100 each	5,00,000	2,00,000	Stock	90,000	40,000
General Reserve	1,00,000	—	Debtors	60,000	30,000
Profit & Loss A/c [redacted]	80,000		6% Debentures in		
6% Debentures [redacted]	—	1,00,000	S Ltd. at par	60,000	—
Trade Creditors [redacted]	75,000	45,000	Shares in S Ltd.		[redacted]
Loan from H Ltd. [redacted]		50,000	1500 @ Rs. 80		
[redacted]			purchased	1,20,000	—
	[redacted]		Bank	75,000	25,000
			Profit & Loss A/c	—	1,00,000
			Loan to S Ltd.	47,000	
	7,55,000	3,95,000		7,55,000	3,95,000

SOLUTION

Working Notes :

Total shares of S Ltd. (Rs. 2,00,000 ÷ Rs. 100) — 2,000

Shares of S Ltd. held by H Ltd. — 1,500

Therefore, $\frac{3}{4}\left(i.e.\ \frac{1{,}500}{2{,}000}\right)$ shares of S Ltd. are held by H Ltd. and $\frac{1}{4}\left(i.e.\ \frac{500}{2{,}000}\right)$ shares are held by minority interest.

(1) ***Calculation of Capital (i.e. Pre-acquisition) Loss***

		Rs.	Rs.
Debit balance in Profit & Loss A/c on 1-4-2007			1,50,000
Less : Capital Profit (*i.e.* Pre-acquisition Profit) :			
Accumulated Loss on 1-4-2007		1,50,000	
Less :	Accumulated Balance of Loss on 31-3-2008	1,00,000	
	Profit made during the year ending 31-3-2008	50,000	
Add :	Loss of stock by fire in June 2007 (Rs. 6,000 – Rs. 2,000)	4,000	
	Adjusted Profit in 2007-08	54,000	
	Profit for pre-acquisition period of 1-4-2007 to 30-7-2007 (4 months) Rs. 54,000 $\times \frac{4}{12}$	18,000	
Less :	Loss of stock by fire in June, 2007 (pre-acquisition period)	4,000	
			14,000
	Capital Loss		1,36,000
	Share of H Ltd. in Capital Loss $\left(\text{Rs. } 1{,}36{,}000 \times \frac{3}{4}\right)$		1,02,000
	Share of Minority Interest in Capital Loss $\left(\text{Rs. } 1{,}36{,}000 \times \frac{1}{4}\right)$		34,000

(2) ***Calculation of Revenue Profit (i.e., Post-acquisition Profit)***

	Rs.
Total adjusted profit in 2007-08	54,000

$\therefore$ Revenue profit for 8 months from 1-8-2007 to 31-3-2008

(*i.e.* Post-acquisition Period) Rs. $54,000 \times \frac{8}{12}$ — 36,000

Share of Revenue Profit of H Ltd. $\left(\text{Rs. } 36,000 \times \frac{3}{4}\right)$ — 27,000

Share of Revenue Profit of Minority Interest $\left(\text{Rs. } 36,000 \times \frac{1}{4}\right)$ — 9,000

(3) ***Calculation of Cost of Acquiring Control or Goodwill***

		Rs.
Cost of acquiring shares in S Ltd.		1,20,000
Less : Face value of 1,500 Shares of Rs. 100 each held	Rs. 1,50,000	
Less : Share in Capital Loss	Rs. 1,02,000	
		48,000
Goodwill		72,000

(4) ***Calculation of Minority Interest***

		Rs.
Paid up value of 500 shares of Rs. 100 each held		50,000
Less : Share of Capital Loss	Rs. 34,000	
Less : Share of Revenue Profit	Rs. 9,000	
		25,000
Minority Interest		25,000

(5) ***Profit & Loss A/c of H Ltd.*** [redacted]

		Rs.
H Ltd.'s Profit	[redacted]	80,000
Share of Revenue Profit in S Ltd.	[redacted]	27,000
Interest on Loan	[redacted]	3,000
[redacted]		1,10,000
Less : Unrealised Profit	[redacted]	1,000
[redacted]	[redacted]	1,09,000

CONSOLIDATED BALANCE SHEET OF H LTD. AND ITS SUBSIDIARY S LTD.

as at 31st March, 2008

Liabilities	Rs.	Rs.	*Assets*	Rs.	Rs.
Share Capital :			*Fixed Assets* :		
5,000 shares of Rs. 100 each		5,00,000	Goodwill (3)		72,000
Minority Interest (4)		25,000	Others : H Ltd. [redacted]	3,03,000	
Reserves & Surplus :			S Ltd.	2,00,000	
General Reserve [redacted]		1,00,000			5,03,000
Profit & Loss Account [redacted] (5)		1,09,000	*Current Assets* :		
Secured Loans :			Stock : H Ltd.	90,000	
6% Debentures [redacted]	1,00,000		S Ltd.	40,000	[redacted]
Less : Held by H Ltd. [redacted]	60,000		*Less* : Unrealised	1,30,000	
		40,000	Profit $\left(\frac{1}{2} \times \text{Rs. } 2,000\right)$	1,000	
Creditors : H Ltd.	75,000				
S Ltd.	45,000				
	1,20,000	[redacted]			1,29,000
Less : Mutual Owing	20,000		Debtors : H Ltd.	60,000	
[redacted]		1,00,000	S Ltd. [redacted]	30,000	
				90,000	[redacted]

[redacted]	[redacted]	*Less* : Mutual Owing	20,000	70,000
		Bank : H Ltd. [redacted]	75,000	
		S Ltd.	25,000	1,00,000
	8,74,000			8,74,000

14.7 TREATMENT OF CONTINGENT LIABILITIES

Contingent liability is that liability which may or may not arise. Its payment depends on the occurrence of a future event which is not certain. Such a liability is shown by way of a footnote in the Balance Sheet. Examples of such liabilities can be

(1) Liability in respect of bills discounted not yet matured. It is possible that bills may be dishonoured on the due date and liability may arise.

(2) Amount uncalled on partly paid shares held.

(3) Arrears of dividend on cumulative preference shares.

(4) Claims against the company not acknowledged debt as yet.

While preparing a Consolidated Balance Sheet, the treatment of contingent liability depends on whether it is towards outsiders or it is internal between holding and subsidiary companies. The external contingent liability is shown by way of footnote in the Consolidated Balance Sheet and internal contingent liability is eliminated treating it as mutual owing and is not shown in the Consolidated Balance Sheet as a footnote.

14.8 REVALUATION OF ASSETS

If assets and liabilities of the subsidiary company are revalued at the time of acquisition of shares in the subsidiary company, profit or loss on account of such revaluation is treated as capital profit or capital loss and is divided among minority shareholders and holding company according to the proportions of the equity shares held by them. Holding company's share of such capital profit is transferred to capital reserve or deducted from cost of controlor goodwill and vice versa if there is loss on revaluation. Share of profit of minority shareholders is added to the minority interest and a deduction is made from the minority interest if there is a loss on revaluation. As the asset value increases or decrease because of revaluation at the time of acquisition, adjustment of depreciation must be made in the revenue profits of the subsidiary company. For appreciation on the value of assets depreciation charge could be increased proportionately and would be deducted from the revenue profits of subsidiary company. But if there is decrease in the value of asset, depreciation would be decreased proportionately and added to the revenue profits of the subsidiary company.

Illustration 14.4 - (Revaluation of Assets). The Balance Sheets of H Ltd. and S Ltd. on 31st March, 2008 were as follows

Liabilities	*H. Ltd.* Rs.	*S. Ltd.* Rs.	*Assets*	*H. Ltd.* Rs.	*S. Ltd.* Rs.
Share Capital :			Land & Building		
10% Preference			at Cost	3,10,000	1,60,000
Shares of Rs. 100 each	—	1,00,000	Machinery less		
Equity Shares of			10% Depreciation	2,70,000	1,35,000
Rs. 100 each [redacted]	10,00,000	4,00,000	3,000 Shares in [redacted]		
General Reserve	1,00,000	50,000	S Ltd.	4,50,000	—
Profit & Loss A/c			Stock at cost	2,20,000	1,50,000
Balance on 1-4-2007	40,000	30,000	Sundry Debtors	1,55,000	90,000
Profit for 2007-08 [redacted]	2,00,000	80,000	Cash & Bank Balance	85,000	1,95,000
Creditors	1,50,000	70,000			
	14,90,000	7,30,000		14,90,000	7,30,000

H Ltd. acquired 3,000 Equity Shares in S Ltd. on 1st October 2007. As on the date of acquisition, H Ltd. found that the value of land and buildings and machinery of S Ltd. should be Rs. 1,50,000 and Rs. 1,92,500 respectively.

Prepare the Consolidated Balance Sheet of H Ltd. and its subsidiary S Ltd. as on 31st March, 2008 taking into consideration the fact that assets are to be taken at their proper values.

Solution

CONSOLIDATED BALANCE SHEET OF H. LTD. & ITS SUBSIDIARY S LTD.
as on 31st March, 2008

Liabilities	Rs.	Rs.	*Assets*	Rs.	Rs.	Rs.
Share Capital :			Goodwill (3)			33,750
10,000 shares of Rs. 100	[redacted]		Land & Buildings at cost :			[redacted]
each fully paid		10,00,000	H Ltd.		3,10,000	
Minority Interest	(4)	2,56,875	S Ltd.		1,50,000	
General Reserve		1,00,000	[redacted]			4,60,000
Profit & Loss Account :			Machinery :			
Balance as per H Ltd.'s			H Ltd.		3,00,000	
Balance Sheet [redacted]	2,40,000		*Less* : Depreciation		30,000	[redacted]
Add : Profit of				Rs.	2,70,000	
S Ltd. (2)	24,375		S Ltd.	2,00,000	[redacted]	
		2,64,375	(Rs. 1,50,000 + Rs. 50,000)			
			Less : Depreciation	17,500	1,82,500	
Creditors :						4,52,500
H Ltd.	1,50,000					
S Ltd.	70,000	2,20,000				
			Stock at cost :			
			H Ltd.		2,20,000	
			S Ltd.		1,50,000	3,70,000
			Sundry Debtors :			
			H Ltd.		1,55,000	
			S Ltd.		90,000	2,45,000
			Cash and Bank Balance :			
			H Ltd.		85,000	
			S Ltd.		1,95,000	2,80,000
		18,41,250				18,41,250

Working Notes :

(1) ***Calculation of Capital Profits :***

	Rs.	Rs.
General Reserve		50,000
Profit & Loss Account Balance on 1-4-2007		30,000
Profits up to 30th September, 2007 :		
Profit for the year ending 31-3-2008	80,000	
Less : Preference Dividend $\left(\frac{10}{100} \times \text{Rs. } 1,00,000\right)$	10,000	
	70,000	
Half of Rs. 70,000		35,000
Add : Increase in the value of machinery :		
Book value on 31-3-2008 after 10% depreciation	1,35,000	
Book value on 1-4-2007		
$\left(\text{Rs. } 1,35,000 \times \frac{100}{90}\right)$	1,50,000	

Less : 10% depreciation for $\frac{1}{2}$ year	7,500	
	1,42,500	
Increased value	1,92,500	
		50,000
		1,65,000
Less : Reduction in the value of land and buildings (Rs. 1,60,000 – Rs. 1,50,000)		10,000
Capital Profits		1,55,000
Less : Holding Company's Share (3/4)		1,16,250
Outsiders' Interest		38,750

(2) ***Calculation of Revenue Profits***

	Rs.
Profits (after deduction of preference dividend) after 30th September, 2007	35,000
Less : Depreciation @ 10% for 6 months from October 1, 2007 to March 31, 2008 on the increase in the value of machinery $\left(\text{Rs. } 50{,}000 \times \frac{10}{100} \times \frac{1}{2}\right)$	2,500
Revenue Profits	32,500
Less : Holding Company's Share (3/4)	24,375
Outsiders' Interest	8,125

(3) ***Calculation of Goodwill or Cost of Control***

		Rs.
Amount paid for shares acquired in S Ltd.		4,50,000
Less : Face Value of 3,000 shares of	Rs.	
Rs. 100 each	3,00,000	
Capital Profits	1,16,250	
		4,16,250
Goodwill		33,750

(4) ***Calculation of Minority Interest***

		Rs.
10% Preference Share Capital		1,00,000
Add : 10% Dividend for the year		10,000
Add :		1,10,000
Equity Shareholders :	Rs.	
1,000 Shares of Rs. 100 each	1,00,000	
Share of Capital Profits	38,750	
Share of Revenue Profits	8,125	
		1,46,875
Total Minority Interest		2,56,875

14.9 TREATMENT OF BONUS SHARES

Treatment of issue of bonus shares by the subsidiary company will depend upon the, source - from which bonus shares are issued. Bonus shares may be issued out of pre-acquisition profits or reserves or post-acquisition profits or reserves of the subsidiary company.

(a) Treatment of Issue of Bonus Shares out of Pre-acquisition Profits. Issue of bonus shares out of pre-acquisition profits or reserves will have no effect on the Consolidated Balance Sheet. It is so because holding company's share in pre-acquisition profits is reduced on account of issue of bonus shares and on the other hand paid-up value of shares held by holding company increases. Therefore, cost of control or goodwill will remain the same as it was before the issue of bonus shares.

Illustration 14.5 - (Bonus shares from preacquisition profits and revaluation of assets). A Ltd. acquired 8,000 shares of Rs. 100 each in B Ltd. on 30th September 2007. The summarised Balance Sheets of the two companies as on 31st March, 2008 were as follows:

	A Ltd. Rs.	B Ltd. Rs.		A Ltd. Rs.	B Ltd. Rs.
Share Capital :			Fixed Assets	15,00,000	14,47,000
30,000 Shares of			Investment in B Ltd.		
Rs. 100 each	30,00,000		at cost	17,00,000	—
10,000 Shares of			Stock in hand	4,00,000	2,00,000
Rs. 100 each		10,00,000	Loan to A Ltd.	—	20,000
Capital Reserve	—	5,50,000	Bills Receivable		
General Reserve	3,00,000	50,000	(including Rs. 5,000		
Profit and Loss Account	3,82,000	1,80,000	from B Ltd.)	12,000	—
Loan from B Ltd.	21,000	—	Debtors	2,50,000	1,80,000
Bills Payable (including			Cash and Bank		
Rs. 5,000 to A Ltd.)	—	17,000	Balance	20,000	20,000
Creditors	1,79,000	70,000			
Note : On the Balance Sheet of A Ltd. : There is a contingent liability for bills discounted of Rs. 6,000.					
	38,82,000	18,67,000		38,82,000	18,67,000

You are given the following information

1. B Ltd. made a bonus issue on 31st March, 2008 of one share for every two shares held, reducing the Capital Reserve equivalently but the accounting effect to this has not been given in the above Balance Sheet.

2. Interest receivable for the yaar (Re. 1,000) in respect of the loan due by A Ltd. to B Ltd. has not been credited in the books of B Ltd.

3. The credit balance in Profit and Loss Account of B Ltd. as on 1-4-2007 was Rs 21,000.

4. The directors decided on the date of the acquisitionthat the fixed assets of B Ltd. were over valued and should be written down by Rs. 50,000. Consequentiai adjustments on depreciation is to be ignored. Prepare the Consolidated Balance Sheet as at 31st March, 2008 showing your working.

SOLUTION

CONSOLIDATED BALANCE SHEET OF A LTD. AND ITS SUBSIDIARY B LTD.

as on 31st March, 2008

Liabilities	Rs.	Rs.	*Assets*	Rs.	Rs.
Share Capital			*Fixed Assets*		
30,000 shares of Rs. 100 each			Goodwill (3)		3,79,200
fully paid up		30,00,000	Fixed Assets :		
Minority Interest (4)		3,46,200	A Ltd.	15,00,000	
Reserves & Surplus			B Ltd.	13,97,000	
General Reserve		3,00,000			28,97,000
Profit & Loss A/c	3,82,000		*Current Assets*		
Add : Share of Revenue			Stock in hand :		
Profit in B Ltd.			A Ltd.	4,00,000	
			B Ltd.	2,00,000	
$\left(\text{Rs. } 80,000 \times \frac{4}{5}\right)$	64,000				6,00,000
		4,46,000	Debtors :		
Current Liabilities			A Ltd.	2,50,000	
Bills Payable	17,000		B Ltd.	1,80,000	
Less : Mutual Owing	5,000				4,30,000
		12,000	Cash & Bank Balance :		
Creditors :			A Ltd.	20,000	
A Ltd.	1,79,000		B Ltd.	20,000	
B Ltd.	70,000				40,000
		2,49,000	*Loans & Advances* :		
			Bills Receivable	12,000	
Contingent Liability for			*Less* : Mutual Debt	5,000	
Bills Discounted	Rs. 6,000				7,000
		43,53,200			43,53,200

Working Notes:

(1) After taking into consideration interest receivable on loan to A Ltd. Rs. 1,000, Profit and Loss balance of B Ltd. is Rs. 1,81,000 (i.e. Rs. 1,80,000 as reported + Rs. 1,000) and Loan to A Ltd. becomes Rs. 21,000 (i.e. Rs. 20,000 as given + Re. 1,000 interest receivable).

(2) Analysis of Reserve and Profit of B Ltd.

	Capital Profit Rs.	*Revenue Profit* Rs.
Capital Reserve of B Ltd.	5,50,000	
Less : Utilised for bonus shares (Issue of 5,000 bonus shares of Rs. 100 each @ 1 bonus share for every 2 shares)	5,00,000	
	50,000	
Add : General Reserve	50,000	
	1,00,000	
Profit & Loss A/c :		
Balance as on 1-4-2007	21,000	
Profit during the year (Rs. 1,81,000 – Rs. 21,000) (Rs. 1,60,000 divided equally between pre-acquisition period and post acquisition period because pre-acquisition period 1-4-2007 to 30-9-2007 and post-acquisition period 1-10-2007 to 31-3-2008 are of equal duration)	80,000	80,000
	2,01,000	80,000
Less : Loss on fixed assets	50,000	
	1,51,000	

(3) ***Calculation of Goodwill/Capital Reserve***

		Rs.
Cost of acquiring 8,000 shares of B Ltd.	Rs.	17,00,000
Less : Face value of 8,000 shares of Rs. 100 each	8,00,000	
Face value of 4,000 bonus shares of Rs. 100 each	4,00,000	
Share of Capital profit $\left(\frac{4}{5} \times \text{Rs. } 1{,}51{,}000\right)$	1,20,800	
		13,20,800
Goodwill		3,79,200

(4) ***Calculation of Minority Interest***

	Rs.
Face value of 2,000 shares of Rs. 100 each	2,00,000
Add : Face value of 1,000 bonus shares of Rs. 100 each	1,00,000
1/5 Share of capital profit $\left(\frac{1}{5} \times \text{Rs. } 1{,}51{,}000\right)$	30,200
1/5 Share of revenue profit $\left(\frac{1}{5} \times \text{Rs. } 80{,}000\right)$	16,000
	3,46,200

Treatment of Bonus Shares out of Post-acquisition Profits. Issue of bonus shares out of the post-acquisition profits will have effect on the Consolidated Balance Sheet in that share of the holding cor pany of revenue profit earned after the date of purchase of shares will be reduced and paid-up v ue of shares held by the holding company will increase because of issue of bonus shares. Increased paid-up value of shares held will reduce the cost of control or increase the capital profits as is clear from the following illustration.

Illustration 14.6 - (Bonus shares from post acquisition profits). H Ltd. acquired 20,000, (i.e., 4/5) equity shares of S Ltd. of Re. 100 each on 31st March, 2007. The summarised Balance Sheets of H Ltd. and S. Ltd. as 31st March, 2008 were as follows:

BALANCE SHEETS

Liabilities	*H. Ltd.*	*S. Ltd.*	*Assets*	*H. Ltd.*	*S. Ltd.*
	Rs.	Rs.		Rs.	Rs.
Share Capital in shares of Rs. 100 each	80,00,000	25,00,000	Fixed Assets	70,00,000	25,00,000
			Current Assets	40,00,000	20,00,000
Reserves	30,00,000	5,00,000	20,000 shares in S Ltd.	30,00,000	—
Profit & Loss A/c	10,00,000	10,00,000			
Creditors	20,00,000	5,00,000			
	1,40,00,000	45,00,000		1,40,00,000	45,00,000

S Ltd. had the credit balance of Rs. 5,00,000 in the reserves and Rs. 2,00,000 in the Profit and Loss Account when H Ltd. acquired the shares in S Ltd. S Ltd. issued bonus shares @ 1 for every 5 shares held out of post-acquisition profits. This is not shown in the above balance sheet. Prepare Consolidated Balance Sheet.

SOLUTION

Working Notes :

(1) ***Analysis of Capital Profit***

	Rs.
Reserve Balance	5,00,000
P/L A/c Balance	2,00,000
	7,00,000
Less : Minority Interest (1/5 share)	1,40,000
Holding Company's Share	5,60,000

(2) ***Analysis of Revenue Profit***

	Rs.
Profit earned after purchase of shares by S. Ltd. (Rs. 10,00,000 – Rs. 2,00,000)	8,00,000
Less : Profit utilised for issue of bonus shares $\left(\text{Rs. } 25{,}00{,}000 \times \frac{1}{5}\right)$	5,00,000
	3,00,000
Less : Minority Interest (1/5)	60,000
Holding Company's Share	2,40,000

(3) ***Cost of Control after Issue of Bonus Shares***

	Rs.	Rs.
Cost of acquiring 20,000 shares		30,00,000
Less : Paid-up value of shares held :		
Value of 20,000 shares of Rs. 100 each		

before issue of bonus shares	20,00,000	
Value of 4,000 bonus shares (20,000 × 1/5)	4,00,000	
Share in Capital Profits	5,60,000	
		29,60,000
Cost of Control		40,000

(4) ***Calculation of Minority Interest***

	Rs.
Paid-up value of 5,000 shares held before issue of bonus shares	5,00,000
Add : Bonus shares (5,000 × 1/5 = 1,000 bonus shares of Rs. 100 each)	1,00,000
Add : Share in Capital Profits	1,40,000
Share in Revenue Profits	60,000
Minority Interest	8,00,000

(5) ***Profit & Loss Account***

	Rs.
Balance in Profit & Loss A/c (as given)	10,00,000
Share of revenue profits	2,40,000
	12,40,000

[redacted] **BALANCE SHEET OF H LTD. AND ITS SUBSIDIARY, S LTD.** [redacted]

as at 31st March, 2008

Liabilities	Rs.	Rs.	*Assets*	Rs.	Rs.
Share Capital :			Cost of Control (*i.e.* Goodwill) (3)		40,000
80,000 shares of Rs. 100			Fixed Assets :		
each fully paid-up		80,00,000	H Ltd.	70,00,000	
Minority Interest (4)	[redacted]	8,00,000	S Ltd. [redacted]	25,00,000	
Reserves		30,00,000			95,00,000
Profit & Loss Account : (5)		12,40,000	Current Assets :		
Creditors :			H Ltd.	40,00,000	
S Ltd.	5,00,000		S Ltd.	20,00,000	
H Ltd.	20,00,000				60,00,000
		25,00,000			
		1,55,40,000			1,55,40,000

14.10 SUMMARY

Goodwill appearing in the Balance Sheet of the subsidiary company will be shown alongwith goodwill (if any) of the holding company. In case there is capital reserve, it will be adjusted in capital reserve on consolidation. While preparing Consolidated Balance Sheet, common transactions appearing in both the Balance Sheets of the holding company and the subsidiary company should be eliminated. Such transactions may be:

1. Goods sold on credit by the holding company to the subsidiary company or vice versa will appear as debtors in the Balance Sheet of the company selling goods and as creditors in the Balance Sheet of the company purchasing goods.

2. Bills drawn by one company and accepted by the other company are eliminated while

preparing Consolidated Balance Sheet but bills discounted and endorsed will continue to appear as a liability because the company, which has accepted such bills, will have to make the payment to an outsider (i.e., bank) on the due date.

3 Loans advanced by the holding company to the subsidiary company or vice versa appears as an asset in the Balance Sheet of the company which gives such loans and as a liability in the Balance Sheet of the company that takes these loans.

4. Debentures issued by one company and held by the other company.

In case if any fictitious assets (i.e. preliminary expenses, discount on issue of shares and debentures, underwriting commission etc.) are given on the assets side of the Balance Sheet of the subsidiary company, then these items must be deducted from the capital profits (or added to the capital loss) before distributing the same among the holding company and minority shareholders.

14.11 GLOSSARY

- Goodwill- Intangible assets
- Fictitious Assets- preliminary expenses, discount on issue of shares and debentures, underwriting of commission etc.
- Bonus Issue- Shares issued by the company to its existing employees for the purpose of raising capital of the company.
- Contingent Liabilities- these are the liabilities which are not included in the balance sheet total but are shown as a footnote.

14.12 SELF ASSESSMENT QUESTIONS

Q.1 How fictitious assets are treated in the consolidated balance sheet?

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____

____

Q.2 What do you mean by revaluation of assets?

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14.13 LESSON END EXERCISE

Q.1 Discuss the treatment of goodwill already appearing in the consolidated balance sheet with suitable examples.

Q.2 Discuss the treatment of contingent liabilities and bonus share in the consolidated balance sheet with suitable examples.

14.14 SUGGESTED READINGS

- Damodaran, Aswath, "Corporate Finance", john Willey and Sons, New York, 2nd edition, 2005.
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- M.C Shukla and Grewal, "Advanced Accounts-II", S.Chand, New Delhi.
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- Maheshwari,S.N "Advanced Accounts-II", Vikash Publisher, New Delhi

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CONSOLIDATED FINANCIAL STATEMENTS

M.Com II Sem.	**Advanced Accounting**	**Unit-III**
M.Com – C 211		**Lesson No. 15**

STRUCTURE:

15.1 INTRODUCTION

One of the popular firms of business combination is by means of holding company or Parent Company. A holding company is one which directly or indirectly acquires either all or more than half the number of Equity shares in one or more companies so as to secure a controlling interest in such companies, which are then known as subsidiary companies. Holding companies are able to nominate the majority of the directors of subsidiary company and therefore control such companies. Holding company meet directly from such subsidiary company or it may acquired majority or shares in existing company. Such company also considered as subsidiary company in which holding company acquired majority shares. A subsidiary company, subsidiary, or sister company is a company that is completely or partly owned and partly or wholly controlled by another company that owns more than half of the subsidiary's stock. The subsidiary can be a company, corporation, or limited liability company. In some cases it is a government or state-owned enterprise. The controlling entity is called its parent company, parent, or holding company. An operating subsidiary is a business term constantly used within the United States railroad industry. In the case of a railroad, it refers to a company that is a subsidiary but operates with its own identity, locomotives and rolling stock. In contrast, a non-operating subsidiary would exist on paper only (i.e. stocks, bonds, articles of incorporation) and would use the identity and rolling stock of the parent company.

15.2 OBJECTIVES

After going through this lesson, you should be able

- to know about the holding company having number of subsidiaries
- to understand the concept of cross holding
- to learn about how, shares are purchased and sold in different dates.

15.3 HOLDING COMPANIES HAVING MORE THAN ONE SUBSIDIARY

So far we have assumed that a holding company has only one subsidiary but that is not the case because a holding company may have a number of subsidiaries. Preparation of the consolidated Balance Sheet of such a holding company presents no difficulty if there is no mutual holdings in between the subsidiaries. Capital profit, revenue profit, goodwill or cost of control, minority interest etc. will be calculated separately for each subsidiary as we have done in case of one subsidiary, and then the total of all these heads for all subsidiaries is taken up under each head. Other items such as unrealised profit on closing stock, mutual owings, dividend, bonus shares, profit or loss on revaluation of assets and liabilities of subsidiaries will be treated exactly in the same way as we have done in case of one subsidiary company. If the subsidiaries nave mutual holdings in between them (i.e., one subsidiary has acquired the shares of another subsidiary), capital profit, revenue profit, dividend, bonus shares etc. of the group should be adjusted keeping in view the total shares acquired by the holding company and the subsidiaries and only then .the share of minority shareholders is taken up in each company.

15.4 CROSS HOLDING

A situation in which a publicly-traded corporation owns stock in another publicly-traded company. So, technically, listed corporations own securities issued by other listed corporations. Cross holding can lead to double counting, whereby the equity of each company is counted twice when determining value. When double counting occurs, the security's value is counted twice, which can result in estimating the wrong value of the two companies.

Companies that have cross holdings are susceptible to confusion and management holdout in cases of company mergers and acquisitions, because one company might refuse consent to the other, and vice versa. Also, if Company A holds stocks or bonds in Company B, the value of this security might be counted twice, in error, because these securities would be counted when determining the value of the company issuing the security, and again when looking over the securities held by the other company.

A cross holding is a security issue by a publicly listed company that is held by another company on the same listing. If the cross holding is not accounted for when determining the values of companies on the exchange, the result can be a double counting of the security's value, which would obscure the true value of the companies involved. It is also important to consider the role of cross holdings in situations like corporate takeovers and ousters of management. A company that holds shares in another can vote just like any other shareholder. In the most simple example of a cross holding, Company X can hold stocks or bonds issued by Company Y. Company Y's value would be counted twice if the cross holding was not accounted for. It would be counted once when looking at the value of securities issued by the company, and again when considering the securities held by Company X. This would lead to having skewed information about the values of companies on the index. It is also possible for companies to hold shares in each other and to hold securities issued by multiple companies. A tangled web of cross holdings can be created on a securities index by companies making diverse investments in order to maximize the potential for returns. The more cross holdings there are, the more challenging it becomes to value companies accurately.

One corporation owning shares in another corporation. Cross-holdings are important when it comes down to accounting because without taking cross-holdings into consideration would mean double-counting. For example, if Corporation X and Corporation Y are both listed on the same index, Corporation X's cross-holdings in Corporation Y need to be accounted for in order to avoid Corporation Y's value from being double-counted.

15.5 PURCHASE AND SALE OF SHARES IN SUBSIDIARY COMPANY

A holding company may purchase shares of the subsidiary company in installments. In such circumstances division of profit between pre and post acquisition will depend upon the lots in which shares are purchased. However, if small purchases are made over the period of time then date of purchase of shares which results in acquiring in controlling interest may be taken as cut of line for division of profits between capital and Revenue.

When a holding company disposed off a part of its holding in the subsidiary company the relationship of holding and subsidiary company continues, as it holds majority of shares of subsidiary. Sale of shares by holding company may be treated as follows.

a) Profit or loss on sale of shares should be ascertained and it should be adjusted while ascertaining goodwill or capital reserve. In brief, such loss or gain on sale of share should be considered in cost of control.

b) The minority interest and cost of control should be ascertained on the basis of number of shares held by the holding company and the minority on the date of consolidated balance sheet.

15.6 PREPARATION OF CONSOLIDATED BALANCE SHEET AND PROFIT & LOSS ACCOUNT

A holding company is required to present to its shareholders consolidated balance sheet of holding company and its subsidiaries. Consolidated balance sheet is nothing but addicting of up or combining the balance sheet of holding and its subsidiary together. However assets and liabilities are straight forward, i.e. added line to line and combination of share capital, reserves, and accumulated losses are not directly added in consolidated balance sheet.

PREPARATION OF CONSOLIDATED BALANCE SHEET.

The following points need special attention while preparing consolidated balance sheet.

1) Share of holding company and share of minority (outside shareholders).
2) Date of Balance sheet of holding company and that of various subsidiary companies must be same. If they are not so necessary adjustment must be made before consolidation.
3) Date of Acquisition of control in subsidiary companies.
4) Inter company owing.
5) Revaluation of fixed assets as on date of acquisition, depreciation, adjustment on revaluation amount etc. which are discussed here in after.

- **Consolidated Statement of Profit and loss**

Consolidated Balance Sheet is prepared to show the financial position of tbe group. Similarly, Consolidated Statement of Profit and Loss is prepared to show the profit of the group so that shareholders may he able to know the profits of the company in which they have made the investment. Apart from the usual items of income, losses and expenses which will be shown in the Statement of Profit and Loss of the holding and the subsidiary companies are am”rregated while preparing Consolidated Statement of Profit and Loss, some adjustments are made so that Consolidated Stat.ement of Profit and Loss may show the earnings of the group. Some of the important adjustments are as follows:

(a) Transfer of goods within the group should he eliminated; so Consolidated Statement of Profit and Loss eliminates purchases and sales within the group. Thus, if the subsidiary company bought goods worth ₹ 5,00,000 from the holding company ₹ 5,00,000 will be deducted from the purchases of the subsidiary company and the sales of the holding company.

(b) Similarly, common expenses and incomes are eliminated frorn the Consolidated Staternent of Profit and Loss.

(c) Reserve for unrealised profits on unsold goods sold by the subsidiary to the holding company (or vice versa should be created by debit to the Consolidated Surplus Account and credit to Stock Reserve Account.

(d) Interest on debentures and dividends received by the holding company from the subsidiary company (or vice versa) should be eliminated as inter company transactions from both sides of the Consolidated Statement of Profit and Loss. **It may be noted that no adjustment is required for tax on dividends or on interest on debentures beeause the payment of tax is to he made to the outsiders.**

(e) Holding company's share of profits of the suhsidiary company arising before the date of acquisition of shares should be debited to Surplus Account and credited to capital reserve or cost of control or goodwill as the case may be and vice versa in case of a loss.

(f) Minority shareholders' share of all profits of the subsidiary company should be credited to Minority Interest Account and debited to Consolidated Statement of Profit and Loss and vice versa in case of a loss.

(g) Holding company's share of the profit set aside for redemption of preference shares should be debited to Surplus Account and credited to Capit.al Redemption Reserve Account. Holding company's share will be in proportion to the value. of preference shares held.

ILLUSTRATION 15.1 - The Trial Balances of H Ltd. and S Ltd. are given below as on 31-11-2016:

	H Ltd	*S Ltd*		
	Dr.	Cr.	Dr.	Cr.
	₹	₹	₹	₹
Equity Share Capital (₹ 10)		1,00,000		4,00,000
6% Preference Share Capital (₹ 10)				1,00,000
Fixed Assets less Depreciation upto 31-3-2015	5,50,000		3,50,000	
Sales (including ₹ 2,00,000 sales by H Ltd. to S Ltd.)		12,00,000		10,00,000
Cost of Goods sold	9,60,000		8,00,000	
Stock (31-3-2016)	1,20,000		90,000	
Debtors and Creditors	2,00,000	1,30,000	1,60,000	60,000
General Expenses	1,30,000		1,20,000	
32,000 Shares in S Ltd.	4,00,000			
Interim Dividend Paid:				
Preference		3,000		
Equity			20,000	
Dividend Received		16,000		
Surplus Account (31-3-2015)		76,000		48,000
Bank	62,000		65,000	
	24,22,000	24,22,000	16,08,000	16,08,000

(1) Shares were purchased on 1-4-2014.

(2) S Ltd. has paid and provided ₹ 20,000 dividend for 2018-2014 and ₹ 46.000 for 2014-2015. The net profit for 2014-2015 was ₹ 74,000.

(3) H Ltd. proposed ₹ 80,000 for 2015-16 and S Ltd. provided for final dividend of ₹ 3,000 as Preference Dividend and ₹ 20,000 Equity Dividend.

(4) Goods sold by H Ltd. to S Ltd. were at 20% profit. on sale price. Closing stock of S Ltd. includes ₹ 20,000 such stocks.

(5) Depreciation is charged @ 10% p.a. on reducing balance method. There is no addition in 2015-16. Fixed assets of S Ltd. were valued at ₹ 10,000 in excess, but no adjustment has been made in the books. Provision for additional depreciation is to be made only to the extent of holding of H Ltd.

Prepare Consolidated Statement of Profit and Loss for the year ended 31st March, 2016 and Consolidated Balance Sheet as at 31st March, 2016.

SOLUTION

(For Consolidated Statement of Profit and Loss please see next page)

CONSOLIDATED BALANCE SHEET OF H LTD. AND ITS SUBSIDIARY S LTD.

as at 31st March, 2016

		Note No	₹
I. Equity and Liabilities			
(1) Shareholders' Funds		A	10,00,000
Share Capital Reserves and Surplus		B	99,880
(2) Minority Interest			
			10,99,880
	(4)		1,96,400
(3) Current Liabilities			
Trade Payables (Creditors) :	₹		
H Ltd,	1,30,000		
S Ltd.	60,000		
			1,90,000
Short-term Provisions		C	

Total Equity and Liabilities (1) + (2) + (3)		
II. Assets		
(1) Fixed Assets:		
Tangible Assets	D	8,10,000
Intangible Assets	E	64,000
(2) Current Assets		
Inventories	F	2,06,000
Trade Receivables	G	3,60,000
Cash and Cash Equivalents	H	1,27,000
		6,93,000
Total Assets (1) + (2)		15,67,000

ACCOMPANYING NOTES TO THE CONSOLIDATED BALANCE SHEET

A. Share Capital

	₹
Authorised Capital:	?
Issued, Subscribed and Paid-up Capital	
1,00,000 Equity Shares of f 10 each fully paid up	10,00,000

CONSOLIDATED STATEMENT OF PROFIT AND LOSS OF H LTD. AND ITS SUBSIDIARY S LTD.

for the year ending 31st March 2016

	H Ltd.	*S Ltd.*	*Adjustment*	*Total*
	₹	₹	₹	₹
I. Income from Operations (i.e. Sales)	12,00,000	10,00,000	2,00,000	20,00,000
II. Other Income	–	–	–	–
III. Total Revenue (I+II)	12,00,000	10,00,000	2,00,000	20,00,000
IV. Expenses :				
Cost of Goods Sold	9,60,000	8,00,000	2,00,000	15,60,000
Depreciation (10%)	55,000	35,000	–	90,000
Other Expenses (i.e. General Expenses)	1,30,000	1,20,000	–	2,50,000
Total Expenses	11,45,000	9,55,000	2,00,000	19,00,000
V. Profit for the year (III-IV)	55,000	45,000	–	1,00,000

B. Reserves and Surplus

	₹	H Ltd. ₹	S. Ltd. ₹
Surplus A/c on 31-3-2015		76,000	48,000
Add: Profit for the year as per Statement of Profit and Loss		55,000	45,000
		1,31,000	93,000
Less: Extra Depreciation on Value Written Off (to the extent of Holding Co.'s share) $\left(\frac{10}{100} \times ₹\,9{,}000 \times \frac{80}{100}\right)$		720	
		1,30,280	
Less : Interim Dividend paid by S Ltd.	₹		
Preference	3,000		
Equity	20,000		
Proposed Dividend by S Ltd.			
Preference	3,000		
Equity	20,000		
			46,000
			43,000
Less: Minority Interest (20% of ₹ 47,000)	9,400		
Capital Reserve (2)	16,000		
			25,400
			21,600
Share of Surplus A/c (Revenue Profit)		21,600	–21,600
		1,51,880	–
Less: Stock Reserve (i.e. Unrealised Profit ₹ 20,000 x $\frac{20}{100}$)		4,000	
		1,47,880	

Add: Share of Dividend in S Ltd.	₹	
Interim $\left(₹\, 20{,}000 \times \frac{80}{100}\right) =$	16,000	
Proposed $\left(₹\, 20{,}000 \times \frac{80}{100}\right) =$	16,000	
		32,000
		1,79,880
Less: Proposed Dividend		80,000
		99,880

C. Short-term Provisions

	₹
Proposed Dividend	80,000
Provision for Depreciation on Excess Value of Fixed Asset Written off to the Extent of Holding of H Ltd $\left(₹\, 9{,}000 \times \frac{10}{100} \times \frac{80}{100}\right)$	720
	80,720

D. Tangible Assets

	₹	₹
Fixed Assets:		
H Ltd.	5,50,000	
S Ltd.	3,50,000	
	9,00,000	
Less: 10% Depreciation	90,000	
		8,10,000

E. Intangible Assets

		₹
Goodwill	(3)	64,000

F. Inventories

	₹	₹
Stock (at cost) : H Ltd.	1,20,000	
S Ltd.	90,000	

	2,10,000	
Less : Stock Reserve	4,000	
		2,06,000

G. Trade Receivables

	₹	₹
Debtors: H Ltd.	2,00,000	
S Ltd.	1,60,000	
		3,60,000

H. Cash and Cash Equivalents

	₹	₹
Bank Balance: H Ltd.	62,000	
S Ltd.	65,000	
		1,27,000

Working Notes:

(1) Calculation of Extra Depreciation on Fixed Assets

	₹
Amount written up on 1-4-2014	10,000
Less: 10% Depreciation $\left(₹\ 10{,}000 \times \frac{10}{100}\right)$	1,000
Book value on 1-4-2015	9,000
10% Depreciation for 2015-16 $\left(₹\ 9{,}000 \times \frac{10}{100}\right)$	900
Holding Company's Share of Depreciation (4/5 x ₹ 900)	720

(2) Calculation of Capital Reserve

		₹
Surplus Account Balance of S Ltd. on 31-3-2015	₹	48,000
Less: Profit of S. Ltd. for 2014-15	74,000	
Less: Dividend for 2014-15	46,000	
		28,000
Surplus Account's Balance on 1-4-2014		20,000
Share of Holding Company (₹ 20,000 x 4/5)		16,000

(3) Calculation of Goodwill

	₹	₹
Amount paid for acquiring shares of S Ltd.		4,00,000
Less: Face value of 32.000 shares	3,20,000	
Capital Reserve	16,000	
		3,20,000
		64,000

(4) Calculation of Minority Interest

	₹	₹
Preference Share Capital	1,00,000	
Add: Proposed Dividend	3,000	
		1,03,000
Equity Share Capital (₹ 4,00,000 – ₹ 3,20,000)	80,000	
Add: Proposed Dividend	4,000	
		84,000
Share in Surplus Account (₹ 47,000 x 1/5)		9,400
		1,96,400

15.7 SUMMARY

Subsidiaries are a common feature of business life, and all multinational corporations organize their operations in this way. Examples include holding companies such as Berkshire Hathaway, Time Warner, or Citigroup; as well as more focused companies such as IBM, or Xerox Corporation. These, and others, organize their businesses into national and functional subsidiaries, oftentimes with multiple levels of subsidiaries. A parent company does not have to be the larger or "more powerful" entity; it is possible for the parent company to be smaller than a subsidiary or the parent may be larger than some or all of its subsidiaries (if it has more than one). The parent and the subsidiary do not necessarily have to operate in the same locations, or operate the same businesses, but it is also possible that they could conceivably be competitors in the marketplace. Also, because a parent company and a subsidiary are separate entities, it is entirely possible for one of them to be involved in legal proceedings, bankruptcy, tax delinquency, indictment and/or under investigation, while the other is not. The most common way that control of a subsidiary is achieved, is through the ownership of shares in the subsidiary by the parent. These shares give the parent the necessary votes to determine the composition of the board of the subsidiary, and so exercise control. This gives rise to the common presumption that 50% plus one share is enough to create a subsidiary. There are, however, other ways that control can come about, and the exact rules both as to what control is needed, and how it is achieved, can be complex (see below). A subsidiary may itself have subsidiaries, and these, in turn, may have subsidiaries of their own. A parent and all its subsidiaries together are called a "group", although this term can also apply to cooperating companies and their subsidiaries with varying degrees of shared ownership.

Subsidiaries are separate, distinct legal entities for the purposes of taxation, regulation, and liability. For this reason, they differ from divisions, which are businesses fully integrated within the main company, and not legally or otherwise distinct from it.

In other words, a subsidiary can sue and be sued separately from its parent and its obligations will not normally be the obligations of its parent. However, creditors of an insolvent subsidiary may be able to obtain a judgment against the parent if they can pierce the corporate veil and prove that the parent and subsidiary are mere alter egos of one another.

In descriptions of larger corporate structures, the terms "first-tier subsidiary", "second-tier subsidiary", "third-tier subsidiary" etc. are often used to describe multiple levels of subsidiaries. A first-tier subsidiary means a subsidiary/daughter company of the ultimate parent company, while a second-tier subsidiary is a subsidiary of a first-tier subsidiary: a "granddaughter" of the main parent company. Consequently, a third-tier subsidiary is a subsidiary of a second-tier subsidiary: a "great-granddaughter" of the main parent company.

The ownership structure of the small British specialist company Ford Component Sales, which sells Ford components to specialist car manufacturers and OEM manufacturers, such as Morgan Motor Company , illustrates how multiple levels of subsidiaries are used in large corporations:

The word "control" used in the definition of "subsidiary" is generally taken to include both practical and theoretical control. Thus, reference to a body which "controls the composition" of another body's board is a reference to control in principle, while reference to being able to cast more than half of the votes at a general meeting, whether legally enforceable or not, refers to theoretical power. The fact that a company has a holding of less than 50% plus one share which, because the holdings of others are widely dispersed, gives effective control is not enough to give that company 'control' for the purpose of determining whether it is a subsidiary.

In Australia, for instance, the accounting standards defined the circumstances in which one entity controls another. In doing so, they largely abandoned the legal control concepts in favour of a definition that provides that 'control' is "the capacity of an entity to dominate decision-making, directly or indirectly, in relation to the financial and operating policies of another entity so as to enable that other entity to operate with it in pursuing the objectives of the controlling entity." This definition was adapted in the Australian Corporations Act 2001: s 50AA. And also it can be a very useful part of the company that allows every head of the company to apply new projects and latest rules.

15.8 GLOSSARY

- Cross holding- A cross holding is a security issue by a publicly listed company that is held by another company on the same listing.

- Ford Motor Company - the ultimate US parent company in Dearborn, Michigan
- Ford International Capital LLC - first-tier subsidiary (a US holding company located in Dearborn, Mi, but registered in Delaware
- Blue Oval Holdings - second-tier subsidiary (a British holding company, located at the Ford UK head office in Brentwood, Essex with five employees)
- Ford Motor Company Limited - third-tier subsidiary (the main British Ford company, with head office in Brentwood, with 10,500 employees)
- Ford Component Sales Limited - fourth-tier subsidiary (small British specialist component sales company at the UK Ford head office, with some 30 employees)

15.9 SELF ASSESSMENT QUESTIONS

Q.1 Write a short note on subsidiary company.

Q.2 What do you mean by a parent company?

15.10 LESSON END EXERCISE

Q.1 "A cross holding is a security issue by a publicly listed company that is held by another company on the same listing". Do you agree with this statement? Comment.

Q.2 Why intercompany purchases and sales are eliminated while preparing consolidated profit & loss, by the Holding Company?

15.11 SUGGESTED READINGS

- M.C Shukla and Grewal, "Advanced Accounts-II", S.Chand, New Delhi.
- Jain, S.P. and Narang, K.L. "Advanced Accounts-II", Kalyani Publisher, New Delhi.
- Maheshwari,S.N "Advanced Accounts-II", Vikash Publisher, New Delhi.

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VALUATION OF RATE OF RETURN ON CAPITAL EMPLOYED AND LEASE EVALUATION

M.Com II Sem.	Advanced Accounting	Unit-IV
M.Com – C 211		Lesson No. 16

STRUCTURE

16.1 INTRODUCTION

Return on capital employed or ROCE is a profitability ratio that measures how efficiently a company can generate profits from its capital employed by comparing net operating profit to capital employed. In other words, return on capital employed shows investors how many dollars in profits each dollar of capital employed generates. ROCE is a long-term profitability ratio because it shows how effectively assets are performing while taking into consideration long-term financing. This is why ROCE is a more useful ratio than return on equity to evaluate the longevity of a company. This ratio is based on two important calculations: operating profit and capital employed. Net operating profit is often called EBIT or earnings before interest and taxes. EBIT is often reported on the income statement because it shows the company profits generated from operations. EBIT can be calculated by adding interest and taxes back into net income if need be. Capital employed is a fairly convoluted term because it can be used to refer to many different financial ratios. Most often capital employed refers to the total assets of a company less all current liabilities. This could also be looked at as stockholders' equity less long-term liabilities. Both equal the same figure.

16.2 OBJECTIVES

After going through this lesson, you will be able to understand:

- meaning of return on capital employed;
- procedure for computing profit for return on capital employed;
- precautions to be taken while computing return on capital employed;
- advantages of return on capital employed;
- disadvantages/limitations of return on capital employed; and
- significance of return on capital employed.

16.3 MEANING OF RETURN ON CAPITAL EMPLOYED

The prime objective of making investments in any business is to obtain satisfactory return on capital invested. Hence, the return on capital employed is used as a measure of success of a business in realizing this objective.

This ratio is also known as Return on Investment (ROI). It is an overall profitability ratio. It indicates the percentage of return on the capital employed in the business and it can be used to show the efficiency of the business as a whole.

Formula:

$$\text{Return on Capital employed} = \frac{\text{Operating Profit}}{\text{Average Capital employed}} \times 100$$

Return on Capital Employed (ROCE) is a profitability ratio that helps to measure the profit or return that a company earns from the capital employed, which is usually expressed in the terms of percentage. It is used to determine the profitability and efficiency of the capital investment of a business entity. It is simply defined as a financial ratio that helps to determine the capital efficiency and effectiveness of business.

Return on Capital Employed is generally calculated on the basis of two major calculations/ components –

Operating profit

Capital employed

Operating Profit

It is the profit that a company earns from its business operations before the deduction of taxes and interests. Therefore, it is also known as earnings before interest and taxes (EBIT). It is calculated by deducting operating expenses and cost of goods sold from revenues.

EBIT= Total revenues – [cost of goods sold (COGS) + Operating Expenses]

Capital Employed

It is the total amount of capital invested in the business operations by the shareholders and other sources to earn a profit. It is also known as fund employed. Capital employed is the sum of the equity of shareholders, all the debt liabilities, and all the long-term finance.

Capital Employed= Total assets – current liabilities

Return on equity is another financial ratio used to calculate profit and people often get confused between these two ratios. ROCE is considered better than the Return on Equity as ROCE is helpful in evaluating company's longevity and durability. ROCE is also considered more beneficial as only the percentage return of equity shareholders is calculated in Return on Equity (ROE) whereas in ROCE, the return percentage of all the shareholders/ capital providers is calculated. Return on capital employed of a company should be higher than its cost of capital in order to remain in the market for a long run and only then it will be considered as a good return on capital employed. Higher will be the ROCE of a company greater will be the efficiency.

16.4 COMPUTATION OF PROFIT FOR RETURN ON CAPITAL EMPLOYED

Capital employed and operating profits are the main items. Capital employed may be defined in a number of ways. However, two widely accepted definitions are 'gross capital employed' and 'net capital employed'.

Gross capital employed usually means the assets used in the business, while net capital employed refers to total assets minus current liabilities. On the other hand, it refers to the total of capital, capital reserves, revenue reserves (including Profit and Loss a/c balance), debentures and long-term loans.

Computation of Capital Employed:

It may be computed from the asset side as well as from the liabilities side.

If it is computed from the asset side, it will comprise:

(a) Fixed assets:

Land and Buildings, Plant and Machinery, Furniture and Fittings, and Motor Vehicles, etc.

(b) Investments made in the business:

(c) Current Assets:

Inventories, Book Debts less provision for bad and doubtful debts, Bills Receivable, Bank, and Cash, etc.

Less Current Liabilities:

Sundry Creditors, Bills Payable, Bank overdraft, outstanding expenses, etc.

Gross Capital employed = Fixed Assets + Investments+ CurrentAssets

Net Capital employed = Fixed Assets + Investments + Working Capital (Current Assets minus Current Liabilities)

Alternatively, if it is calculated from the liabilities side it will include the following items:

Share Capital:

Equity and Preference Share Capital (issued capital)

Reserve and Surplus:

Capital Reserve, General Reserves, P&L A/C balance

Debentures

Other Long-term loans

16.5 PRECAUTIONS TO BE TAKEN WHILE COMPUTING RETURN ON CAPITAL EMPLOYED

(a) The valuation of fixed assets may be done at their replacement cost. The current market prices may be ascertained either by reference to reliable published index numbers, or on valuation of experts. At the same time the provision for depreciation should also be readjusted.

(b) All idle assets should be excluded from the computation. However, standby plant and equipment required for normal working may be included.

(c) All intangible assets like goodwill, patents and trademarks unless they have potential sales value and all fictitious assets like preliminary expenses, discount on issue of shares, etc., should be excluded.

(d) All investments made outside the business should be excluded.

(e) All current assets should be properly valued. Any excess bank balance, which is more than the normal requirements, should not be considered.

Some people suggest that average capital employed should be used in order to give effect to the capital investment throughout the year. It is argued that the profits earned remain in the business throughout the year and are distributed by way of dividends only at the end of the year. Average capital employed may be calculated by two methods.

Under the first method, only the simple arithmetic mean of the total capital employed at the beginning and at the end of the year is found out. Under the second method, it is calculated by adding half of the profits after tax and interest to the opening capital employed.

When net capital employed has been calculated either from the asset side or liabilities side, half of the profits earned during the year may be deducted from the figure so computed in order to arrive at 'average capital employed'.

Operating profit used for the computation of return on capital employed should be the profits earned by such capital. Hence, the net profit should be adjusted, if necessary, for obtaining the true operating profit with the following items:

(a) Any abnormal and non-recurring losses or gains,

(b) Income from investments made outside the business,

(c) Depreciation based on the replacement cost of the asset,

(d) Interest on long-term loans and debentures should be added back.

(e) Profits before the payment of income tax

ROCE is calculated by using a simple formula. Various financial statements like Balance Sheets, Profit/Loss account are used to calculate ROCE. As it is a profitability ratio, it is calculated by dividing net operating profit of the company with the employed capital.

The formula of calculating Return on Capital Employed

ROCE= Net Operating Profit (EBIT) / Capital Employed

OR

ROCE= Net Operating Profit (EBIT) / Total Assets – Current Liabilities

OR

ROCE= Net Operating Profit (EBIT) / Equity + Non- Current Liabilities

Apart from this ROCE can also be calculated with the help of return on capital employed calculators available on the internet. You just have to enter your values and you will get desired output without doing calculations manually.

Return on Capital Employed Ratio exactly shows the profit generated by each unit of capital employed. It is important because it is used to measure the financial performance of a business. It has built a strong position as a financial tool to be used for evaluation in highly capital-intensive sectors like telecommunication, infrastructure engineering, oil and gas companies, power utilities etc. The higher rate of ROCE indicates how effectively a company is utilizing its funds. Before calculating the return on capital employed a level business strategy is necessary to be framed to check the applicability of ROCE in a particular business as ROCE varies from industry to industry.

Industries these days are aware of the advantages of Return on capital employed. Most of the industries, especially highly capital-intensive industries, use this financial tool to achieve maximum profitability from the capital employed.

16.6 ADVANTAGES OF RETURN ON CAPITAL EMPLOYED

Some major benefits of ROCE are as follows:

1. Return on Capital Employed focuses on profit.
2. Facilitates improved company's balance sheet management and profitability.
3. Helps managers gain knowledge about the effective utilization of capital.
4. Used for performance measurement of the company and helps investors in making investment decisions.
5. Facilitates comparison of profitability of two companies of same sectors.
6. Useful in evaluating the growth forecast of a company.
7. Companies with high return on capital employed industry average can be spotted with the help of Return on Capital Employed.
8. It is the only measure, which can be said to show satisfactorily the benefits being obtained for the sacrifice involved, the latter being represented by capital invested.
9. It allows external comparisons to be made. The progress of one company or companies may be compared with that of other companies.
10. It is an effective tool for making an internal comparison in respect of different divisions or departments of a company. It may be used as an instrument of control by comparing the relative profitability of different products.
11. It enables the management to make efficient capital budgeting decisions.

It can become an integral part of the budgetary control system.

12. It gives ideas for analysis and decisions to bring about effective changes in the financial policies. For example, there should be no borrowing when the rate of interest is higher than the rate of return.
13. If management ensures that an adequate return on capital invested is earned, then many direct benefits such as regular and satisfactory dividends to shareholders, adequate strength to face competition, etc., may accrue to the business concern.

16.7 DISADVANTAGES/ LIMITATIONS OF RETURN ON CAPITAL EMPLOYED

Besides the advantages, ROCE also has few drawbacks.

1. One of the major limitations of return on capital employed is that the returns are measured in the book value of assets, which only favours the older companies.
2. Sometimes the ambiguous and debatable nature of ROCE also makes investors think twice. 3. 3. ROCE is calculated on historical data and this again serves as a drawback of ROCE.

16.8 SIGNIFICANCE OF RETURN ON CAPITAL EMPLOYED

Return on Capital employed is considered to be the best measure of profitability in order to assess the overall performance of the business satisfactorily. It is commonly used as a basis for various managerial decisions since it relates to the benefits obtained in the form of income with the sacrifice made in the form of capital invested. A starting point in budgeting and management planning is the determination of a minimum rate of return on capital invested. All business decisions should result in a reasonable (minimum) return. Investments, which generate rates lower than this minimum rate of return, are rejected. However, it is very difficult to set a standard rate of return on capital employed as a number of factors such as business risk, the type of industry, inflation, changes in economic conditions, etc., may influence such a rate. Different views prevail with regard to standard rate. Bank rate, discount rates of gilt-edged securities or some opportunity rate are some of the suggested rates as the norm for this ratio. However, it is left to the discretion of management to set some rate against which they are to compare the actual result with a view to measuring their efficiency, or the overall performance of the business. This ratio could be supplemented with a number of ratios depending upon the purpose for which it is computed.

16.9 SUMMARY

The Return on Capital invested is a concept that measures the profit which a firm earns on investing a unit of capital. 'Yield on Capital' is another term employed to express the idea. It is desirable to ascertain this periodically. The profit being the net result of all operations the return on capital expresses all efficiencies or inefficiencies of a business collectively and, thus, is a dependable measure for judging its over all efficiency or inefficiency. On this basis, there can be comparison of the efficiency of one department with that of another, of one plant with that of another, one company with that of another and one industry with that of another. For this purpose, amount of the profits considered is that before making deductions on account of interest, income-tax and dividends and capital is aggregate of all the capital at the disposal of the company, vis., equity capital, reserves, debentures, etc.

The Return on Capital when calculate in this manner would also show whether the company's borrowing policy was economically wise and whether the capital had been employed fruitfully. Suppose, funds have been borrowed at 8% and the Return on Capital is 7.5%, it would have been better not to borrow (unless borrowing was vital for survival). It would also shoe that the firm had not been employing the funds efficiently.

The business can survive only when the return on capital employed is more than the cost of capital employed in the business.

16.10 GLOSSARY

- **ROCE**- Return on capital employed
- **EBIT**-Earning before interest and taxes
- **Gross Capital employed** = Fixed Assets + Investments+ Current Assets

- **Net Capital employed** = Fixed Assets + Investments + Working Capital (Current Assets minus Current Liabilities)
- **P&L A/C-** Profit and loss account

16.11 SELF ASSESSMENT QUESTIONS

Q.1 Explain the term return on capital employed.

Ans. ____

____

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____

Q.2 Explain the procedure for calculating return on capital employed.

Ans. ____

____

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____

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Q.3 Discuss the precautions to be taken while computing term return on capital employed.

Ans. ____

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Q.4 Discuss the advantages of the term return on capital employed.

Ans. ____

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16.12 LESSON END EXERCISE

1. What is meant by return on capital employed? How it is calculated?
2. Discuss the procedure for calculating return on capital employed. Highlights the precautions to be taken while computing return on capital employed.
3. Give the merits and demerits of return on capital employed.
4. What is understand by return on capital employed? Give its significance.

16.13 SUGGESTED READINGS

- Jain, S.P and Narang, K.L. (2014). Advanced Accountancy-Vol-II. Kalyani Publisher, New Delhi.
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VALUATION OF RATE OF RETURN ON CAPITAL EMPLOYED AND LEASE EVALUATION

M.Com II Sem.	Advanced Accounting	Unit-IV
M.Com – C 211		Lesson No. 17

STRUCTURE

17.1 INTRODUCTION

It is a clear fact that every business entity is operating in the market to earn a profit. Profit making is the major objective of every business firm and this can be achieved only when a company is highly efficient. Effective and optimum utilization of company's funds and capital leads to greater efficiency which ultimately leads to higher profitability. It is also important for business firms to benchmark their performance against the competitors in the market. Therefore, it becomes necessary for a business firm to have a financial tool that can act as a base for its performance measurement on a yearly basis. This is where the return on capital employed i.e. ROCE helps companies to measure their business performance and efficiency.

ROCE also allows comparison of a company with the other companies within the same sector/industry.

17.2 OBJECTIVES

After going through this lesson, you will be able to

- gain an insight into the term return on capital employed;
- make valuation of return on capital employed; and
- & its various aspects that may help them in calculating business profit against the capital employed.

17.3 AN INSIGHT INTO THE TERM RETRURN ON CAPITAL EMPLOYED

The term capital employed has been given different meanings by different accountants. Some of the popular meanings are as follows:

- Sum total of all assets whether fixed or current.
- Sum total of fixed assets.
- Sum total of long-term funds employed in the business, i.e.,

Share Capital + Reserves and Surplus + Long-term Capital - (Non-business Assets + Fictitious Assets)

However, the term capital employed is generally used in the meanings given in the point third above.

The term 'Operating Profit' means 'Profit before interest and Tax'. The term 'Interest means 'Interest on long-term borrowings'. Interest on short-term borrowings will be deducted for computing operating profit. Non-trading incomes such as interest on Government securities or non-trading losses or expenses such as loss on account of fire, etc., will also be excluded

17.4 PROFITABILITY IN RELATION TO CAPITAL EMPLOYED

The following ratios are calculated while calculating return on capital employed

1. Return on gross investment or gross capital employed
2. Return on net investment or net capital employed
3. Return on shareholder's investment or shareholder's capital employed.

4. Return on equity shareholder investment or equity shareholder capital employed.

1. RETURN ON GROSS CAPITAL EMPLOYED

This ratio establishes the relationship between net profit and the gross capital employed. The term gross capital employed refers to the total investment made in business. The conventional approach is to divide Earnings After Tax (EAT) by gross capital employed.

$$\text{Return on gross capital employed} = \frac{\text{Earnings After Tax (EAT)} \times 100}{\text{Gross Capital Employed}}$$

2. RETURN ON NET CAPITAL EMPLOYED

It is calculated by dividing Earnings Before Interest & Tax (EBIT) by the net capital employed. The term net capital employed in the gross capital in the business minus current liabilities. Thus it represents the long-term funds supplied by creditors and owners of the firm.

$$\text{Return on net capital employed} = \frac{\text{Earnings Before Interest \& Tax (EBIT)} \times 100}{\text{Net Capital Employed}}$$

3. RETURN ON SHARE CAPITAL EMPLOYED

This ratio establishes the relationship between earnings after taxes and the shareholder investment in the business. This ratio reveals how profitability the owners' funds have been utilized by the firm. It is calculated by dividing Earnings after tax (EAT) by shareholder capital employed.

$$\text{Return on share capital employed} = \frac{\text{Earnings After Tax (EAT)} \times 100}{\text{Shareholder Capital Employed}}$$

4. RETURN ON EQUITY SHARE CAPITAL EMPLOYED

Equity shareholders are entitled to all the profits remaining after the all outside claims including dividends on preference share capital are paid in full. The earnings may be distributed to them or retained in the business. Return on equity share capital investments or capital employed establishes the relationship between earnings after tax and preference dividend and equity shareholder investment or capital employed or net worth. It is calculated by dividing earnings after tax and preference dividend by equity shareholder's capital employed.

Return on equity share capital employed =

$$\frac{\text{Earnings After Tax (EAT), Preference Dividends} \times 100}{\text{Equity Share Capital Employed}}$$

17.5 COMPONENTS OF RETURN ON CAPITAL EMPLOYED

Return on capital employed is an overall profitability ratio. It indicates the percentage of return on the capital employed in the business and it can be used to show the efficiency of the business as a whole.

The main components of capital employed are as follow:

1. Capital employed
2. Operating profits

Capital employed may be defined in a number of ways. However, two widely accepted definitions are 'gross capital employed' and 'net capital employed'.

Gross capital employed usually means the assets used in the business, while net capital employed refers to total assets minus current liabilities. On the other hand, it refers to the total of capital, capital reserves, revenue reserves (including Profit and Loss a/c balance), debentures and long-term loans. Operating profit is the earning available after interest and taxes.

17.6 VALUATION OF RETURN ON CAPITAL EMPLOYED

Capital employed can be calculated either by the asset approach or by the liability approach.

A. ASSET APPROACH

If it is computed by the asset approach, it will comprise:

(a) Fixed assets : Land and Buildings, Plant and Machinery, Furniture and Fittings, and Motor Vehicles, etc.

(b) Investments made in the business:

(c) Current Assets : Inventories, Book Debts less provision for bad and doubtful debts, Bills Receivable, Bank, and Cash, etc.

Less Current Liabilities : Sundry Creditors, Bills Payable, Bank overdraft, outstanding expenses, etc.

Gross Capital employed = Fixed Assets + Investments+ CurrentAssets

Net Capital employed = Fixed Assets + Investments + Working Capital (Current Assets minus Current Liabilities)

B. LIABILITY APPROACH

Alternatively, if it is calculated from the liabilities side, it will include the following items:

Share Capital : Equity and Preference Share Capital (issued capital)

Reserve and Surplus : Capital Reserve, General Reserves, P&L A/C balance

Debentures

Other Long-term loans

While calculating net capital employed either from the asset side or liabilities side, half of the profits earned during the year may be deducted from the figure so computed in order to arrive at 'average capital employed'.

Operating profit used for the computation of return on capital employed should be the profits earned by such capital. Hence, the net profit should be adjusted, if necessary, for obtaining the true operating profit with the following items:

(a) Any abnormal and non-recurring losses or gains,

(b) Income from investments made outside the business,

(c) Depreciation based on the replacement cost of the asset,

(d) Interest on long-term loans and debentures should be added back.

(e) Profits before the payment of income tax

Example:1

From the following financial statements, calculate Return on Capital employed:

Profit and Loss Account for the year ended 31-12-2002

	Rs.		Rs.
To Cost of goods sold	1,50,000	By Sales	2,50,000
To Interest on debentures	5,000	By Income from investment	5,000
To Provision for Taxation	50,000		
To Net Profit c/d	50,000		
	2,55,000		2,55,000

Balance Sheet as on 31-12-2002

Liabilities	Rs.	Assets	Rs.
Share Capital:		Fixed Assets	2,25,000
Preference	50,000	Investments in Govt. Bonds	50,000
Equity	1,00,000	Current Assts	75,000
Reserves	50,000		
P & L A/C	50,000		
10% Debentures	50,000		
Provision for Taxation	50,000		
	3,50,000		3,50,000

Solution:

$$\text{Return on Capital employed} = \frac{\text{Operating Profit}}{\text{Average Capital employed}} \times 100$$

Operating :

Profit = Net Profit before interest and tax minus income from investments

= Rs.50,000 + 5,000 + 50,000 – 5,000 = Rs.1,00,000

Capital employed = Fixed Assets + Current Assets – Provision for Taxation

= Rs.2,25,000 + 75,000- 50,000 = Rs.2, 50,000

OR

= Share capital + Reserves + P&L a/c + Debentures – Government Bonds

= Rs. 1,50,000 + 50,000 + 50,000 + 50,000 -50,000

= Rs.2,50,000

Average Capital employed = Capital employed – 1/2 (Profits earned during the year)

= Rs.2, 50,000 – 25,000 = Rs.2, 25,000

$$\text{Return On Capital employed} = \frac{\text{Rs.}1{,}00{,}000}{\text{Rs.}2{,}25{,}000} \times 100 = \frac{400}{9}$$

$$= 44.4\% \text{ (app.)}$$

OR

Return on Closing Capital employed

$$= \frac{\text{Rs.}1{,}00{,}000}{\text{Rs.}2{,}50{,}000} \times 100 = 40\%$$

The computation of return on capital employed (ROCE) can be understood with the help of the following example:

Example:

From the following figures extracted from the Income Statement and the Balance Sheet of Messrs Ali & Sons Pvt. Ltd., calculate the Return on Total Capital employed:

Particulars	Amount (Rs.)
Fixed assets	4,50,000
Current assets	1,50,000
Investment in Govt. securities	1,00,000
Sales	5,00,000
Cost of goods sold	3,00,000
Share capital	3,00,000
Reserves	1,00,000
Debentures	1,00,000
Income from investments	10,000
Interest on debentures at 10%	
Provision for tax at 50% of net profits	

Solution:

It will be appropriate to prepare the Profit and Loss Account and Balance sheet of the company before computation of the '**return on capital employed (ROCE)**'.

Profit and Loss Account

Details	Rs.	Details	Rs.
Cost of goods sold	3,00,000	Sales	50,00,000
Interest on debentures	10,000	Income from investments	1,50,000
Provision for taxation	1,00,000		
Net profit after tax	1,00,000		
	5,10,000		5,10,000

Balance Sheet

Liabilities	Rs.	Assets	Rs.
Share capital	3,00,000	Fixed assets	4,50,000
10% debentures	1,00,000	Current assets	1,50,000
Profit and loss account	1,00,000	Investment in Govt. Securities	1,00,000
Provision for taxation	2,00,000		
Total	7,00,000		7,00,000

Return on total capital employed = Net operating profit before interest and tax / Total capital employed = 2,00,000 / 5,00,000 x 100 = 40 %

Net operating profit = Net profit + Provision for tax - Income from investments + Interest on Debentures

= Rs.1,00,000 + Rs.1,00,000 - Rs.10,000 + Rs.l0,000

= Rs.2,00,000

Capital employed = Fixed assets + Current assets - Provision for taxation

= Rs.4,50,000 + Rs.1,50,000 -Rs.1,00,000

= Rs.6,00,000 - Rs.1,00,000

= Rs.5,00,000

Return on Investment (ROI) can be computed for computing the return for different purpose. Some of the ratios that are calculated are as follows:

(1) Return on Shareholder's Funds:

In case, it is desired to work out the profitability of the company from the shareholders point of view, it should be computed as follows:

(Net Profit after Interest and Tax / Shareholders' funds) × 100

The term Net Profit here means 'Net Income after Interest and Tax'. It is different from the 'Net Operating Profit' which is used for computing the 'Return on Total Capital Employed' in the business. This is because the shareholders are interested in Total Income after Tax including Net Non-operating Income (i.e., Non-operating Incomes-Non-operating Expenses).

Taking the figures from the example above the Return on Shareholder's Funds can be computed as follows:

(Rs.1,00,000 / Rs.5,00,000) × 100

= 20 %

(2) Return on Gross Capital Employed:

The term **Gross Capital employed** means the total of Fixed Assets and the Current Assets employed in the business. The formula for its computation can be put as follows:

(Net profit before Interest and Tax / Gross Capital employed) × 100

Gross capital employed = Fixed assets + Current assets

The students are advised to give their assumptions regarding computation of 'Net Profit' as well as 'Capital employed' while calculating the Return on Investment (ROI).

Average Capital Employed:

Some people prefer to use 'Average Capital employed' (or average total assets, as the case may be) in place of only 'Capital employed' (or Total Assets). Average Capital employed is the average of the capital employed at the beginning and at the end of the accounting period.

ROI = (Net profit before interest and tax / Average capital employed) × 100
Average capital employed = (Opening capital employed + Ending capital employed) / 2

Important: It should be noted that while computing "Return on Investment" according to any of the above methods 'Abnormal Gains or Losses' should always be excluded from Net profit.

17.7 SUMMARY

Companies with higher ROCE and greater efficiency are favoured by investors because such companies tend to be more stable compared to the companies with low ROCE. We have learned the importance of return on capital employed and every Industry should consider ROCE as a powerful tool to get higher returns, therefore, it must be given attention. Hence, we can say that calculating your profits with the return on capital employed can bring more stability and efficiency to your business.

17.8 GLOSSARY

- Capital employed = Fixed assets + Current assets - Provision for taxation
- ROI = (Net profit before interest and tax / Average capital employed) × 100
- Average capital employed = (Opening capital employed + Ending capital employed) / 2
- Net operating profit = Net profit + Provision for tax - Income from investments + Interest on Debentures

17.9 SELF ASSESSMENT QUESTIONS (SAQ)

Q.1 What is gross capital employed? How it is calculated?

Ans. ____

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Q.2 What is net capital employed? How it is calculated?

Ans. ____

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Q.3 What is average capital employed? How is it calculated?

Ans.

17.10 LESSON END EXERCISE

1. The following is the balance sheet of M/S Bharat Ltd. for the year ending 31st December 2018

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
50,000 equity shares of ₹ 10 each fully paid	5,00,000	Goodwill	50,000
		Freehold property	1,00,000
20,000 Preference shares		Plant & machinery	2,00,000
of ₹ 20 each fully paid	4,00,000	Land & buildings	4,00,000
P&L (including ₹40,000		Furniture	45,000
current year's profits)	1,00,000	Stock	1,75,000
5% debentures	1,00,000	Debtors	55,000
Bills payable	60,000	Cash at bank	1,50,000
Creditors	40,000	Preliminary expenses	25,000
Total	12,00,000		12,00,000

The value of land and building will be Rs. 4,50,000 and Plant and Machinery Rs. 1,80,000. Calculate:

i. Gross capital employed ii. Net Capital Employed iii Average capital employed iv Return on Net Capital Employed.

2. Following are the summarised profit and loss account and balance sheet of X Ltd. for the year ended 31st December, 2017

Profit and Loss Account

	Rs.		Rs.
To opening stock	1,50,000	By sales	13,00,000
" purchases	8,50,000	By closing stock	2,00,000
" wages	50,000		
" freight and carriage	20,000		
" Gross profit	4,30,000		
	15,00,000		15,00,000
To office and administrative expenses	2,00,000	By gross profit	4,30,000
"selling and distribution expenses	10,000	By interest on Govt. securities	12,000
"Interest on debentures	10,000	By profit on sale of plant	8,000
"interest on bank over draft	5,000		
"Depreciation	15,000		
"loss on sale of machine	10,000		
"provision for tax	1,00,000		
"net profit	1,00,000		
	4,50,000		4,50,000

Balance Sheet

Liabilities	**Amount (Rs.)**	**Assets**	**Amount (Rs.)**
Equity share capital	4,00,000	Land &building (net)	2,50,000
8% preference share capital	2,00,000	Plant & machinery	3,00,000
Reserves	60,000	Investments in Govt. securities	1,00,000
Profit & loss A/C	40,000	Stocks	2,00,000
10% debentures	1,00,000	Sundry debtors	1,00,000
Bank overdraft	50,000	Cash	40,000
Other current liabilities	1,50,000	Discount on issue of shares	10,000
Total	10,00,000	Total	10,00,000

You are required to calculate:

(i) Return on gross capital employed.

(ii) Return on net capital employed.

17.11 SUGGESTED READINGS

- Jain, S.P and Narang, K.L. (2014). Advanced Accountancy-Vol-II. Kalyani Publisher, New Delhi.
- Gupta, Sashi, K. (2015). Management Accounting. Kalyani Publisher, New Delhi.
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VALUATION OF RATE OF RETURN ON CAPITAL EMPLOYED AND LEASE EVALUATION

M.Com II Sem.	Advanced Accounting	Unit-IV
M.Com – C 211		Lesson No. 18

STRUCTURE

18.1 INTRODUCTION

Lease financing is one of the important sources of medium- and long-term financing where the owner of an asset gives another person, the right to use that asset against periodical payments. The owner of the asset is known as lessor and the user is called lessee. The periodical payment made by the lessee to the lessor is known as lease rental. Under lease financing, lessee is given the right to use the asset but the ownership lies with the lessor and at the end of the lease contract, the asset is returned to the lessor or an option is given to the lessee either to purchase the asset or to renew the lease agreement.

18.2 OBJECTIVES

After going through this lesson, you will be able to understand-

- the meaning of lease financing;
- types of lease financing;
- forms of lease financing;
- the advantages and disadvantages lease financing to the lessor; and
- the advantages and disadvantages lease financing to the lessee.

18.3 MEANING OF LEASE FINANCING

Leasing has emerged as an important source of long term financing of the corporate enterprises during the recent few years. Leasing is an arrangement under which a company acquires the right to make use of the assets without holding title to it. In other words, in a lease agreement the lessor, i.e., the owner of the asset permits the lessee to use the asset for a specified payment but retains the title over the property. A lease thus is an agreement between the lessor and the lessee.

The lease agreement also sets forth the period covered by the lease, cancellation provisions, rental payments, additional rents or purchase options, allocations of maintenance and other expenses and other features of the agreement. Since leasing represents an alternative to ownership, leasing can be viewed as a specialised means for generating funds. In exchange for the use of the asset the company can issue a claim against its future cash flows, long term debt equity or lease obligations. Viewed in this way leasing is strictly a financing decision. But it should also be remembered that it is not a way of avoiding financing.

It is financing because if the company chooses leasing instead of owning the asset by means of borrowing it incurs a contractual obligation to make payments of fixed amounts at specified times. The lease, therefore, is analogous to any other financial claim issued by the company. The important question is the cost of the lease in relation to other financing alternatives.

18.4 TYPES OF LEASE ARRANGEMENTS

Depending upon the transfer of risk and rewards to the lessee, the period of lease and the number of parties to the transaction, lease financing can be classified into two categories i.e. Financial lease and Operating lease.

i. **Financial Lease :** It is the lease where the lessor transfers substantially all the risks and rewards of ownership of assets to the lessee for lease rentals. In other words, it puts the lessee in the same condition as he/she would have been if he/she had purchased the asset. Finance lease has two phases: The first one is called primary period. This is non-cancellable period and in this period, the lessor recovers his total investment through lease rental. The primary period may last for indefinite period of time. The lease rental for the secondary period is much smaller than that of primary period.

Features of Finance Lease:

From the above discussion, following features can be derived for finance lease:

1. A finance lease is a device that gives the lessee a right to use an asset.
2. The lease rental charged by the lessor during the primary period of lease is sufficient to recover his/her investment.
3. The lease rental for the secondary period is much smaller. This is often known as peppercorn rental.
4. Lessee is responsible for the maintenance of asset.
5. No asset-based risk and rewards is taken by lessor.
6. Such type of lease is non-cancellable; the lessor's investment is assured.

ii. **Operating Lease :** Lease other than finance lease is called operating lease. Here risks and rewards incidental to the ownership of asset are not transferred by the lessor to the lessee. The term of such lease is much less than the economic life of the asset and thus the total investment of the lessor is not recovered through lease rental during the primary period of lease. In case of operating lease, the lessor usually provides advice to the lessee for repair, maintenance and technical knowhow of the leased asset and that is why this type of lease is also known as service lease.

Features of Operating Lease:

Operating lease has following features:

1. The lease term is much lower than the economic life of the asset.
2. The lessee has the right to terminate the lease by giving a short notice and no penalty is charged for that.
3. The lessor provides the technical knowhow of the leased asset to the lessee.
4. Risks and rewards incidental to the ownership of asset are borne by the lessor.
5. Lessor has to depend on leasing of an asset to different lessee for recovery of his/her investment.

18.5 FORMS OF LEASE FINANCING

Broadly speaking, lease financing may take different forms like sale and lease back, direct leasing, operating leasing and leveraged leasing. We shall describe, in brief, the characteristic features of these forms of lease financing.

1. Sale and Lease Back :

   Under a sale and lease back, a company owning an asset sells to another party and leases it back. This type of lease arrangement exists if company A, already the owner of a property sells it to B and immediately leases it for continued use.

   The new lessee, A, then has in his possession the use of the property as well as the cash received from the sale. Thus, the seller gives up the title to the asset but retains its use. The main advantage of this kind of arrangement to the company that sells and then leases back is that it receives cash from sale of the asset which could be reinvested in the business while still making economic use of the asset during the lease period.

The sale and lease back is mostly found in real estate financing and financial institutions prominently insurance companies and financial companies play the role of lessors who buy a property from a business concern and then lease it back to the company.

2. Direct Leasing:

   In contrast with sale and lease back arrangement, under direct leasing the company acquires the right to use the property that it did not previously own. Direct leasing may be arranged through either the manufacturer or a financial institution.

   Finance companies and independent leasing companies usually enter into the business of acquiring property for their clients who are in need of certain assets for their business purposes. Once the financial institution owns the property, a direct lease is arranged under usual terms and conditions.

3. Operating Leasing:

   In operating lease, lease facility is provided on a period to period basis. Under this arrangement, no long-term obligation is imposed on either the lessor or lessee and the agreement is cancellable at the option of either the owner or user of assets after giving a certain stipulated notice. This type of lease may be written, say, on a month-to-month basis without any specified expiration date.

4. Financial Leasing:

   Financial lease, as opposed to operating lease, is a non-cancellable contract covering intermediate to long-term period. The lessee is normally responsible for maintenance, insurance and taxes and for this reason financial lease is also called net lease. Original cost of the asset is fully amortized. The agreement provides that the lease will cover the service life of the asset.

   For example, if a firm leases an asset with an expected life of 12 years, the lease period will be approximately 12 years. Where an asset has an indefinite life, as in the case of an office building, the lease will be written for as long a period as 20 years. In this case, the building cost would be fully amortized even though it may have a residual value at the end of the lease period.

Thus, full amortization and non-cancel-ability are the key features that distinguish financial lease from operating lease. Non-cancel-ability implies that the lessee is legally obliged to make all the lease payments regardless of whether he continues to use the assets, and thus can cancel only by paying off the entire contract. Default by the lessee can lead to insolvency just as in the case of a debt contract.

5. Leveraged Leasing:

   In leveraged leasing the lessee contracts to make periodic payments during the lease period and in return, is entitled to the use of the asset over that period of time. The lessor owns the property but acquires it partly by contributing his own funds and partly by taking loans from the financial institutions.

The financial institution usually provides loan against the mortgage on the asset as well as by the assignment of the lease and lease payment. Thus, the lessor is the owner and the borrower. As the owner of the asset, he is entitled to deduct all depreciation charges associated with the asset as well as utilize the entire investment allowance facility.

18.6 ADVANTAGES AND DISADVANTAGES OF LEASE FINANCING

At present leasing activity shows an increasing trend. Leasing appears to be a cost-effective alternative for using an asset. However, it has certain advantages as well as disadvantages.

Advantages of Leasing to the Lessor:

1. Higher Profits:

   The lessor acting prudently can make high profits from leasing of the asset. The profits will take care of his cost of capital as well as the risk involved.

2. Tax Benefits:

   The lessor being the owner of the asset can claim various tax benefits such as depreciation, investment allowance, etc. In fact, leasing has been successfully employed by the leasing companies to reduce their tax liabilities.

3. Quick Returns:

   The lessor gets quick returns in the form of lease rentals as compared to investment in other projects which have a longer gestation period.

4. Increased Sales:

   Lease financing through third parties has helped manufacturers to increase their sales. The lessors are also in a position to demand certain concessions from the manufacturers.

Disadvantages for the Lessor

1. High Risk of Obsolescence:

   The lessor has to bear the risk of obsolescence especially in the present era of rapid technology developments.

2. Competitive Market:

   As a number of leasing companies have emerged in recent years in India, the lessor has to face a tough competition from Indian as well as foreign companies. Due to this competition, the lessor may not be able to obtain sufficient lease rentals to recover the cost of the asset and his expected profit on investment as well as taking the risk.

3. Price-Level Changes:

   Inspite of the increase in prices of assets due to inflation, the lessor gets only fixed rentals based on previous costs.

4. Management of Cash flows:

   The success of a leasing business depends to a large extent upon efficient use of cashflows which are very difficult to manage because of unexpected market fluctuations.

5. Increased Cost due to Loss of User Benefits:

   The lessor is not entitled to certain benefits available to buyers who are actual users of the assets such as concession in sales tax, duties, etc. This increases the cost of the asset and compels the lessor to charge higher lease rentals.

6. Long-term Investment:

   It usually takes a long time to recover the cost of the lessor in the capital outlays through lease rentals. Thus, lease rentals received may not represent actual realised profits because of inherent risks involved. Payment of dividends out of present earnings may ultimately result into payment out of capital.

Advantages and Disadvantages of Leasing for the Lessee

After reading this chapter you will learn about the Advantages and Disadvantages of Leasing for the Lessee.

Advantages of Leasing to the Lessee:

(i) Avoidance of Initial Cash Outlay:

Leasing enables a firm to acquire the use of an asset without making capital investment in buying the asset. The lessee may avail 100% finance from lease financing and avoid even initial investment in margin money as required under loan financing. However, some leasing companies demand that first lease rent should be paid in advance.

(ii) Minimum Delay:

Usually, leasing companies take much lessor time in processing the lease proposal as compared to the lengthy procedure involved in the term-loan financing. Thus, a firm can avoid delay in the use of an asset by taking it on lease.

(iii) Easy Source of Finance:

Leasing provides one of the easiest sources of intermediate and long-term financing. It does not require any mortgage of the assets because the ownership of asset leased remains with the lessor and is not transferred to the lessee.

Moreover, various restrictive provisions imposed in term loan financing are avoided. The initial cost of raising finance through leasing is also much lesser than that of raising long-term loans.

(iv) Shifting the Risk of Obsolescence:

In the present era of rapid changing technologies, a firm has to bear the risk of obsolescence if it purchases the asset. The firm (lessee) can easily shift this risk upon the lessor by acquiring the use of the asset on lease rather than buying the same.

(v) Enhanced Liquidity:

Sale and leaseback arrangement enables a firm to improve its liquidity position by realising cash from the sale of fixed assets and retaining the economic use of the same. Thus, the lessee can salvage its working capital crisis through lease financing.

(vi) Conserving Borrowing Capacity:

Leasing is a form of financing that does not reduce or affect the borrowing capacity of the lessee firm. It is considered to be a hidden form of debt which does not appear as a liability in the balance sheet of the lessee. Thus, it does not affect the debt equity ratio of the firm acquiring use of an asset through leasing.

(vii) Tax Planning and Differential Tax Advantage:

As lease rentals are considered as a revenue expense while determining taxable profits, it is advantageous for the lessee in minimising tax liabilities. Moreover, the lessor who is usually in the higher tax bracket passes on the benefit of depreciation advantage to the lessee in the form of reduced lease payments.

The lessee can also arrange to adjust lease rentals in such a way that it reduces his tax liability and thus helps him in tax planning.

(viii) Higher Return on Capital Employed:

Since the lessee acquires only the right to use the asset without owning it, such asset does not appear on the asset side of the balance sheet. This implies higher earnings against capital employed and higher rate of return on capital employed.

(ix) Convenience and Flexibility:

Operating or service leases are usually cancellable enabling the lessee firm to terminate the lease if it does not require the use of the asset, any more. Hence, it is very convenient and flexible mode of financing fixed assets.

(x) Lesser Administrative and Maintenance Costs:

Under a ' gross lease' arrangement, the lessee can avail the specialised services of the lessor for maintenance of the asset leased. Even in case of operating lease agreement there could be a provision of maintaining the asset by the lessor.

Although, the lessor charges for such maintenance and service costs by way of higher rentals, the lessee's overall administrative and service costs are reduced because of specialised services of the lessor.

Disadvantages of Leasing for the Lessee:

(i) Higher Cost:

The lease rentals include a margin for the lessor as also the cost of risk of obsolescence; it is, thus, regarded as a form of financing at higher cost.

(ii) Loss of Moratorium Period:

The lease rentals do not take care of the gestation period. It usually takes a long time before the asset generates funds to pay it back. The term loan provides certain moratorium period in repayments for that reason. But no such moratorium is permitted under lease' arrangements.

(iii) Risk of Being Deprived of the Use of Asset:

The lessee may be deprived of the use of the asset due to the deterioration in the financial position of the lessor or winding up of the leasing company.

(iv) No Alteration or Change in Asset:

As the lessee is not the owner of the asset, he cannot make any substantial changes in the asset. Contrary to it, in case of outright purchase the buyer can modify or alter the asset to increase its utility.

(v) Loss of Ownership Incentives:

There are certain advantages of owning the assets, such as depreciation and investment allowance, In case of lease; the lessee is not entitled to such benefits.

(vi) Penalties on Termination of Lease:

The lessee is usually required to pay certain penalties if he terminates the lease before the expiry of the lease period.

(vii) Loss of Salvage Value of the Asset:

An asset generally has certain salvage value at the expiry of the useful life. As the lessee does not become the owner of the asset, he cannot realise the salvage value at the expiry of the lease rather he has to return the asset to the lessor.

Advantages and Disadvantages of Acquiring Capital Assets on Lease

Advantages:

There are several advantages of acquiring capital assets on lease:

1. Alternative Use of Funds:

   A lease agreement makes available an asset to use without making any huge investments. The firm is obliged to make periodic rental payment only. Thus, the firm may make alternative use of the funds saved due to lease agreement.

2. Beneficial for Small Firms:

   As small firms do suffer from paucity of funds, they can acquire assets on lease agreement. Thus, leasing becomes a boon more especially for small firms to use the most required and costly assets and, thus are immensely benefited.

3. Flexibility and Convenience:

   The lease agreement can be tailor-made in respect of lease period and lease rentals according to the convenience and requirements of all lessees.

4. Free from Restrictive Covenants:

   While lending the financial institutions impose several restrictive covenants on the borrowers like management, debt- equity norms, dividend declaration, etc. But, there are no such restrictions while financing through a lease agreement. That is the way a lease agreement arranges cheaper and faster credit to borrower, i.e. lessee.

5. Tax Shielding:

   When a tax paying lessor enters into a lease agreement, he generally passes a part of tax benefit to the lessee also by charging lower rental rates. As a result of this, the real cost of the assets to the lessee works out to be lower than what it would have been if he were the owner of the asset.

6. Improvement in Liquidity:

   Leasing enables the lessee to improve their liquidity position by adopting the sale and lease back technique.

Theoretically, thus, leasing has been accepted as a better alternative to financing the business operations because of the benefits it offers to the parties involved in the transaction.

18.7 SUMMARY

Leasing has emerged as an important source of long-term financing of corporate enterprises during the recent few decades. Leasing is an arrangement under which a company acquires the right to make use of the asset without holding title to it. A lease, thus, is the written agreement allowing the economic use of the assets for a stated period of time.

The lease agreement is signed by both owner of the assets, called the lessor and the user, called the lessee. The lessor permits the lessee the use of the asset for a specified payment but retains title to the property.

The lease agreement sets forth the period covered by the lessee, provisions for payment of taxes, insurances, maintenance expenses and the like, provisions for renewal of the lease or purchase of the asset at expiration and the timing and amounts of periodic rental payments during the lease period.

Since leasing represents an alternative to ownership, leasing can be viewed as a specialized means of garnering funds. In exchange for the use of the asset the company can issue a claim against the future cash flows, long-time debt, equity or lease obligations. Viewed in this way, leasing is strictly a financing decision.

If a company chooses leasing instead of owning the assets by means of borrowing, it incurs a contractual obligation to make payments of fixed amounts at specified times. The lease, therefore, is analogous to any other financial claim issued by the company. In that the payments are fixed and contractual a lease is the functional equivalent of debt.

18.8 GLOSSARY

- **Financial Lease-**It is the lease where the lessor transfers substantially all the risks and rewards of ownership of assets to the lessee for lease rentals.
- **Operating Lease-**Lease other than finance lease is called operating lease. Here risks and rewards incidental to the ownership of asset are not transferred by the lessor to the lessee.
- **Sale and Lease Back**-The sale and lease back is mostly found in real estate financing and financial institutions prominently insurance companies and financial companies play the role of lessors who buy a property from a business concern and then lease it back to the company.
- **Direct Leasing**-Direct leasing may be arranged through either the manufacturer or a financial institution.

- **Operating Leasing**-In operating lease, lease facility is provided on a period to period basis. Under this arrangement, no long-term obligation is imposed on either the lessor or lessee and the agreement is cancellable at the option of either the owner or user of assets after giving a certain stipulated notice.
- Financial Leasing-Financial lease, as opposed to operating lease, is a non-cancellable contract covering intermediate to long-term period.
- Leveraged Leasing-In leveraged leasing the lessee contracts to make periodic payments during the lease period and in return, is entitled to the use of the asset over that period of time.

18.9 SELF ASSESSMENT QUESTIONS

Q1. What do you understand by lease financing?

Ans. ____

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Q2. Explain the term financial lease.

Ans. ____

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3. Write a brief note on operating lease.

Ans. ____

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18.10 LESSON END EXERCISE

1. What is lease financing? Explain the various forms of lease financing.
2. Discuss the various types of lease financing. Discuss the features of financial and operating lease.
3. Highlights the advantages and disadvantages of lease financing.

18.11 SUGGESTED READINGS

- Jain, S.P and Narang, K.L. (2014). Advanced Accountancy-Vol-II. Kalyani Publisher, New Delhi.
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VALUATION OF RATE OF RETURN ON CAPITAL EMPLOYED AND LEASE EVALUATION

M.Com II Sem.	**Advanced Accounting**	**Unit-IV**
M.Com – C 211		**Lesson No. 19**

STRUCTURE

19.1 INTRODUCTION

Leasing is an arrangement under which a company acquires the right to make use of the assets without holding title to it. In other words, in a lease agreement the lessor, i.e., the owner of the asset permits the lessee to use the asset for a specified payment but retains the title over the property. A lease thus is an agreement between the lessor and the lessee.

19.2 OBJECTIVES

After going through this lesson, you will be able to understand-

- the difference between financial lease and operating lease;
- financial evaluation of leasing from Lesse's point of view; and
- financial evaluation of leasing from Lesse's point of view.

19.3 DIFFERENCE BETWEEN FINANCIAL LEASE AND OPERATING LEASE

An agreement in which the lessor allows the lessee to use a particular asset, for a fixed term which covers the major part of the economic life of the asset, without the transfer of title but with the transfer of risk and rewards is known as Finance Lease. It is also known as the capital lease.

In a finance lease, the ownership of the asset is transferred to the lessee when the lease term expires. The lessee has the option to buy the asset at a nominal amount i.e. a price which is less than the fair market value of the asset. The lease returns the full payout, i.e. principal (cost) plus interest thereon of the asset, in a single lease. The present value of Minimum Lease Payments (MLP) at the beginning of the lease agreement is more than or equal to the total Fair Market Value of the asset leased. The finance lease is non-cancellable in nature i.e. it can be canceled only if: the lessor allows or the happening of any contingent event or the lessee enters into a lease agreement with the Lessor for the same asset. However, if the Lessee cancels the lease agreement any losses incurred to the lessor will be borne by the lessee.

An agreement in which the lessee is allowed to use an asset with the permission of the lessor, for a limited term which is smaller than the economic life of the asset, without the transfer of title, risk and reward is known as Operating Lease. An Operating lease is more like a rental agreement, and that is why the rental payments for the use of the asset are charged a rental expense in the Profit and Loss Account in the books of the Lessee.

At the end of the operating lease, the asset is neither transferred to the lessee nor he has the right to purchase the asset at a price less than the Fair Market Value of the asset. The leased asset is transferred to the lessor at the expiry of the lease term. There is no security that the lessor will get the complete payout regarding the cost and return of the asset as the same asset is leased again and again by the lessor to many customers. The operating lease is cancellable in nature and so, it can be canceled by any of the parties.

Key Differences Between Finance (Capital) Lease and Operating Lease

The following are the major differences between finance (capital) lease and operating lease:

1. The lease agreement in which the risk and rewards are transferred with the transfer of an asset is known as Finance Lease. The lease agreement in which the risk and rewards are not transferred with the transfer of the asset is known as Operating Lease.

2. Finance Lease is a sort of loan agreement in which the lessor plays the role of financier. As opposed to the Operating Lease, which is similarly like a rental agreement.

3. Finance Lease is for the long term as it covers the maximum part of the life of the asset. Unlike, Operating Lease, which is for a shorter period.

4. An Operating lease is more flexible as compared to the Finance Lease.

5. In the finance lease, the ownership of the asset is transferred to the lessee at the end of the lease term, by paying a nominal amount which is equal to the fair market value of the asset. Conversely, in operating lease, there is no such kind of option.

6. In Finance Lease, the lessee bears the risk of obsolescence whereas in Operating Lease the lessor bears the risk for so.

7. Any cost for repairs and maintenance will be borne by the lessee in the finance lease, but the cost of repairs and maintenance will be borne by the lessor in operating lease.

COMPARISON CHART

BASIS FOR COMPARISON	FINANCE LEASE	OPERATING LEASE
Meaning	A commercial arrangement in which the lessor allows the lessee to use the asset for the maximum part of its economic life against payment of rentals is known as finance lease.	A commercial arrangement in which the lessor allows the lessee to use the asset for a term smaller than the economic life of the asset against the payment of rentals is known as operating lease.
Nature	Loan Agreement	Rental Agreement
Lease Term	The lease term of finance lease is longer as compared to operating lease.	The lease term of operating lease is short.
Risk Bearing for obsolescence	Rests with the lessee	Rests with the lessor
Transferability of risk and rewards	From the lessor to the lessee, with the transfer of asset.	Does not transfers from the lessor to the lessee, with the transfer of the asset.
Cancellation of the lease	Only on the happening of certain specified event.	Can be done
Tax Benefit	Depreciation and finance charges are allowable as a deduction to lessee.	Lease rent is allowable as a deduction to lessee.
Cost of Repairs and Maintenance	Are to be borne by the lessee.	Are borne by the lessor.
Bargain Purchase Option	The lease contains an option where the lessee can purchase the equipment at the price less than the Fair Market Value.	No such option in this regard

19.4 FINANCIAL EVALUATION OF LEASE FROM LESSEE'S POINT OF VIEW (Lease or Buy/Lease or Borrow Decisions):

Once a firm has evaluated the economic viability of an asset as an investment and accepted/selected the proposal, it has to consider alternate methods of financing the investment. However, in making an investment, the firm need not own the asset. It is basically interested in acquiring the use of the asset.

Thus, the firm may consider leasing of the asset rather than buying it. In comparing leasing with buying, the cost of leasing the asset should be compared with the cost of financing the asset through normal sources of financing, i.e., debt and equity.

Since, payment of lease rentals is similar to payment of interest on borrowings and lease financing is equivalent to debt financing, financial analysts argue that the only appropriate comparison is to compare the cost of leasing with that of cost of borrowing. Hence, lease financing decisions relating to leasing or buying options primarily involve comparison between the cost of debt-financing and lease financing.

The evaluation of lease financing decisions from the point of view of the lessee involves the following steps:

(i) Calculate the present value of net-cash flow of the buying option, called NPV (B).

(ii) Calculate the present value of net cash flow of the leasing option, called NPV (L)

(iii) Decide whether to buy or lease the asset or reject the proposal altogether by applying the following criterion:

(a) If NPV (B) is positive and greater than the NPV (L), purchase the asset.

(b) If NPV (L) is positive and greater than the NPV (B), lease the asset.

(c) If NPV (B) as well as NPV (L) are both negative, reject the proposal altogether.

Since many financial analysts argue that the lease financing decisions arise only after the firm has made an accept-reject decision about the investment; it is only the comparison of cost of leasing and borrowing options.

The following steps are involved in such an analysis:

(i) Determine the present value of after-tax cash outflows under the leasing option.

(ii) Determine the present value of after-tax cash outflows under the buying or borrowing option.

(iii) Compare the present value of cash outflows from leasing option with that of buying/borrowing option.

(iv) Select the option with lower presented value of after-tax cash outflows.

We have illustrated the above analysis in the following illustrations.

Illustration 19.1

A limited company is interested in acquiring the use of an asset costing Rs. 5,00,000. It has two options:

(i) To borrow the amount at 18% p.a. repayable in 5 equal installments or

(ii) To take on lease the asset for a period of 5 years at the year end rentals of Rs. 1,20,000.

The corporate tax is 50% and the depreciation is allowed on w.d.v. at 20%. The asset will have a salvage of Rs. 1,80,000 at the end of the 5th year.

You are required to advise the company about lease or buy decision. Will decision change if the firm is allowed to claim investment allowance at 25%?

Note:

(1) The present value of Re. 1 at 18% discount factor is:

1st year	–	.847
2nd year	–	.718
3rd year	–	.609
4th year	–	.516
5th year	–	.437

(2) The present value of an annuity of Re. 1 at 18% p.a. is Rs. 3.127.

Solution:

(i) **Calculation of loan instalment**

$$\text{Loan Instalment} = \frac{\text{Amount of Loan}}{\text{P.V. Factor of Annuity}}$$

$$= \frac{5,00,000}{3.127}$$

= ₹ 1,59,898 appx.

(ii) **Schedule of Loan Payment**

Year	Loan Balance at beginning of the year (₹)	Loan Instalment (₹)	Interest Payment (₹)	Principal Payment (₹)	Loan Balance at the end of the year (₹)
1.	5,00,000	1,59,898	90,000	69,898	4,30,102
2.	4,30,102	1,59, 898	77,418	82,480	3,47,622
3.	3,47,622	1,59,898	62,572	97,326	2,50,296
4.	2,50,296	1,59,898	45,053	1,14, 845	1,35,451
5.	1,35,451	1,59,832*	24,381	1,35,451	Nil

* The amount of loan instalment in the last year is different from the equal payments because of compensation for rounding error.

(iii) **Calculation of Present Value of After-Tax Cash Outflows under Borrowing/Buying Option**

Year end	Loan Instalment (₹)	Tax Saving on Interest (₹)	Tax Saving on Dep. (after-tax) (₹)	Tax Saving on Total (₹)	Net cash Outflow (₹)	P.V. factor at 18%	P.V. of after tax Net cash Outflow (₹)
Col. 1	2			3	4 = 2–3	5	6
1.	1,59,898	45,000	50,000	95,000	64,898	.847	54,969
2.	1,59,898	38,709	40,000	78,709	81,189	.718	58,294
3.	1,59,898	31,286	32,000	63,286	96,612	.609	58,837
4.	1,59,898	22,527	25,600	48,127	1,11,771	.516	57,674
5.	1,59,832	12,190	20,480	32,670	1,27,162	.437	55,570
							Total : 2,85,344
			Less : P.V. of salvage at the end of 5th year (1,80,000 × .437)				78,660
							2,06,684

(iv) **Calculation of Present Value of After-Tax Cash Outflows under Lease Option**

Year end	Lease Rental (₹)	Tax Savings on Lease Rent (₹)	After-Tax Cash Outflow (₹)	P.V. Annuity Factor at 18% (₹)	Total P.V. of Cash Outflows (₹)
1–5	1,20,000	60,000	60,000	3.127	1,87,620

(v) Evaluation:

As the present value of after-tax cash outflows under the leasing option is lesser than the present value of after-tax cash outflows of the buying option, it is advisable to take the asset on lease.

(vi) Decision if Investment Allowance is allowed:

In case Investment Allowance is allowed on purchase of asset the total of present value of net cash outflows will decrease by the present value of tax savings on investment allowance as below:

	₹
Investment Allowance :	
(allowed at the end of 1st year) $5,00,000 \times \frac{25}{100}$	1,25,000
Tax Savings (50%)	62,500
P.V. Factor at the end of year 1	.847
P.V. of Tax Savings on Investment Allowance	52,938
Hence, P.V. of Cash Outflows in Buying Option shall be = ₹ 2,06,684-52,938	1,53,746

In that case, the P.V. of cash outflows under buying option shall be lesser than the P.V. of cash outflows under leasing option and the company should buy the asset.

19.5 FINANCIAL EVALUATION OF LEASING FROM LESSOR'S POINT OF VIEW

The financial viability of leasing out an asset from the point of view of lessor can be evaluated with the help of the two time adjusted methods of capital budgeting:

(a) Present Value Method

(b) Internal Rate of Return Method.

(a) Present Value Method:

This method involves the following steps:

(i) Determine cash outflows by deducing tax advantage of owning an asset, such as investment allowance, if any.

(ii) Determine cash inflows after-tax as below:

(ii) Determine the present value of cash outflows and after tax cash inflows by discounting at weighted average cost of capital of the lessor.

(iv) Decide in favour of leasing out an asset if P.V. of cash inflows exceeds the P.V. of cash outflows, i.e., if the NPV is +ve; otherwise in case N.P.V. is -ve, the lessor would lose on leasing out the asset.

The above technique has been explained with the help of the following example.

Illustration 19.2

From the information given below, you are required to advise about leasing out of the asset:

Cost of Equipment	₹ 4,00,000	
Average Cost of Capital to the lessor	12%	
Depreciation (Allowable)	20%	on original cost
Expected Life of Asset	5	years
Salvage Value	Nil	
Lease Rent payable at the end of each of 5 years	₹ 1,50,000	
Corporate Tax (applicable to lessor)	50%	
P.V. of an annuity of Re. 1 for 5 years at 12% is ₹ 3.605		

Solution:

(i) **Calculation of Cash Outflow**			*(₹)*
Cost of Equipment			4,00,000
Less Tax Advantage, if any			Nil
Cash Outflow			4,00,000
(ii) **Calculation of After-Tax Cash Inflows**			*(₹)*
Lease Rental			1,50,000
Less Depreciation			80,000
Earnings Before Tax (EBT)			70,000
Less Tax at 50%			35,000
Earnings After Tax (EAT)			35,000
Add Depreciation			80,000
Cash Inflows After Tax (CFAT)			1,15,000
(iii) **Calculation of Present Value (P.V.) of Cash Outflows**			
Year (₹)	***Cash Outflow (₹)***	***P.V. Discount Factor at 12%***	***P.V. of Cash Outflow (₹)***
0	4,00,000	1.00	4,00,000
(iv) **Calculation of P.V. of Cash Inflows**			
Year	***Cashflow After Tax (CFAT) ₹***	***P.V. Annuity Discount Factor at 12%***	***P.V. of Cash Inflows ₹***
1-5	1,15,000	3.605	4,14,575
(iv) **Calculation of Net Present Value**			₹
Present value of Cash Inflows			4,14,575
Less P.V. of Cash Outflows			4,00,000
Net Present value of Cash flows			14,575

Since the present value of cash inflows is more than the present value of cash outflows or says N.P.V. is positive, it is desirable to lease out the asset.

(b) Internal Rate of Return Method:

The internal rate of return can be defined as that rate of discount at which the present value of cash- inflows is equal to the present value of cash outflows.

It can be determined with the help of the following mathematical formula:

C = A1/(1+r) + A2/(1+r)2 + A3/(1+r)3 + … … … … + An/(1+r)n

where, C = Initial Outlay at time Zero.

A1, A2, … … … An = Future net cash flows at different periods.

2,3 …….. , = Numbers of years

r = Rate of discount of internal rate of return.

The Internal rate of return can also be determined with the help of present value tables.

The following steps are required to practice the internal rate of return method:

(1) Determine the future net cash flows for the period of the lease. The net cash inflows are estimated future net cash flows for the period of the lease. The net cash inflows are estimated future earnings, from leasing out the asset, before depreciation but after taxes.

(2) Determine the rate of discount at which the present value of cash inflows is equal to the present value of cash outflows. This may be determined as follows:

(a) When the annual net cash flows are equal over the life of the asset:

Firstly, find out Present Value Factor by dividing initial outlay (cost of the investment) by annual cash flow, i.e., Present Value Factor = Initial Outlay/Annual Cash Flow. Then, consult present value annuity tables with the number of year equal to the life of the asset and find out the rate at which the calculated present value factor is equal to the present value given in the table.

Illustration 3:

Initial Outlay	₹ 50,000
Life of the Asset	5 years
Estimated Annual Cash-flow	₹ 12,500
Calculate the Internal Rate of Return.	

Solution:

Present Value Factor	$= \dfrac{\text{Initial Outlay}}{\text{Annual Cash Flow}}$
	$= \dfrac{50,000}{12,500} = 4.$

Consulting Present Value Annuity Tables for 5 years periods at Present Value Factor of 4. (For Present Value Tables see Appendix A and B given at the end of the book)

Internal Rate of Return =8% approx.

(as seen from the table that at 8% for 5 year period, the present value is 3.9927 which is nearly equal to 4.)

(b) When the annual cash flows are unequal over the life of the asset:

In case annual cash flows are unequal over the life of the asset, the internal rate of return cannot be determined according to the technique suggested above. In such cases, the internal rate of return is calculated by hit and trial and that is why this method is also known as hit and trial yield method.

We may start with any assumed discount rate and find out the total present value of all the cash flows by consulting present value tables.

The so calculated total present value of cash inflows as compared with the present value of cash outflows which is equal to the cost of the initial investment where total investment is to be made in the beginning. The rate, at which the total present value of all cash inflows equals the initial outlay, is the internal rate of return. Several discount rates may have to be tried until the appropriate rate is found. The calculation process may be summed up as follows.

(i) Prepare the cash flow table using an arbitrary assumed discount rate to discount the net cash flow to the present value.

(ii) Find out the Net Present Value by deducting from the present value of total cash flows calculated in (i) above the initial cost of the investment.

(iii) If the Net Present Value (NPV) is positive, apply higher rate of discount.

(iv) If the higher discount rate still gives a positive net present value, increase the discount rate further until the NPV becomes negative.

(v) If the NPV is negative at this higher rate, the internal rate of return must be between these two rates:

(3) Accept the proposal if the internal rate of return is higher than or equal to the minimum required rate of return, i.e. the cost of capital or cut off rate.

(4) In case of alternative proposals select the proposal with the highest rate of return as long as the rates are higher than the cost of capital or cut-off rate.

Illustration 4:

Initial Investment – Rs. 60,000

Life of the Asset – 4 years

Estimated Net Annual Cash Flows:

	₹
1st Year	15,000
2nd Year	20,000
3rd Year	30,000
4th Year	20,000

Compute the internal rate of return and also advise the lessor about the leasing out decision if his expected minimum rate of return is 15%.

Note:

Present Value Factor at various rates of discount.

Year	10%	12%	14%	15%	16%
1	.909	.892	.877	.869	.862
2	.826	.797	.769	.743	.756
3	.751	.711	.674	.657	.640
4	.683	.635	.592	.571	.552

Solution:

P.V. Cash Flows Table at Various Assumed Discount Rates of 10%, 12%, 14% & 15%

Year	Annual Cash Flow ₹	Discount rate 10% P.V.F.	P.V. ₹	12% P.V.F.	P.V. ₹	14% P.V.F.	P.V. ₹	15% P.V.F.	P.V. ₹
1	15,000	.909	13,635	.892	13,380	.877	13,155	.869	13,035
2	20,000	.826	16,520	.797	15,940	.769	15,380	.756	15,120
3	30,000	.751	22,530	.711	21,330	.674	20,220	.657	19,710
4	20,000	.683	13,660	.635	12,700	.592	11,840	.571	11,420
			66,345		63,350		60,595		59,285

(1) The present value of cash flows at 14% rate of discount is Rs. 60,595 and at 15% rate of discount it is t 59,285. So the initial cost of investment which is Rs. 60,000 falls in between these two discount rates. At 14% the NPV is+ 595 but at 15% the NPV is – 715, we may say that IRR = 14.5% (approx).

(2) As the IRR is less than the minimum required rate of return, the lessor should not lease out the asset.

19.6 SUMMARY

Lease financing decisions relating to leasing or buying options primarily involve comparison between the cost of debt-financing and lease financing. The evaluation of lease financing decisions from the point of view of the lessee involves the following steps:

(i) Calculate the present value of net-cash flow of the buying option, called NPV (B).

(ii) Calculate the present value of net cash flow of the leasing option, called NPV (L)

(iii) Decide whether to buy or lease the asset or reject the proposal altogether by applying the following criterion:

(a) If NPV (B) is positive and greater than the NPV (L), purchase the asset.

(b) If NPV (L) is positive and greater than the NPV (B), lease the asset.

(c) If NPV (B) as well as NPV (L) are both negative, reject the proposal altogether.

Since many financial analysts argue that the lease financing decisions arise only after the firm has made an accept-reject decision about the investment; it is only the comparison of cost of leasing and borrowing options.

The following steps are involved in such an analysis:

(i) Determine the present value of after-tax cash outflows under the leasing option.

(ii) Determine the present value of after-tax cash outflows under the buying or borrowing option.

(iii) Compare the present value of cash outflows from leasing option with that of buying/borrowing option.

(iv) Select the option with lower presented value of after-tax cash outflows.

The financial viability of leasing out an asset from the point of view of lessor can be evaluated with the help of the two time adjusted methods of capital budgeting:

(a) Present Value Method

(b) Internal Rate of Return Method.

(a) Present Value Method:

This method involves the following steps:

(i) Determine cash outflows by deducing tax advantage of owning an asset, such as investment allowance, if any.

(ii) Determine cash inflows after-tax as below:

(ii) Determine the present value of cash outflows and after tax cash inflows by discounting at weighted average cost of capital of the lessor.

(iv) Decide in favour of leasing out an asset if P.V. of cash inflows exceeds the P.V. of cash outflows, i.e., if the NPV is +ve; otherwise in case N.P.V. is -ve, the lessor would lose on leasing out the asset.

19.7 GLOSSARY

- NPV- Net present Value Method
- IRR- Internal Rate of Return Method
- P.V.F –Present Value Factor
- EAT-Earning After Tax
- EBT-Earning Before Tax

19.8 SELF ASSESSMENT QUESTIONS

Q1. Differentiate between financial lease and operating lease.

Ans. ____

Q2. Explain the steps involved in the financial evaluation of lease from the Lesse's point of view.

Ans. ____

Q3. Explain the IRR method of lease evaluation.

Ans. ____

19.9 LESSON END EXERCISE

1. How financial evaluation of lease is done from the Lessor's point of view? Explain your answer with suitable example.
2. How financial evaluation of lease is done from the Lesse's point of view? Explain your answer with suitable example.
3. Calculate the IRR with imaginary figures.
4. Calculate the net present value of cash flows with the help of imaginary figures.

19.10 SUGGESTED READINGS

- Jain, S.P and Narang, K.L. (2014). Advanced Accountancy-Vol-II. Kalyani Publisher, New Delhi.
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VALUATION OF RATE OF RETURN ON CAPITAL EMPLOYED AND LEASE EVALUATION

M.Com II Sem.	**Advanced Accounting**	**Unit-IV**
M.Com – C 211		**Lesson No. 20**

STRUCTURE

20.1 INTRODUCTION

The lease is a finance agreement in which lessor (owner of the asset) purchases the asset and let the lessee (user of the asset) use the asset for a limited period against periodic payments, i.e. lease rentals. The terms and conditions of the lease are written in the lease deed. Finance or capital lease and operating lease are two types of lease. Finance Lease is a lease in which the risk and rewards are transferred to the lessee with the transfer of the asset. Unlike, Operating Lease, in which the risks and rewards are not transferred to the lessee with the transfer of the asset. Therefore, the lease is an alternative to buying the asset out of owned or borrowed funds. One of the major difference between a finance lease and an operating lease is, the former cannot be cancelled, during the primary lease period, whereas the latter can be cancelled by the lessee.

20.2 OBJECTIVES

After going through this lesson, you will be able to understand-

- methods of computing lease rentals; and
- methods used in evaluation of lease decisions.

20.3 METHODS OF COMPUTING LEASE RENTALS

The following six main steps are involved in computing lease rentals.

1. Determine the cost of the asset which includes the actual purchase price and expenses like freight, insurance, taxes and installation, etc.
2. Determine the cash flows to the lessor on account of ownership of the asset. These include tax advantage provided by depreciation and investment allowance.
3. Calculate the present value of cash flows as determined in step 2.
4. Subtract the present value of cash flows of ownership advantage from the cost of the asset determined in step 1 so as to determine the minimum required net recovery through lease rentals.
5. Calculate the post-tax lease rentals by dividing the minimum required net recovery through lease rentals by present value factor of annuity.
6. Compute the pre-tax lease rentals by adjusting the post-tax lease rentals for the tax factor. The above method of computing lease rentals can be followed from the following illustration.

Illustration 20.1

Sunny Leasing is considering to lease out an equipment costing Rs. 10,00,000 for five years, which is the expected life of the equipment, and has an estimated salvage value of Rs. 1,00,000. Sunny Leasing can claim a depreciation of 20% on w.d.v. of the asset but is not eligible for investment allowance.

The firm falls under a tax rate of 50% and the minimum post-tax required rate of return is 12%. You are required to calculate the lease rental which the firm should charge.

Note:

(1) Present Value Factor at 12% discount rate is as below:

Year 1 = .893; Year 2= .797; Year 3 = .712; Year 4 = .636 and Year 5 = .567

(2) Annuity Discount Factory at 12% for 5 years = 3.605.

Solution:

(i) **The cost of the equipment = ₹ 10,00,000 (given)**

(ii) **Calculation of cash flows to the lessor on account of ownership of the asset :**

Year	*Amount of Depreciation* (₹)	*Tax Advantage on Dep.* (₹)	*Tax advantage on Investment Allowance* (₹)	*Salvage Value* (₹)	*Total C.F.* (₹)
1.	2,00,000	1,00,000	Nil	—	1,00,000
2.	1,60,000	80,000	—	—	80,000
3.	1,28,000	64,000	—	—	64,000
4.	1,02,400	51,200	—	—	51,200
5.	81,920	40,960	—	1,00,000	1,40,960

(iii) **Calculation of Present Value of Cash Flow :**

Year	*Cash Flows* (₹)	*P.V. Factor at 12%*	*P.V. of Cash Flolw* ₹
1	1,00,000	.893	89,300
2	80,000	.797	63,760
3	64,000	.712	45,568
4	51,200	.636	32,563
5	1,40,960	.567	79,924
		Total :	3,11,115

(iv) **Minimum required net recovery through lease rentals :**

MRLR = ₹ 10,00,000–3,11,115
= ₹ 6,88,885

(v) Post-tax Lease Rental (PTLR) $= \frac{6,88,885}{3.605}$
= ₹ 1,91,092

(vi) Pre-tax Lease Rental (LR) $= 1,91,092 \times \frac{100}{50}$ = Rs. 3,82,184

∴ Lease Rent expressed in terms of lease financing

$= 3,82,184 \times \frac{1,000}{10,00,000} \times \frac{1}{12}$

= 31.85 per thousand per month.

20.4 METHODS USED IN LEASE EVALUATION DECISIONS

The methods used in evaluation of lease decision are as follows:-

1. Present Value Method
2. Cost of Capital Method
3. Bower-Herringer-Williamson Method.

1. Present Value Method:

Under this method the present value of lease rentals are compared with the present value of the cost of an asset acquired on outright purchase by availing a loan. In leasing, the tax advantage in payment of lease rentals will reduce the cash outflow.

In case an asset is purchased by borrowing a loan, the repayment of principal and interest charges on loan is considered as cash outflow and it is reduced by tax advantage of depreciation claim and interest charge. The present value of the net cash outflows over the period of lease is considered to ascertain the present value over the lease/loan period. The alternative with low total present value of cash outflow will be selected.

2. Cost of Capital Method:

Under this method, the rate of cost of capital is calculated for the payments of instalments and then it is compared with the cost of capital of the other available sources of finance such as fresh issue of equity capital, retained earnings, debentures, term loans etc. The lease option is chosen if the rate is lower than the cost of equity capital etc. This method does not require the prior selection of any discounting rate.

3. Bower-Herringer-Williamson Method:

Under this method, the financial and tax aspects of lease financing are considered separately.

The following steps are involved in evaluation of lease decision:

Step 1:

Make a comparison of the present value of cost of debt with the discounted value of gross amount of lease rentals. The rate of discount applicable is being the gross cost of debt capital. Then, obtain the total present value of a financial advantage/ disadvantage of leasing.

Step 2:

Again compute the comparative tax benefit during the lease period and discount it at an appropriate cost of capital. The total present value is the operating advantage/ disadvantage of leasing.

Step 3 – When the present value of operating advantage of lease is more than its financial disadvantage, then select the leasing. When the present value of financial advantage is more than operating disadvantages, then select the leasing.

Illustration:

Vindhya Papers Ltd. planning to install a captive generator set at its plant. Its Finance Manager is asked to evaluate the alternatives either to purchase or acquire generator on lease basis.

Buying	Initial cost Rs. 5,00,000	Residual Value Rs. 1,60,000
Leasing for 5 years	Annual lease rental Rs. 1,50,0000 to lessee in 5 years time	Residual value Rs. 90,000 returned

Depreciation @ 20% p.a. on written down value. Corporate tax rate 40%. After tax cost of debt is 14%.

The time gap between the claiming of the tax allowance and receiving the benefit is one year.

Evaluate the lease or buy decision based on the above information.

Solution:

Alternative (1) : Buying

Year	Cost or W.D.V.	Depreciation @ 20%	Corporate tax @40%
1	5,00,000	1,00,000	40,000
2	4,00,000	80,000	32,000
3	3,20,000	64,000	25,600
4	2,56,000	51,200	20,480
5	2,04,800	-	-
Less: Residual value	1,60,000	-	-
	44,800	44,800	17,920

Calculation of Net Present Value

Year	Cost (Rs.)	Tax relief (Rs.)	Net cashflow (Rs.)	P.V. factor @ 14%	P.V. (Rs.)
0	(5,00,000)	-	(5,00,000)	-	(5,00,000)
1	-	-	-	0.8772	-
2	-	40,000	40,000	0.7695	30,780
3	-	32,000	32,000	0.6750	21,600
4	-	25,600	25,600	0.5921	15,158
5	1,60,000	20,480	1,80,480	0.5194	93,741
6	-	17,920	17,920	0.4556	8,164
				N P V =	(3,30,557)

Alternative (2) : Leasing

Year	Lease rentals (Rs.)	Tax relief (Rs.)	Net cashflow (Rs.)	P.V. @ 14%	P.V. (Rs.)
0	(1,50,000)	-	(1,50,000)	-	(1,50,000)
1	(1,50,000)	-	(1,50,000)	0.8772	(1,31,580)
2	(1,50,000)	60,000	(90,000)	0.7695	(69,255)
3	(1,50,000)	60,000	(90,000)	0.6750	(60,750)
4	(1,50,000)	60,000	(90,000)	0.5921	(53,289)
5	90,000	60,000	1,50,000	0.5194	77,910
6	(Share residual value)	60,000	24,000	0.4556	10,934
	Tax on residual value	(36,000)			
				NPV =	(3,76,030)

Analysis:

From the above analysis, by applying the discounted cashflow technique, we can observe that the net present value of cash outflow is higher in case of leasing decision i.e., Rs. 3,76,030 as compared to buying decision it is only Rs. 3,30,557. The company may go for purchase of the generator instead of acquiring on lease basis.

20.5 SUMMARY

Nowadays many business concerns enter into these lease agreement because the company does not have directly to bear the cost of the financing the asset. Therefore, the finance lease and operating lease are getting popular. One of the best advantages of these lease agreement is that the depreciation and interest charges are tax deductible in nature, and so they are allowable as deduction. Similarly, the lease rentals are also tax deductible in case of the operating lease and hence they are allowed as deduction.

20.6 GLOSSARY

- **Residual value**-Scrap value
- **N.P.V**- Net Present Value
- **P.V.F**- Present Value Factor
- **C.F**- Cash Flows
- **Financial Lease**- The lease agreement in which the risk and rewards are transferred with the transfer of an asset is known as Finance Lease.
- **Operating Lease**-The lease agreement in which the risk and rewards are not transferred with the transfer of the asset is known as Operating Lease.

20.7 SELF ASSESSMENT QUESTIONS

Q1. What is financial lease?

Ans. ____

____

____

____

Q2. What is operating lease?

Ans.

Q1. Highlights the difference between financial lease and operating lease?

Ans.

20.8 LESSON END EXERCISE

1. Explain the methods of computing lease rentals with suitable examples.

2. Discuss the methods used in lease evaluation decisions with suitable example.

3. Differentiate between financial lease and operating lease.

4. A limited company is interested in acquiring the use of an asset costing Rs. 5,00,000. It has two options:

(i) To borrow the amount at 18% p.a. repayable in 5 equal instalments or

(ii) To take on lease the asset for a period of 5 years at the year end rentals of Rs. 1,20,000.

The corporate tax is 50% and the depreciation is allowed on w.d.v. at 20%. The asset will have a salvage of Rs. 1,80,000 at the end of the 5th year.

You are required to advise the company about lease or buy decision. Will decision change if the firm is allowed to claim investment allowance at 25%?

Note:

(1) The present value of Re. 1 at 18% discount factor is:

1st year	–	.847
2nd year	–	.718
3rd year	–	.609
4th year	–	.516
5th year	–	.437

(2) The present value of an annuity of Re. 1 at 18% p.a. is Rs. 3.127.

5. J.K Leasing is considering to lease out an equipment costing Rs. 12,00,000 for five years, which is the expected life of the equipment, and has an estimated salvage value of Rs. 2,00,000. J.K Leasing can claim a depreciation of 20% on w.d.v. of the asset but is not eligible for investment allowance.

The firm falls under a tax rate of 50% and the minimum post-tax required rate of return is 13%. You are required to calculate the lease rental which the firm should charge.

Note:

(1) Present Value Factor at 12% discount rate is as below:

Year 1 = .893; Year 2= .797; Year 3 = .712; Year 4 = .636 and Year 5 = .567

(2) Annuity Discount Factory at 12% for 5 years = 3.605.

6. Illustration 4:

Initial Investment – Rs. 60,000

Life of the Asset – 4 years

Estimated Net Annual Cash Flows:

	`
1st Year	15,000
2nd Year	20,000
3rd Year	30,000
4th Year	20,000

Compute the internal rate of return and also advise the lessor about the leasing out decision if his expected minimum rate of return is 15%.

Note:

Present Value Factor at various rates of discount.

Year	10%	12%	14%	15%	16%
1	.909	.892	.877	.869	.862
2	.826	.797	.769	.743	.756
3	.751	.711	.674	.657	.640
4	.683	.635	.592	.571	.552

20.9 SUGGESTED READINGS

- Jain, S.P and Narang, K.L. (2014). Advanced Accountancy-Vol-II. Kalyani Publisher, New Delhi.
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