CENTRE FOR DISTANCE AND ONLINE EDUCATION

UNIVERSITY OF JAMMU

JAMMU

SELF LEARNING MATERIAL
FOR
B. COM SEMESTER - III

COURSE NO. : BCG-301 **UNIT : I TO IV**

SUBJECT : CORPORATE ACCOUNTING **LESSON NO. : 1 -12**

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B. COM SEMESTER - III

UNIVERSITY OF JAMMU

B.COM. THIRD SEMESTER

CORPORATE ACCOUNTING

COURSE NO: BCG-301 **Max Marks = 100**

Internal assessment = 20

External Exam. = 80

OBJECTIVE: To acquaint the students with the concept and methods of corporate accounting.

UNIT-I: PROFIT PRIOR TO INCORPORATION

Concept of profit prior to incorporation, procedure for ascertaining P/L prior to incorporation; Computation of time ratio, sales ratio, procedure and basis of allocation of expenses and incomes.

Computation of profit prior to incorporation as per prescribed form.

UNIT- II: BANKING COMPANIES

Meaning of banking companies, important terms in banking business – rebate on bill discounted, statutory reserve, cash credit. Concept of nonperforming assets (NPA's) Preparation of P&L A/c, contents of schedule no. 13,14,15,16.

Preparation of B/S, various contents of schedule no 1 to 11; Treatment of contingent liabilities as per schedule no. 12.

UNIT-III:

ACCOUNTS OF INSURANCE COMPANIES

Meaning of insurance types of insurance, statutory and subsidiary books, important terms in insurance.

Preparation of revenue account & balance sheet of life insurance companies as per prescribed form.

UNIT — IV: ACCOUNTS OF HOLDING COMPANIES

Accounts of holding companies (Two concerns only), concept of holding & Subsidiary companies, legal requirements for holding companies; Meaning of minority interest, cost of control/ capital reserve, revenue profit and capital profits. Preparation of consolidated balance sheet as per prescribed form including treatment of unrealized profit, revaluation of assets and mutual owing.

SKILL DEVELOPMENT (GUIDELINES FOR CLASS ROOM TEACHING AND INTERNAL ASSESSMENT)

Critically evaluate financial statements (Published) of any reputed company.

Interaction with persons/officials concerned with LIC business.

Comment upon the consolidated financial statement of any holding co.

Create deep understanding of all concepts specified in the syllabus.

BOOKS RECOMMEND

1. Jain & Narang: Corporate Accounting, Kalyani Publishers, New Delhli
2. Gupta R.L. and Radha Swamy: Advanced Company Accounts, Sultan Chand & Son, New Delhi
3. Maheshwari S.N.: Corporate Accountancy, Vikas Publishing House, New Delhi.
4. Monga J.R. Ahuja: Financial Accounting, Mayur Paper Books, Noida Girish and Sehagl Ashok

5. Shukia, M.C. Grewal: Advanced Accounts, S. Chand and Co. New Delhi T.S. and Gupta SC
6. Moore C.L. and Managerial Accounting, South Western Publishing Co., Jaedicke
7. R.K. Cinnannati, Ohia
8. Tulsain, P.C: Corporate Accounting, S. Chand Publication, New Delhi.

NOTE FOR PAPER SETTER

Equal weightage shall be given to all the units of the syllabus. The external Paper shall be of the two sections viz, A & B of three hours duration.

Section-A: This section shall contain four short answer questions selecting one from each unit. Each question shall carry 5 marks. A candidate shall be required to attempt all the four questions. Total weightage to this section shall be of 20 marks.

Section-B: This section shall contain eight long answer questions of 15 marks each. Two questions with internal choice shall be set from each unit. A candidate shall have to attempt any four questions selecting one from each unit. Total weightage to this section shall be of 60 marks.

MODEL QUESTION PAPER

CORPORATE ACCOUNTING

Max Marks: -80 **Time allowed: -3 hrs**

Section A (20 Marks)

Attempt all the questions. Each question carries 5 marks.

1. How are profits prior to incorporation dealt with? How will you ascertain such profits?
2. What are the main features of bank's accounting system?
3. What is meant by re-insurance How is it helpful to insurance companies?
4. How would you ascertain the amount of minority interest?

Section B (60 Marks)

Attempt any four questions, selecting one question from each unit. Each question carries 15 marks each

1. ABC ltd. was incorporated on 1st July, 2012 to take over the business of XYZ Ltd. with effect from 1st April 2012. The following profit and loss account for the year ended 31st March, 2013 was drawn up:

	Rs.		Rs.
To commission	2625	By Gross profit	98000
To Advertisement	5250	By Bad debts recovered	500
To Managing director's remuneration	9000		
To Depreciation	2800		
To Salaries	18000		
To Insurance	600		
To Preliminary exp.	700		
To Rent and rates	3000		
To Discount	350		

To Bad debts To Net profit	1250 54925		
	98500		98500

The following details are available:

1. The average monthly turnover from July 2012 onwards are double than that of the previous months
2. Rent for the first 3 months was paid @ Rs. 200 p.m. and thereafter at a rate increased by Rs. 50 p.m.
3. Bad debts are Rs. 350, related to sales effected after 1st September, 2012 and realization of bad debts was in respect of debts written off during 2010.
4. Advertisement expenses were directly proportionate to the sales.

You are required to find out the profit prior to incorporation and state the treatment thereof in the books of the company.

OR

Define profit prior to incorporation. Explain the steps for computation of profit prior to incorporation.

2. Prepare profit and loss account of People's Bank from the following particulars for the year ended 31st March, 2012:

	Rs. ('000)
Interest on loan	250

Interest on savings A/C	150
Interest on cash credits	160
Interest on fixed deposits	190
Interest on overdrafts	70
Payments to employees	150
Discount on bill discounted	40
Rent and rates	5
Commission and brokerage	15
Auditors’ fees	10
Director’s fee and expenses	20

OR

Prepare Profit and loss A/c of Laxmi Bank from the following particulars for the year ended 31st March, 2012:

	Rs.(‘000)
Payment to employees	74
12,500 shares of Rs. 100 each	1250
Statutory reserve	600
Current a/c and deposits a/c	7732
Interest paid	27
Govt. securities	600

Other securities	825
Shares and stock	637
Dep. on Premises	22
Interest, discount and commission	245
Cash in hand with Reserve Bank of India	20
Money at call and short notice	274
Bills discounted	379
Loans and advances	4665
Bank Premises and Furniture	480
Non-Banking Assets	337

Make a provision for rebate on bills discounted Rs 3,000.

3. The Life Assurance Fund of an Insurance company on 31st March, 2012 showed a balance of Rs. 87,76,500. It was later found that the following were not taken into account:

   a. Dividend from investment Rs. 4,80, 000.
   b. Income tax on above Rs. 48,000.
   c. Bonus in reduction of Premium Rs. 8,77,500 (not taken as expense).
   d. Claims covered under re-insurance Rs. 4,23,000.
   e. Claims intimated, but not accepted by the company Rs. 7,62,000.

   Ascertain correct balance of the fund.

   OR

   a. Explain the meaning and types of Life Insurance?
   b. Prepare (with imaginary figures) the Balance sheet of a Life Insurance Company.

4. Define a holding company. How would you ascertain the amount of minority interest and cost of control?

   OR

H Ltd. acquired all the shares in S Ltd. on 1st Jan.2012 and the balance sheet of the two companies on 31st March, 2012:

Liabilities	**H Ltd. Rs.**	**S Ltd Rs.**	**Assets**	**H Ltd Rs.**	**S Ltd Rs.**
Share Capital	50,000	30,000	Sundry Assets	65,000	70,000
Reserve on 1-4-11	20,000	15,000			
Profit & loss A/c	25,000	10,000	Shares in S Ltd at cost	50,000	-
Creditors	20,000	15,000			
	1,15,000	70,000		1,15,000	70,000

The profit and loss account of S Ltd. had a credit balance of Rs. 3,000 on 1st April,2011.

Prepare Consolidated Balance Sheet as on 31st March, 201

Dear Learners,

Welcome to the subject of **Corporate Accounting**, an essential area of study that provides you with the conceptual and practical framework for understanding financial statements and accounting treatments in specialized corporate contexts. This subject is divided into four key units, each of which is designed to deepen your understanding of accounting practices in specific corporate scenarios.

In **Unit I**, you will study the concept of *Profit Prior to Incorporation*, which deals with how profits or losses are determined for the period before a company officially comes into existence. This includes learning the *time ratio* and *sales ratio*, and the systematic procedure for allocating incomes and expenses. You will also practice the computation of such profit or loss in the prescribed format.

Unit II focuses on *Banking Companies*, introducing you to key banking terms like *rebate on bills discounted*, *statutory reserve*, and *cash credit*, along with the crucial concept of *Non-Performing Assets (NPAs)*. You will learn how to prepare the Profit & Loss Account and Balance Sheet for banking companies, in accordance with regulatory schedules (Schedules 1 to 16), including proper treatment of *contingent liabilities*.

In **Unit III**, the focus shifts to *Accounts of Insurance Companies*. You will explore the types of insurance, necessary books maintained by insurance firms, and core insurance-related terms. The unit emphasizes the preparation of *Revenue Accounts* and *Balance Sheets* for *life insurance companies* in the format prescribed by regulatory authorities.

Lastly, **Unit IV** delves into *Accounts of Holding Companies*. This unit covers the relationship between holding and subsidiary companies, the legal framework, and key concepts such as *minority interest*, *cost of control*, and *capital/revenue profits*. You will also learn how to prepare *consolidated balance sheets* while addressing adjustments like unrealized profits, mutual owing, and asset revaluation.

We encourage you to approach each unit with a focus on both theory and its application through practical problems. Understanding corporate accounting not only builds your technical knowledge but also prepares you for real-world financial reporting and decision-making scenarios. Wishing you success in your learning journey.

Warm regards,
Centre of Distance and Online Education

UNIT- 1 Lesson no. 1

COURSE NO: BCG-301

INTRODUCTION TO PROFIT PRIOR TO INCORPORATION

STRUCTURE

1.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

After going through this lesson, you should be able to know:

- Concept and meaning of profit prior to incorporation.
- Importance and purpose of calculating profit prior to incorporation.

Learning outcomes

After completing the lesson, learners will be able to:

- articulate the meaning and concept of profit prior to incorporation
- evaluate the purpose of profit prior to incorporation

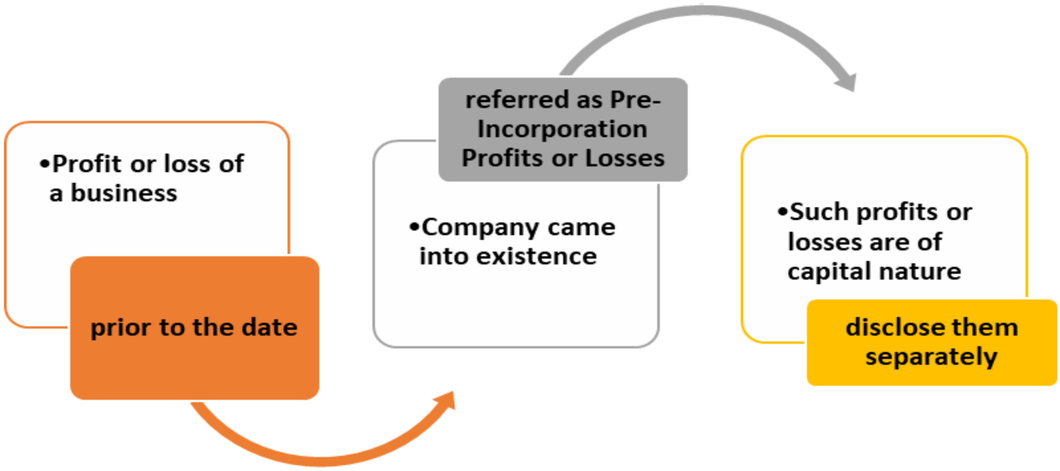
1.1 INTRODUCTION

Sometimes a company purchases a running business from a date prior to its incorporation, e.g., a company incorporated on 1st April, 2024 may purchase a business from 1st January, 2024, the date on which the accounting year of the vendor starts. Generally, the business is purchased from vendor on the last date of the balance sheet so that assets and liabilities are taken over on the basis of the figures given in the balance sheet. If the company has earned any profit from the date of purchase to the date of incorporation such profit is called ***as profit prior to incorporation.*** Such profit cannot be said to have been earned by the company as it is not available for distribution as dividend to the shareholders. Such profit is treated as capital profit and is transferred to ***Capital Reserve Account.*** If there is any loss prior to incorporation such loss is in the nature of capital loss and can be dealt in different ways discussed afterwards. It should be noted carefully that it is the date of incorporation and not the date of commencement of business which is taken into consideration for calculating profits or loss prior to incorporation. When a running business is taken over from a date prior to its incorporation/commencement, the profit earned up to the date of incorporation/commencement (incorporation, in case of private company; and commencement, in case of public company) is known as ***'Pre-incorporation profit'.*** The same is to be treated as capital profit since these are profits which have been earned before the company came into existence. In short, the profit earned after the date of purchase of business is called '**post-incorporation or post-acquisition** profit' and the profit earned before the date of purchase of business is termed as **'Pre-incorporation profit'.**

The general practice in this regard is that:

1) If there is a loss,
    i It is either written off by ***debit to the Profit and Loss Account*** or to a special account described as "Loss Prior to Incorporation" and show as an "asset" in the Balance Sheet,
    ii Alternatively, it may be **debited to the Goodwill Account.**

2) On the other hand, if a profit has been earned by business prior to the same



being taken over and the same is not fully absorbed by any interest payable for the period, it is credited to **Capital Reserve Account or to the Goodwill Account**, if any goodwill has been adjusted as an asset. The profit will not be available for distribution as a dividend among the members of the company.

EXAMPLE:

Y Ltd was incorporated on 1/7/2024 to take over the business of Z Ltd from 1/4/2024. The year ended on 31/3/2025. Calculate the pre incorporation period.

Solution: Business was taken over from 1/4/2024 and incorporated on: 1/7/20X1 Pre-Incorporation period = 1/4/2024 to 1/7/2025: (3 months)

1.2 MEANING AND CONCEPT OF PROFIT PRIOR TOINCORPORATION

☑ Meaning of Profit Prior to Incorporation

"The profits earned b/w the date of acquisition and the date of incorporation are called profits prior to incorporation. These profits are of capital nature and these are not available for distribution among shareholders and transferred to capital reserve account. If there is any loss prior to incorporation, it is capital loss and debited to goodwill account. Under company's act 2013, pre incorporation profits are capital profits and hence not available has the declaration of the dividend. A company comes into existence only when it receives the certificate of incorporation from the registrar of companies. Sometimes a newly incorporated company acquires a running business from a date prior to its incorporation. In such a case, the amount of profit earned by the company from the date of purchase to the date of incorporation is called as "profit prior to incorporation."

For example: ABC Ltd. was incorporated on **1st August 2024**, but it purchased the business of XYZ Enterprises with effect from **1st April 2024**. The profit earned between **1st April and 31st July 2024** is referred to as ***Profit Prior to Incorporation*.**

1.3 FEATURES OF PROFIT PRIOR TO INCORPORATION

1. **Capital Nature**

- Profit prior to incorporation is not a trading or revenue profit.
    - It is treated as a capital profit because it is earned before the company legally comes into existence.

2. **Non-Distributable**

    - It cannot be distributed as dividend to shareholders.

- This is because shareholders did not contribute capital or assume risk during the pre-incorporation period.

3. **<u>Earned in Transitional Period</u>**
    - This profit arises in the interim period between:
        - The date of acquisition of business, and
        - The date of incorporation of the company.
4. **<u>Transferred to Capital Reserve</u>**
    - Since it is capital in nature, it is transferred to the Capital Reserve Account in the balance sheet.
5. **<u>Used for Capital Adjustments</u>**
    - It is often used to:
        - Write off goodwill
        - Write down overvalued assets
        - Write off preliminary or incorporation expenses
        - Offset capital losses
6. **<u>Cannot be Recorded in Profit & Loss Account</u>**
    - It is not credited to the Profit and Loss Account, as it is not an operational profit.
7. **<u>Calculated through Apportionment</u>**
    - This profit is calculated by apportioning the total profit between:
        - Pre-incorporation period
        - Post-incorporation period
    - Apportionment is done using time ratio, sales ratio, or a combination.

8. **<u>Recognized under Company Law</u>**
   - As per the Companies Act and accepted accounting practices, this profit must be shown and treated separately from revenue profits.
9. **<u>Requires Separate Disclosure</u>**
   - In financial statements, it requires separate disclosure under capital
10. **<u>Not Earned by Legal Entity</u>**
    - Technically, the company is not a legal entity before incorporation. Hence, it cannot be considered as business profit earned by the company.

1. CHECK YOUR PROGRESS

FILL IN THE BLANKS

1. Profit earned between the date of acquisition and the date of incorporation is called _________.

   ANSWER: ***Profit Prior to Incorporation***
2. Profit prior to incorporation is of _________ nature.

   ANSWER: ***Capital***
3. Such profits are not available for distribution as __________ to shareholders.

   ANSWER: ***dividend***
4. Profit prior to incorporation is transferred to the _________ Account.

   ANSWER: ***Capital Reserve***
5. Loss prior to incorporation is treated as _________ loss.

   ANSWER: ***Capital***

1.4 PURPOSE OF PROFIT PRIOR TO INCORPORATION

Profit Prior to Incorporation refers to the profits earned by a business before it is legally incorporated as a company. These profits are generally calculated for the period between the date of acquisition or commencement of business and the date of incorporation.

Here are the **main purposes** of calculating and understanding Profit Prior to Incorporation:

1. Separation of Pre- and Post-Incorporation Profits

The primary purpose is to distinguish the profits earned before and after incorporation**.** This distinction is important for:

- Accurate accounting,
- Legal compliance,
- Fair distribution of profits.

2. Ensuring Fair Treatment of Shareholders

Profits prior to incorporation cannot be distributed as dividends because:

- The company did not legally exist during that period.
- Shareholders were not entitled to those profits.

Thus, identifying these profits ensures that dividends are declared only out of post-incorporation profits**,** protecting the interests of shareholders and aligning with corporate law.

3. Proper Allocation of Expenses and Income

The business might have common revenues and expenses for both periods. Identifying profit prior to incorporation allows:

- Proper apportionment of income and expenditure,
- Transparent financial reporting.

4. Compliance with Legal and Accounting Standards

Accounting for profit prior to incorporation helps meet the requirements of the Companies Act and other regulatory standards. It ensures that:

- The financial statements are correct,
- There's no misuse of funds earned before legal formation.

5. Taxation and Audit Clarity

Since profits prior to incorporation are treated as capital profits, they are not taxed in the same way as regular business income. Proper identification:

- Avoids tax complications,
- Provides clarity to auditors and stakeholders.

6. Use for Specific Purposes Only

These profits are often transferred to a capital reserve and can be used for:

- Writing off preliminary expenses,
- Paying for goodwill or assets acquired,
- Other capital nature expenses.

They are **not used for regular business operations or profit-sharing**.

From the above points, mainly purpose of company for calculating the profits or loss from pre and post incorporation of business is that, how much profit is earned from pre incorporation and post incorporation of business. These both profits are adjusted in the balance sheet on the liability side. To know about the profit earned by the company prior to its incorporation, company prepares its profit and loss account in two columns i.e., one for pre incorporation and other for post incorporation item.

2. CHECKYOUR PROGRESS

TRUE OR FALSE

1. Profit prior to incorporation can be distributed as dividends.
ANSWER: False

2. Profit prior to incorporation is considered a capital profit.
ANSWER: True

3. Shareholders are entitled to profits earned before the company was legally formed.
ANSWER: False

4. Profit prior to incorporation is usually transferred to Capital Reserve.
ANSWER: True

5.A separate columnar Profit and Loss Account is prepared to distinguish pre- and post-incorporation profits.
ANSWER: True

1.5 LET US SUM UP

- Profit Prior to Incorporation refers to the profits earned by a business between the date of acquisition and the date of incorporation of the company.
- These profits are of capital nature, not revenue, and hence, not available for distribution as dividends to shareholders.

- Such profit is transferred to the Capital Reserve Account and can be used for capital adjustments like writing off preliminary expenses, goodwill, or overvalued assets.
- Any loss prior to incorporation is treated as a capital loss and may be debited to goodwill or adjusted against capital reserves.
- The Companies Act, 2013 requires that pre-incorporation profits be disclosed separately in the financial statements.

1.6 KEYWORDS

- **Profit Prior to Incorporation:** The profit earned between the date a company acquires a business and the date it is legally incorporated. It is capital in nature and not available for dividend distribution.
- **Capital Profit:** Profits that are not derived from regular trading activities but from capital sources like pre-incorporation periods. These are not shared with shareholders.
- **Capital Reserve:** A reserve created in the balance sheet to which capital profits (like profit prior to incorporation) are transferred. It is used for capital purposes like writing off losses or expenses.
- **Apportionment of Profit:** The process of dividing the total profit or loss between the pre- and post-incorporation periods using suitable bases like time or sales.

1.7 SELF-ASSESSMENT QUESTIONS

1. Discuss the basic concepts involved of profit prior to incorporation?

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2. What are the characteristics and nature of a profit prior to incorporation?

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3. What is the purpose of calculating profit prior to incorporation?

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1.8 LESSON END EXERCISE

1. Y Ltd was incorporated on 1/7/2024 to take over the business of Z Ltd from 1/4/2025. The year ended on 31/3/20X2.Calculate the pre incorporation period.

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2. Q Ltd was incorporated on 1/8/24 to take over the business of W Ltd from 1/5/2025 The year ended on 31/3/2025. Which Period should be taken as the Pre- Incorporation Period and Post-Incorporation Period?

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3**. CHECK YOUR PROGRESS**

MATCH THE FOLLOWING

A. Items	B. Items
1. Profit prior to incorporation	→ b. Capital profit
2. Profit after incorporation	→ a. Revenue profit
3. Pre-incorporation expenses	→ e. Debited to Capital Reserve
4. Capital Reserve	→ c. Used to write off preliminary expenses
5. Dividend distribution	→ d. Done only from post-incorporation profit

Answer Key:

- 1 → b
- 2 → a
- 3 → e
- 4 → c
- 5 → d

1.9 SUGGESTED READING

1. S.P. Jain and K.L. Narang. Corporate accounting. Kalyani Publication.

2. S.N. Maheshwari, and. S. K. Maheshwari. Financial Accounting. Vikas Publishing House, New Delhi

UNIT: 1 **LESSON: 2**

COURSE CODE: BCG 301

PROCEDURE FOR ASCERTAINING P/L PRIOR TO INCORPORATION

STRUCTURE:

2.0 LEARNING OBJECTIVES AND LEARNING OUTCOMES

Learning objectives

- To compute the **correct amount of capital profit** earned before incorporation.
- To apportion **income and expenses** between pre- and post-incorporation periods correctly.

- To ensure **compliance with accounting principles** and correct treatment in financial statements.

Learning outcomes

- Compute the capital profit earned before the date of incorporation with accuracy using appropriate accounting techniques.
- Apportion various incomes and expenses effectively between the pre-incorporation and post-incorporation periods based on suitable ratios (time, sales, or actual basis).

- Apply correct accounting treatment to profits and expenses in compliance with standard accounting principles and practices.

2.1 INTRODUCTION

When a newly established company acquires an existing business with a date preceding its legal incorporation, it may generate income prior to its formal existence. However, according to accounting principles and company law, a company cannot earn business income before incorporation, as it does not legally exist during that period. Consequently, the profit earned between the acquisition date and the incorporation date is termed Profit Prior to Incorporation and is classified as capital profit rather than revenue profit. To differentiate this profit from the regular business profit earned post-incorporation, companies prepare a columnar Profit and Loss Account, segregating items between the pre-incorporation and post-incorporation periods. This practice ensures accurate financial reporting and prevents the unlawful distribution of capital profits as dividends.

- ***Example:*** *ABC Ltd. was incorporated on* ***1st August 2024*** *but acquired a business with effect from* ***1st April 2024****. The company's financial year ends on* ***31st March 2025****. Therefore, the profits from* ***1st April to 31st July 2024*** *represent the* ***pre-incorporation period****, and from* ***1st August 2024 to 31st March 2025*** *represent the* ***post-incorporation period****. While preparing the Profit and Loss Account, ABC Ltd. must allocate income and expenses to these two periods using appropriate methods such as* ***time ratio*** *and* ***sales ratio****. The profit allocated to the pre-incorporation period will be treated as* ***capital reserve****, not available for dividend, while the post-incorporation profit will be available for distribution to shareholders.*

2.2 Procedure for ascertaining profit prior to incorporation

The procedure for determining profit prior to incorporation involves assessing the financial performance of a business for the period before a company is legally established. This assessment is essential when a company acquires a business that was operational before its incorporation, as the profits earned during this pre-incorporation period are classified as capital profits and are not distributable as dividends. The process ensures the accurate allocation of profits between the pre-incorporation and post-incorporation periods. The following outlines a step-by-step procedure:

1. **Prepare trading account.** In order to ascertain the amount of gross profit, the trading a/c, for the whole period should be prepared. The whole period means the period starting from the date of incorporation to the last date of closing of accounts.
2. **Calculation of time ratio.** Calculate time ratio by taking into consideration the time falling from the date of purchase of business to the date of incorporation and the period b/w the date of incorporation to the last date of preparing final accounts.

3. **Calculate sales ratio**. It may be calculated as under: - sales ratio = sales of pre incorporation period: sales of post incorporation period.
4. **Prepare profit and loss a/c** for pre incorporation and post incorporation periods immediately. This is done on the following basis: (a) Gross profit should be allocated b/w two periods on the basis of sales ratio. (b) Expenses that are connected with sales should be allocated on the basis of sales ratio. Examples of such expenses are: selling expenses are; advertisement, discount allowed, bad debts etc. (c) Expenses that are incurred on the basis of time should be allocated on the basis of time ratio. For example: administration expenses, audit fees, salaries, rent and taxes, misc. Expenses, depreciation, insurance, electricity charges, general expenses, printing and stationery etc. (d) Expenses which are incurred after the incorporation of the company like director fees, preliminary expenses, debenture interest etc. Should be charged wholly to the post incorporation period.

"Profit prior to incorporation" is the profit earned or loss suffered during the period before incorporation. It is a capital profit and is not legally available for distribution as dividend because a company cannot earn a profit before it comes into existence. Profit earned after incorporation is revenue profit, which is available for dividend".

2.3 INCORPORATION OF BUSINESS

Incorporation is the formation of a new corporation (a corporation being a legal entity that is effectively recognized as a person under the law). The corporation may be a business, a non-profit organization, sports club, or a government of a new city or town.

2.3.1 Features of incorporation of business

1. **Separate Legal Entity**

- The company has its own legal identity, separate from its shareholders and directors.
- It can own property, enter contracts, sue and be sued in its own name.

2. **Perpetual Succession**

- The company continues to exist even if the shareholders, directors, or owners change or die.
- It has an uninterrupted existence unless legally dissolved.

3. **Limited Liability**

- The liability of shareholders is limited to the amount unpaid on their shares.
- Personal assets of shareholders are not at risk for the company's debts.

4. **Transferability of Shares**

- In the case of a public company, shares are freely transferable.
- In a private company, there are restrictions, but shares can still be transferred according to the Articles of Association.

5. **Capacity to Sue and Be Sued**

- The incorporated company can initiate or face legal proceedings in its own name.

6. **Artificial Legal Person**

- A company is not a natural person, but the law recognizes it as having legal personality.
- It can enter contracts and hold property, but only through human agents (directors/officers).

2.4 REQUIREMENT FOR CERTIFICATE OF INCORPORATION

The Certificate of Incorporation (Requirements)

The information required differ in different states. However, there are some common information that are asked by almost all the states and so, must be included in the Certificate of Incorporation, accordingly. They are as follows:

- **Business purpose -** It would describe the incorporated tasks a company has to do or provide. At present, only two types of business purpose clauses are used. They are:

    1. General - General purpose clauses are accepted by some and not all states. It indicates that the budding company has been formed to carry out "all lawful business" in the region.

    2. Specific - Alternatively, some states have made it mandatory for the business owners to furnish a more detailed explanation of the products and/or services to be offered by their companies.

- **Corporate name -** A chosen name must be added to the Certificate of Incorporation. This should be followed with the corporate identifier like "Corporation", "Incorporated", "Company", or one of the abbreviations like "Inc". A preliminary name availability search is advisable, prior to the submission of the Articles of Incorporation. In case of online incorporation, the state will have final say with regards to the name chosen for the company and that the name shouldn't deceive or mislead the consumers.

- **Registered agent -** Almost all the states require every corporation to have a registered agent of their own in the state of incorporation. Registered agents will receive all the important legal as well as tax documents on behalf of the corporation. A typical registered agent will need a physical address (P.O box nos.) in the state of incorporation and should be accessible during normal business hours.

- **Incorporator -** An incorporator is the person who prepares and files the Certificate of Incorporation with the concerned state.

- **Share par value -** It refers to the stated minimum value, and generally doesn’t correspond to the actual value. Usually, $0.01, $1.00 or no par are some of the common par values. In reality, the value of a share is based on its fair market value, or whatever amount a buyer is willing to pay for the same.
- **Number of authorized shares of stock -** An incorporation needs to stipulate the exact number of shares they as a company are willing to authorize. Moreover, it is mandatory for every corporation, be it small or large, to have stock. A stock represents ownership in the corporation.
- **Directors -** A lot of states need the name and addresses of the initial directors of the corporation in the incorporation papers. They are responsible for the corporation’s daily affairs and oversee major corporate decisions. Directors hold an elected office as chosen by the shareholders’ mandate and will be responsible to appoint officers.
- **Preferred shares -** If a company/corporation is willing to permit both preferred as well as common shares of stock, then this should have a mention in the Articles of Incorporation, along with the voting rights information. Generally, preferred shares provide its shareholders preferential payments of distribution of assets or dividends, in case the company shuts down its operations. A lot of small business owners only allow shares of common stock.
- **Officers -** Officers include president, vice president, secretary and treasurer have the responsibility towards the daily activities of the corporation. Certain states require that officer information be included, while others have kept it optional.
- **Legal address of the company/corporation -** In many states, it is optional to provide the legal or principal business address. But in some states, it is mandatory.

1. CHECK YOUR PROGRESS'

MATCH THE FOLLOWING

Column A	Column B
1. Profit prior to incorporation | |	a. Legal existence of company begins
2. Time ratio | |	b. Charged to post-incorporation period
3. Sales ratio | |	c. Used to divide gross profit
4. Director's fees | |	d. Capital profit
5. Certificate of Incorporation | |	e. Based on duration of each period

ANSWERS: 1 → d, 2 → e, 3 → 4 → b 5 → a

2 CHECK YOUR PROGRESS

MARK TRUE/ FALSE TO THE FOLLOWING STATEMENTS

1. Profit prior to incorporation is a revenue profit and can be distributed as dividend.

ANSWER: False, because profit prior to incorporation is capital profit and can not be treated as dividend.

2. Director's fees are charged entirely to the post-incorporation period.

ANSWER: True, because director's fees are incurred **only after** the company comes into legal existence, hence charged fully to post-incorporation.

3. A company becomes a legal entity only after receiving the certificate of incorporation.

ANSWER: True, A company has **no legal existence** until it receives its certificate of incorporation.

4. Sales ratio is used to allocate administration expenses.

ANSWER: False, **Administration expenses** are time-based and should be

5. Limited liability protects shareholders' personal assets from company debts.

ANSWER: TRUE, under **limited liability**, shareholders are only liable up to the unpaid amount on their shares; personal assets are protected.

2.5 LEGAL BENEFITS OF INCORPORATION CERTIFICATE

Legal benefits

- **Protection of personal assets**. One of the most important legal benefits is the safeguarding of personal assets against the claims of creditors and lawsuits. Sole proprietors and general partners in a partnership are personally and jointly responsible for all the liabilities of a business such as loans, accounts payable, and legal judgments. In a corporation, however, stockholders, directors and officers typically are not liable for the company's debts and obligations. They are limited in liability to the amount they have invested in the corporation. For example, if a shareholder purchased $100 in stock, no more than $100 can be lost. Corporations and limited liability companies (LLCs) may hold assets such as real estate, cars or boats. If a shareholder of a corporation is personally involved in a lawsuit or bankruptcy, these assets may be protected. A creditor of a shareholder of a corporation or LLC cannot seize the assets of the company. However, the creditor can seize ownership shares in the corporation, as they are considered a personal asset.

- **Transferable ownership**. Ownership in a corporation or LLC is easily transferable to others, either in whole or in part. Some state laws are particularly corporate-friendly. For example, the transfer of ownership in a corporation incorporated in Delaware is not required to be filed or recorded

  - **Raising funds through sale of stock**. A corporation can easily raise capital from investors through the sale of stock.

- **Durability**. A corporation is capable of continuing indefinitely. Its existence is not affected by the death of shareholders, directors, or officers of the corporation.

- **Credit rating**. Regardless of an owner’s personal credit scores, a corporation can acquire its own credit rating, and build a separate credit history by applying for and using corporate credit.

2.6 LET US SUM UP

- **Profit Prior to Incorporation** refers to the income earned by a business between the date of acquisition and the date of incorporation. As a company legally does not exist during that period, such profit is treated as **capital profit**, not available for dividend distribution.
- **Calculation of Profit Prior to Incorporation** involves:
  - Preparing a **Trading Account** for the entire period.
  - Calculating **Time Ratio** and **Sales Ratio**.
  - Allocating **gross profit and expenses** based on these ratios.
  - Classifying profits into **capital (pre-incorporation)** and **revenue (post-incorporation)**.
- **Incorporation of a Business** gives the firm a **legal identity**, separates owners’ liabilities, and provides various legal and financial benefits like raising capital, transferable ownership, and perpetual succession.

2.7 KEYWORDS

- **Profit Prior to Incorporation:** Profit earned before a company's legal formation; treated as capital profit.
- **Capital Profit:** Non-operating income not available for dividend.
- **Revenue Profit:** Operating profit earned after incorporation, available for distribution.
- **Time Ratio:** Ratio used to apportion time-based expenses.
- **Sales Ratio:** Ratio used to divide sales-based income and expenses.

- **Registered Agent:** Person or entity authorized to receive legal documents on behalf of the company.

3. CHECK YOUR PROGRESS

FILL IN THE BLANKS

1. Profit earned before the incorporation of a company is termed as ---------

Profit Prior to Incorporation.

2. Profit prior to incorporation is treated as _____________and is not available for distribution as dividend.

capital profit

3. Administration expenses are apportioned on the basis of _________

Time Ratio.

4. Selling and distribution expenses are divided between the periods using __________

Sales Ratio.

5. A company comes into legal existence only after receiving the _____________

Certificate of Incorporation.

2.8 SELF ASSESSMENT QUESTIONS

Question 1: Explain the procedure of ascertaining profit/loss prior to incorporation?

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Question 2: Discuss the legal benefits of incorporation certificate?

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2.9 LESSON END EXCERCISES

Question 3: What are the requirements of incorporation certificate?

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2.10 SUGGESTED READING

1. S.P. Jain and K.L. Narang. Corporate accounting. Kalyani Publication.
2. S.N. Maheshwari, and. S. K. Maheshwari. Financial Accounting. Vikas Publishing House, New Delhi

UNIT: 1 **LESSON: 3**

COURSE CODE: BCG-301

METHODS OF COMPUTING PROFIT AND LOSS PRIOR INCORPORATION

STRUCTURE:

3.0 LEARNING OBJECTIVES AND OUCTOMES

Learning objectives

By the end of this lesson on Profit Prior to Incorporation, students will be able to:

- To define and distinguish pre- and post-incorporation profit.
- To explain why pre-incorporation profit is treated as a capital item.

- To calculate time-based, sales-based and weighted ratios for apportionment.
- To prepare the necessary journal entries for income-tax adjustments.
- To disclose related items (sundry debtors, bank balances) correctly in the final accounts.

Learning Outcomes

After completing this topic, students will be able to:

- Demonstrate the steps to split total profit into pre- and post-incorporation periods.
- Accurately compute apportionment ratios under different methods and apply them to

expenses/incomes.

- Prepare a combined trading account and related profit-and-loss entries, showing correct treatment of capital profits.

3.1 INTRODUCTION

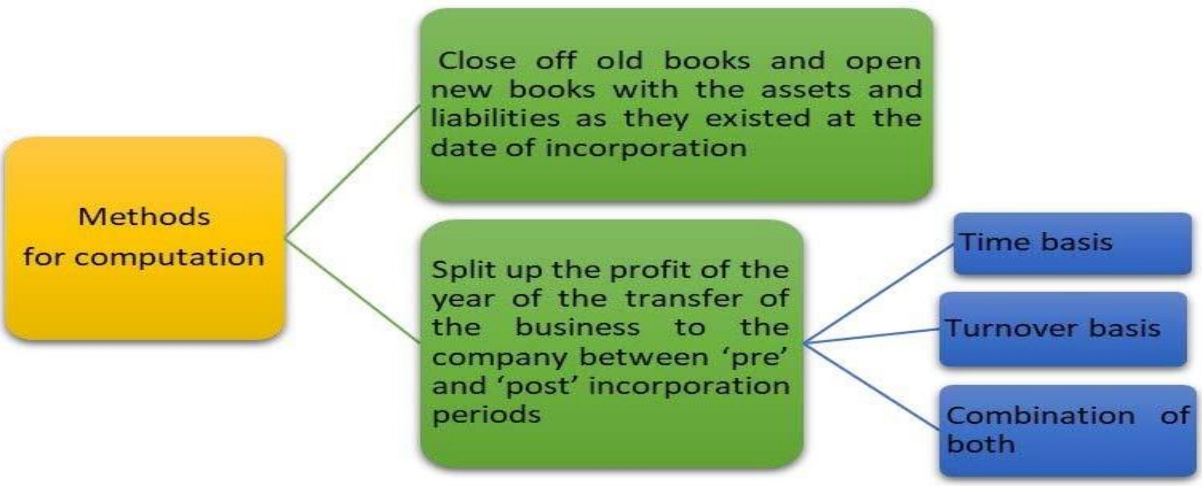
When a running business is taken over from a date prior to its incorporation / commencement, the profit earned up to the date of incorporation/commencement (incorporation, in case of private company; and commencement, in case of public company) is known as „Pre-incorporation profit‟. The same is to be treated as capital profit since these are profits which have been earned before the company came into existence. In short, the profit earned after the date of purchase of business is called ***post-incorporation or post-acquisition profit‟*** and the profit earned before the date of purchase of business is termed as ***Pre-incorporation profit***.

For example, X Ltd. was incorporated on 1st April 2006, took over a running business, Y Ltd., from 1st January 2006 and it closed its accounts on 31st December 2006. Now, the company X Ltd. is entitled not only to the profit/loss made by Y Ltd. from 1st April to 31st December 2006 but also to the profit/loss made by Y Ltd. from 1st January 2006 to 31st

March 2006. Thus, any profit/loss made before the incorporation is known as "Profit (Loss) Prior to Incorporation" which is treated as a capital profit and the same cannot be distributed as business profit. Hence, it cannot be distributed by way of dividend. The same is to be transferred to Capital Reserve or may be adjusted against Goodwill. "Loss prior to incorporation" is treated as a capital loss and, hence, the same is shown under the head "Miscellaneous Expenditure" in the assets side of the Balance Sheet.

3.2 METHODS OF COMPUTING PROFIT AND LOSS PRIOR TO INCORPORATION

Methods of computing profit and loss prior incorporation



existed at the date of incorporation. In this way, automatically the result to that will be adjusted.

Methods 2nd: the second method is to split up the profit for the year of the transfer of the business to the company between "pre-Incorporation" and "post-Incorporation" periods. This is done either on the time basis or on the turnover basis or by a method which combines the two.

i **Time basis: -** Some types of expenses and income which are divided between pre and post period item on the basis of time ratio. For example-Depreciation, salary & wages, Rent and trade expenses etc.

Example 1: (Determination of pre and post incorporation periods) The partners of Omega Ltd. decided to convert their partnership into a private limited company called Omega (P) Ltd. with effect from 1st April, 2023. However, due to some procedural difficulties, the company could be incorporated only on 1st July, 2023. The accounts of the business continued for the accounting year ended 31st March, 2024. Determine the pre and post incorporation periods and corresponding time ratio.

Solution: Pre-incorporation period (1.4.2023 to 1.7.2024) = 3 months

Post incorporation period (1.7.2024 to 31.3.2024) = 9 months

Time Ratio = 3:9 = 1:3

ii **SALES BASIS/ Turnover Basis:** Some expenses and Incomes are divided between the pre and post period items on the basis of sales /Turnover.

Example 2: **(Calculation of time ratio and sales ratio)**

Lion Ltd. was incorporated on 1.8.2024 to take over the running business of M/s Happy with assets from 1.4.2024. The accounts of the company were closed on 31.3.2025.

The average monthly sales during the first four months of the year were twice the average monthly sales during each of the remaining eight months.

Calculate time ratio and sales ratio for pre and post incorporation periods.

Solution

Time ratio:

Pre-incorporation period (1.4.2024 to 1.8.2025) = 4 months

Post incorporation period (1.8.2024 to 31.3.2025) = 8 months

Time ratio = 4:8 or 1: 2

Sales ratio:

Average monthly sale before incorporation was twice the average sale per month of the post incorporation period. If x is the sales per month in post incorporation period, then sales per month of pre incorporation period will be 2x.

Weighted sales ratio = 4   2x: 8   1x =8x: 8x or 1: 1

Calculation of Weighted Ratio:

The total amount of certain expenses such as salary, wages etc. does not remain the same throughout the year. If the expenses remain the same throughout the year, these can be easily divided in the time ratio. But if the expenses change as salary due to a greater number of workers employed because of conversion of partnership business into a limited company, then weighted ratio is to be calculated by taking into consideration time and the number of workers in pre- and post-incorporation periods.

For example: A company is incorporated on 1st May, 1998. The total amount of wages paid is Rs. 90,000. Number of workers employed in pre-incorporation period 6, post-incorporation period 24. The wages for pre-incorporation period will be 90,000 x 1/9 = Rs. 10,000 and post-incorporation wages are 90,000 x 8/9 = Rs. 80,000. The ratio is calculated as under:

Simple time ratio = 4 month: 8 months or 1: 2

Weighted time ratio = (1 x 6): (2 x 24) = 6: 48 or 1: 8

3.3 SPECIAL POINTS IN RESPECT OF CERTAIN ITEMS

1. Income-tax: For provisions relating to advance tax, provision for income-tax refer any recommended Text Book. The following is an example –

Illustration

Trial Balance of Soma Ltd. as on 31st March, 2024[extract]

Name of Account	Dr. (Rs.)	Cr. (Rs.)
Advance income tax for 1995-96	2,20,000	-
Advance income tax for 1996-97	2,30,000	-
Provision for income tax 1995-96		2,00,000

Adjustments:

i. The income tax assessment for 2023-2024 completed during the year showed gross tax demand of Rs. 2,40,000 but no effect has been given for this in the account.

ii. Provision for income tax is to be made for Rs. 2,10,000 for 2023- 2024.

Show Journal Entries and relevant extract in the Final Account.

Solution:

DATE	PARTICULARS	L.F	Dr. (Rs.)	Cr. (Rs.)
31.3.2024	Profit & Loss A/c Dr. To Provision for Income-tax A/c ***(Being the amount of provision for Income-tax for the year 2023-2024)***		2,10,000	2,10,000
31.3.2024	Profit & Loss Appropriation A/c Dr. To Provision for Income-tax A/c		40,000	40,000

	(Being the amount of less provision for Income-tax for 2023-2024 charged to P&L A/c of this year 203-2024)			
31.3.2024	Provision for Income-tax A/c Dr. To Advance Income-tax A/c ***(Being the amount of advance income-tax for earlier year 2023-2024 adjusted with provision for tax.)***		2,20,000	 2,20,000

2. Sundry Debtors: Sundry debtors should be segregated namely, debts outstanding for a period exceeding six months, and other debts.

In regard to Sundry Debtors particulars to be given separately of –

(a) debts considered good and in respect of which the company is fully secured :

(b) debts considered good for which the company holds no security other than the debtor's personal security; and

(c) debts considered doubtful or bad.

3. **Bank Balances:** Bank balances should be shown as follows –

   a. Bank balance with Scheduled Banks, and
   b. Bank balance with others.

Thus, any profit/loss made before the incorporation is known as "Profit (Loss) Prior to Incorporation" which is treated as a capital profit and the same cannot be distributed as business profit. Hence, it cannot be distributed by way of dividend. The same is to be transferred to Capital Reserve or may be adjusted against Goodwill. "Loss prior to incorporation" is treated as a capital loss and, hence, the same is shown under the head "Miscellaneous Expenditure" in the assets side of the Balance Sheet. Business is very often taken over by a company from a date earlier than the date of its incorporation or date of commencement of business. The profit of the company up to the date of its incorporation/commencement of business, cannot be treated as Trading Profit of the company. Thus, the profit arising to the company from the date of purchase, up to the date of incorporation/commencement of business is known as pre-incorporation profit. This pre-incorporation profit being considered as capital profit is transferred to Capital Reserve or adjusted with Goodwill. When a business is taken over and working continued, usually same set of books is used and ultimately, the total profit for the year is divided between pre and post incorporation periods. At times, this division is made on some estimation.

The usual practice is to prepare the profit and loss account only at the end of the year and then to allocate the profits between the two periods in the following manner:

(a) Gross profit and expenses connected with sales to be apportioned according to the ratio of sales for the two periods.

(b) Salaries, rent, interest etc. should be apportioned on the basis of ratio of time before incorporation and after.

(c) Expenses solely incurred for the company on and after its incorporation e.g. preliminary expenses, directors' fees, etc. should be charged wholly to the post-incorporation period.

1. CHECK YOUR PROGRESS

MULTIPLE CHOICE QUESTIONS

1. Which of the following is *not* a method for computing profit or loss prior to incorporation?

A. Closing old books and opening new books
B. Apportionment based on time and sales

C. Preparing only a consolidated profit and loss account
D. Separate audit of vendor’s books

☑ **Answer:** C. Preparing only a consolidated profit and loss account

2. If the company is incorporated on 1st August and the accounting year starts on 1st April, what is the time ratio (pre:post)?

A. 4:8
B. 8:4
C. 1:3
D. 1:2

☑ **Answer:** D. 1:2

3. Profit prior to incorporation is generally treated as:

A. Revenue profit
B. Deferred revenue
C. Capital profit
D. Operating profit

☑ **Answer:** C. Capital profit

3.4 METHODS OF ACCOUNTING

1. Steps to find out the profit or loss before and after incorporation are as follows:
2. Prepare one trading account for the whole period. Do not consider the date of incorporation. Thus, one figure of gross profit for the entire period is arrived at.
3. The gross profit is apportioned between the two periods, prior to incorporation and post-incorporation, on the basis of sales in the two periods.

4. The various expenses, which are shown in the profit and Loss Account, should be divided between pre and post incorporation periods on some logical and appropriate basis.

2. CHECK YOUR PROGRESS

Determine whether each statement is True or False.

1. Pre-incorporation profit can be distributed as dividend.
2. Depreciation is typically apportioned on a time basis.
3. Sales-based apportionment uses the ratio of turnover before and after incorporation.
4. A weighted ratio ignores variations in the number of workers.
5. Loss prior to incorporation appears under "Miscellaneous Expenditure."

Answers

1. False
2. True
3. True
4. False
5. True

3.5 LET US SUM UP

- Profit or loss prior to incorporation arises when a company takes over a business with effect from a date **earlier than its incorporation**.
- Two major methods are used to compute pre- and post-incorporation profit:

✓ **Closing old books and opening new books** at the date of incorporation.

✓ **Apportioning the annual profit** between pre- and post-incorporation periods based on **time** and **sales** ratios.

- **Time Basis** is used for fixed or regular expenses like salary, rent, and depreciation.
- **Sales Basis** is used for variable items like commission, carriage outward, and gross profit.
- **Time Ratio** = Months in pre-incorporation period: Months in post-incorporation period.
- **Sales Ratio** = Sales during pre-incorporation period: Sales during post-incorporation period.

3.6 KEYWORDS

- **Time Basis** is used for fixed or regular expenses like salary, rent, and depreciation.
- **Sales Basis** is used for variable items like commission, carriage outward, and gross profit.
- **Time Ratio** = Months in pre-incorporation period: Months in post-incorporation period.
- **Sales Ratio** = Sales during pre-incorporation period: Sales during post-incorporation period.

3.7 SELF ASSESSMENT QUESTIONS

1) Name two methods of computing profit or loss prior to incorporation.

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2. Define time ratio and sales ratio with one example each.

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3. A company is incorporated on 1st August 2024 to take over a business from 1st April 2024. The financial year ends on 31st March 2025. Calculate the time ratio.

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3. CHECK YOUR PROGRESS

MATCH THE FOLLOWING

Column 1	Column 2
1. Capital Reserve	A. Expense apportionment using months only
2. Time Basis	B. Expense apportionment based on turnover
3. Sales Basis	C. Item created when pre-incorporation profit is not distributed
4. Weighted Ratio	D. Unrealised loss prior to incorporation shown as an asset
5. Miscellaneous Expenditure	E. Expense apportionment weighted by time and change in a factor

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Answers

1 → C
2 → A
3 → B
4 → E
5 → D

3.8 LESSON AND EXERCISE

1. In the above example, if average monthly sales during April to July were double the average monthly sales during August to March, calculate the sales ratio.

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2. A company is incorporated on 1st August 2024 to take over a business from 1st April 2024. The financial year ends on 31st March 2025. Calculate the time ratio.

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3.9 SUGGESTED READINGS

1. S.P. Jain and K.L. Narang. Corporate accounting. Kalyani Publication.
2. S.N. Maheshwari, and. S. K. Maheshwari. Financial Accounting. Vikas Publishing House, New Delhi

UNIT: 1 **LESSON: 4**

COURSE CODE: BCG-301

BASIS AND PROCEDURE OF ALLOCATION OF INCOMES AND EXPENSE

STRUCTURE:

4.0 LEARNING OBJECTIVES AND OUTCOMES

Learning objectives

- Understand the concept and significance of profit prior to incorporation.

- Identify the appropriate bases for apportioning incomes and expenses between pre- and post-incorporation periods.

Learning outcomes

After completing this lesson, learners will be able to:

- Meaning of profit prior to incorporation and its importance in accounting and financial reporting.
- Classify and apportion income and expenses using logical and acceptable bases (e.g., time, turnover, ratio of area used).

4.1 INTRODUCTION

When a newly formed company acquires a running business with effect from a date prior to its legal incorporation, it is common for the company to earn revenue during this interim period. However, since a company is not legally recognized until its incorporation date, any profit earned before this date is termed ***"Profit Prior to Incorporation."*** Such profit is capital in nature and must be treated separately from revenue profits.

For accurate reporting, it becomes essential to apportion the incomes and expenses between the pre- and post-incorporation periods using appropriate bases. This ensures fair presentation in the financial statements and compliance with accounting principles. The process involves determining relevant time periods, categorizing expenses as specific or common, and using justified bases for allocation.

4.2 BASIS AND PROCEDURE OF ALLOCATION OF INCOME AND EXPENSES

Basis of allocation of items between 'pre' and 'post' incorporation period

1. Time basis: - Some types of expenses and income which are divided between pre and post period item on the basis of time ratio. For example-Depreciation, salary & wages, Rent and trade expenses etc.

List of Expenses: Allocated on the basis of Time:

- Office and Administration Expenses
- Salaries to Office Staff
- Rent, Rates and Taxes
- Depreciation on Fixed Assets
- Printing and Stationery
- Insurance
- Audit Fees
- Miscellaneous Expenses
- Distribution Expenses (Fixed Portion)
- Travelling Expenses (General)
- Interest of Debenture
- General Expenses
- Expenses Fixed in Nature

The table provided illustrates the allocation of certain expenses with reasons based on a time ratio:

Expenses	Reasons For Time Basis

Rent	Incurred evenly over time
Salaries (fixed staff)	Paid monthly, irrespective of business volume
Insurance	Covers time-based risk
Depreciation	Depends on usage over time
General Administrative Expenses	Related to time, not to activity level

2. Turnover/ Sales basis: - Some types of expenses and income which are divided between pre and post period item on the basis of turnover. For example- Sales promotion expenses, bad debts, sales commission and selling expenses.

- **List of Expenses: Allocated on the basis of Sales/Turnover:**
  - Gross Profit
  - Selling Expenses
  - Advertisement
  - Carriage Outwards
  - Godown Rent
  - Discount Allowed
  - Salesmen's Salaries
  - Commission to Salesmen
  - Promotion Expenses for Sales
  - Distributions Expenses (Variable Portions)
  - Free Samples given
  - Expenses incurred for After-Sale Service, etc.
  - Delivery Van Expenses

The table provided illustrates the allocation of certain expenses with reasons based on a time ratio:

Expense Type	**Reason for Turnover Basis**

Selling Commission	Paid on volume of sales
Carriage Outward	Depends on quantity sold
Advertisement Expenses	Related to marketing and selling efforts
Discount Allowed	Based on total sales value

Treatment of debtors and creditors taken over from a vendor is handled during the acquisition of a running business: A company taking over a running business may also agree to collect its debts as an agent for the vendor and may further undertake to pay the creditors on behalf of the vendors ins such a case, the debtors and creditors of a vendors will be included in the accounts for the company by debit or credit separate total accounts in the general ledger to distinguish them from the debtors and creditors of the business and contra entries will be made in corresponding suspense account. Also details of debtors and creditors balance will be kept in separate ledger. The vendor is treated as a creditor for the cash received by the purchasing company in respect of the debts due to the vendor, just as if he has himself collected cash from his debtors and remitted the proceeds to the purchasing company. The vendor is considered a debtor in respect of cash paid to his creditors by the purchasing company. The balance of cash collected, less paid, will represent the amount due to or by the vendor, arising from debtors and creditors balances which have been taken over, subject to any collection expenses. The balance in the suspense account will always equal to the amount of debtor and creditors taken over remaining unadjusted at any time.

3. Expenses Specific to Pre- or Post-Incorporation: Some expenses are directly identifiable with one period.

1. Some expenses which are treated as always pre-incorporation period like promoters' remuneration, survey report and expenses regarding articles of association and memorandum of association.
2. Some expenses which are treated as always post-Incorporation period like directors' fees and debenture interest.

The table provided illustrates the expenses directly identifiable with one period

Expense Type	**Allocation**
Preliminary Expenses	Post-incorporation only
Director’s Remuneration	Post-incorporation only
Audit Fees (Statutory)	Post-incorporation only
Formation Expenses	Post-incorporation only

4.2.1 BASIS OF APPORTIONMENT

ITEMS	**BASIS OF APPORTIONMENT BETWEEN PRE AND POST INCORPORATION PERIOD**
Gross profit or gross loss	On the basis of turnover in the respective periods. Or On the basis of cost of goods sold in the respective periods in the absence of any information regarding turnover. Or On the basis of the time in the respective periods in the absence of any information regarding turnover and cost of goods sold.

Variable expenses linked with turnover (e.g., Carriage / cartage outward, Selling and distribution expenses, commission to selling agent/travelling agents, advertisement expenses, bad debts (if actual bad debts for the two periods are not given), brokerage, sales promotion.	On the basis of turnover in the pre and post incorporation.
Fixed Common charges (e.g., Salaries, office and administration expenses, rent, rates and taxes, printing and stationery, telephone, telegram and postage, depreciation.	On the basis of turnover in the pre and post incorporation periods.
Expenses exclusively relating to pre incorporation period (e.g., interest on vendor's capital)	Charge to pre-incorporation period but if the purchase consideration is not paid on taking over business, interest for the subsequent period is charged to post incorporation period.
Expenses exclusively relating to post-incorporation period (e.g., formation expenses, interest on debentures, directors' fees, Director's remuneration.	Charge to post- incorporation period.
Fixed common charges (e.g., Salaries, office and administration expenses, rent, rates and taxes, printing and stationery, telephone, telegram and postage, depreciation.	On the basis of time in the pre and post incorporation periods.

Expenses exclusively relating to pre-incorporation period	Charge to pre- incorporation period but if the purchase consideration is not pai on taking over of business, interest for the subsequent period is charged to post incorporation period.
Interest on the purchase consideration to vendor for the period from the date of acquisition of business to date of incorporation. For the period from the date.	Charge to pre-incorporation period Charge to post-incorporation period

1. CHECK YOUR PROGRESS

TRUE OR FALSE

1) Profit prior to incorporation can be distributed as dividend. ☐

2) Preliminary expenses are always pre-incorporation in nature. ☐

3) Profit prior to incorporation is shown in the Profit & Loss Account. ☐

4) Apportioning income and expenses help in accurate financial reporting. ☐

5) Promoter's remuneration is a pre-incorporation expense. ☐

ANSWERS: 1) TRUE 2) TRUE 3) FALSE 4) TRUE 5) FALSE

4.3 APPLICATION OF PROFIT/ LOSS PRIOR TO APPLICATION

Application of profit/ loss prior to incorporation

(a) Pre-incorporation Profit: Since "Profit prior to Incorporation" is a ***Capital Profit*** the same should be written off against:

i. Preliminary Expenses Account
ii. Formation Expenses Account
iii. Liquidation Expenses Account
iv. Write down the value of Fixed Assets, if any
v. Goodwill Account
vi. Balance, if any, transferred to Capital Reserve.

(b) **Pre-incorporation Loss:** Since "Pre-incorporation Loss" is a ***Capital Loss*** the same is adjusted against

i. Any Capital Profit
ii. Debited to Goodwill Account
iii. Writing-off Fictitious Assets
iv. Capital Reserve

4.4 PURPOSE OF PROFIT PRIOR TO INCORPORATION

Company can use profit prior to incorporation for the following purposes.

- **To Comply with Legal Principles:** A company legally starts to exist only after its incorporation. Hence, any profits earned before that date cannot legally belong to the company as revenue profits. These profits are treated as capital profits and shown in the balance sheet, not in the Profit and Loss Account.

- **To Ensure Proper Allocation of Income and Expenses**
  The total profit of the entire accounting period must be apportioned between the:

  - **Pre-incorporation period** (capital profit)

- **Post-incorporation period** (revenue profit

- **To Prevent Misstatement of Profits**

  If profits prior to incorporation are mistakenly included as revenue profits, it may lead to **overstatement of distributable profits** and **illegal payment of dividends**.

- **For Accurate Financial Reporting**

  Distinguishing profits ensures that **financial statements** reflect the true performance of the company **after its formation**, and capital profits are **not mixed with operational profits**.

- **To Treat Capital Profit Appropriately**

  Profit prior to incorporation is treated as **capital reserve** and can be used only for:

- Writing off preliminary expenses
- Writing down goodwill or other capital losses
- Issuing bonus shares

2. CHECK YOUR PROGRESS

Match the following

1. Selling Expense	**a) Time ratio**
2. Rent	**b) Turnover ratio**
3. Director's Remuneration	**c) Pre-incorporation**
4. Preliminary Expenses	**d) Post-incorporation**

ANSWERS: 1 B 2 A 3D 4C

4.5 LETS US SUM UP

- A company may acquire a running business with effect from a date prior to its legal incorporation, resulting in profits earned before incorporation.
- Profit Prior to Incorporation is capital in nature and must be shown in the Balance Sheet under Capital Reserve, not in the Profit & Loss Account.
- Income and expenses must be apportioned between the pre- and post-incorporation periods using logical bases such as time, turnover, or direct allocation.
- Examples of time-based allocations include rent, salaries, and depreciation; turnover-based allocations include sales commission, advertising, and bad debts.
- Certain expenses are clearly specific to pre- or post-incorporation, like preliminary expenses (post), director's fees (post), and promoter's expenses (pre).
- Profit Prior to Incorporation serves key purposes including legal compliance, accurate reporting, preventing profit misstatement, and appropriate use of capital profits.

4.6 KEYWORDS

- **Capital Reserve** – Reserve account in the balance sheet where capital profits are transferred.
- **Time Ratio** – Used to allocate time-based expenses such as rent, salaries, and depreciation.
- **Sales/Turnover Ratio** – Used to apportion sales-related expenses like commission, advertisement, and bad debts.
- **Apportionment** – Process of dividing income and expenses between pre- and post-incorporation periods.
- **Preliminary Expenses** – Costs incurred for forming the company; always post-incorporation.

- **Director's Remuneration** – Expense paid to directors; arises only after incorporation.
- **Promoter's Remuneration** – Expense paid to promoters; treated as a pre-incorporation expense.
- **Formation Expenses** – Costs related to setting up the company; recorded in the post-incorporation period.
- **Audit Compliance** – Ensuring financial records are prepared according to accounting rules and laws.

4.7 SELF ASSESSMENT QUESTIONS

QUESTION 1: What are the purposes of determining Profit Prior to Incorporation? Explain any three in detail.

ANSWER:

………………………………………………………………………………………………
………………………………………………………………………………………………
………………………………………………………………………………………………
………

QUESTION 2: Define Profit Prior to Incorporation. Why is it treated as capital profit rather than revenue profit?

ANSWER:

………………………………………………………………………………………………
………………………………………………………………………………………………
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………

QUESTION 3: Explain how the treatment of debtors and creditors taken over from a vendor is handled during the acquisition of a running business.

ANSWER:

………………………………………………………………………………………………
………………………………………………………………………………………………
………………………………………………………………………………………………
………

4.8 LESSON END EXERCISE

QUESTION 1: Identify and explain any three expenses that are always considered post-incorporation in nature with reasons.

ANSWER:

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………………………………………………………………………………………………
………………………………………………………………………………………………
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QUESTION 2: A company was incorporated on 1st August 2024, but took over a business from 1st April 2024. The annual rent of ₹1,20,000 is paid evenly. Calculate the rent apportioned to the pre- and post-incorporation periods.

ANSWER:

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QUESTION 3: List any four expenses that are typically apportioned on a time basis and provide the reason for choosing this method.

ANSWER:

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……
……
……

4.9 SUGGESTED REASONING

1. S.P. Jain and K.L. Narang. Corporate accounting. Kalyani Publication.
2. S.N. Maheshwari, and. S. K. Maheshwari. Financial Accounting. Vikas Publishing House, New Delhi

UNIT: 1 **LESSON:5**

COURSE CODE: BCG-301

COMPUTATION OF PROFIT PRIOR TO INCORPORATION AS PER PRESCRIBED FORM

STRUCTURE:

5.0 LEARNING OBJECTIVES AND OUTCOMES

Learning objectives

- Understand the Concept of profit prior to incorporation and the legal basis behind it.
- Identify the Need for separating profits into pre- and post-incorporation periods.
- Describe the Procedure for calculating profit prior to incorporation.
- Distinguish Between Capital and Revenue Profits in the context of incorporation
- Apply Appropriate Basis of Apportionment for various income and expenses.
- Prepare a Profit & Loss Account allocating profits correctly between pre- and post-incorporation periods.

Learning outcomes

- Define "profit prior to incorporation" with clarity and provide examples.
- Explain why profits earned before incorporation are treated as capital profits.
- Apportion income and expenses correctly between the pre- and post-incorporation periods.
- Choose the correct basis (time, sales, or specific) for allocation of different items.
- Prepare accurate profit prior to incorporation statements in accordance with accounting norms.
- Demonstrate conceptual clarity in case study or practical problems involving business takeovers and incorporation.

5.1 INTRODUCTION

When a newly established company acquires an existing business with a date preceding its legal incorporation, it may generate income prior to its formal existence. However, according to accounting principles and company law, a company cannot earn business income before incorporation, as it does not legally exist during that period. Consequently, the profit earned between the acquisition date and the incorporation date is termed Profit Prior to Incorporation and is classified as capital profit rather than revenue profit. To differentiate this profit from the regular business profit earned post-incorporation, companies prepare a columnar Profit and Loss Account, segregating items between the pre-incorporation and post-incorporation periods. This practice ensures accurate financial reporting and prevents the unlawful distribution of capital profits as dividends.

Example: *ABC Ltd. was incorporated on* ***1st August 2024*** *but acquired a business with effect from* ***1st April 2024****. The company's financial year ends on* ***31st March 2025****. Therefore, the profits from* ***1st April to 31st July 2024*** *represent the* ***pre-incorporation period****, and from* ***1st August 2024 to 31st March 2025*** *represent the* ***post-incorporation period****. While preparing the Profit and Loss Account, ABC Ltd. must allocate income and expenses to these two periods using appropriate methods such as* ***time ratio*** *and* ***sales ratio****. The profit allocated to the pre-incorporation period will be treated as* ***capital reserve****, not available for dividend, while the post-incorporation profit will be available for distribution to shareholders.*

5.2 ASCERTAINMENT OF PROFIT PRIOR TO INCORPORATION

Ascertainment of Profit or Loss Prior to Incorporation

Following steps are taken for calculating the profit or loss prior to Incorporation:

1st Step: Make Trading Account of Whole Period

First of all, we have to make trading account for calculating gross profit of whole period. We will not make different trading account for prior and after incorporation because after calculating gross profit of a year, we can divide it prior incorporation on the basis of time.

2nd Step: Calculate Time Ratio and Sale Ratio

Time and sale ratios are two very important ratio which can be used for allocation of gross profit and other items of profit and loss account into prior and after to incorporation. Suppose, if after buying company, if it was incorporate after 4 months from 1st Jan. 2010, then time ratio will be 4 months: 8 months or 1:2

If before incorporation sale is Rs. 1,00,000 and after incorporation sale is Rs. 3,00,000, then sale ratio is 1:3

3rd Step: Make Profit and loss account prior and after incorporation in different Columns

a) Gross profit will divide on the basis of sale ratio

b) All expenses which are relating to sale will be divide on the basis of sale ratio

c) All fixed charges like salaries, rent, audit fees, insurance, depreciation, administrative expenses will divide on the basis of time ratio. All expenses which done after incorporation will be charged totally to after incorporation.

As the profits earned prior to incorporation are not available for dividend, it is necessary to separate it from divisible profits. This is possible, when the profit and loss account is prepared separately for the pre-incorporation period and post-incorporation period. And this is possible only by closing of the books and stock taking for the two periods. These involve tedious work. Therefore, the profit or loss is estimated by apportioning on some reasonable basis – time, turnover, equitable or actual. In practice, the same sets of books of accounts are maintained throughout the accounting year.

A Profit and Loss Account is prepared at the end of the year and thereafter the profits or losses between the two periods are allocated:

I. From the date of purchase to the date of incorporation (Pre-incorporation period) and

II. From the date of incorporation to the closing of the accounting year (post-incorporation period).

1. CHECK YOUR PROGRESS

Match the following

1. Selling Expense	**a) Time ratio**
2. Rent	**b) Turnover ratio**

3. **Director's Remuneration** c) **Pre-incorporation**
4. **Preliminary Expenses** d) **Post-incorporation**

ANSWERS: 1 B 2 A 3D 4C

5.3COMPUTATION OF PROFIT PRIOR TO INCORPORATION AS PER PRESCRIBED FORMAT

5.3.1 PRE-INCORPORATION PROFITS AND LOSSES

S. No	Pre-incorporation Profits	Pre-incorporation Losses
1.	It is transferred to capital reserve account (i.e., capitalized)	It is treated as a part of business Acquisition cost (Goodwill)
2.	It can be used for: • Writing off Goodwill on acquisition • Writing off preliminary expenses • Writing down over-valued assets • Issuing of bonus shares • Paying up partly paid shares	It can be used for: • Setting off against Post-incorporation Profit • Addition to goodwill on acquisition • Writing off capital profit

5.3.2 Prescribed Format

Alternatively

Profit & Loss Account

Dr. *for the year ended* Cr.

Expenses	Basis of allocation	Pre-incorporation	Post-incorporation	Total	Incomes	Basis of allocation	Pre-incorporation	Post-incorporation	Total
		Rs.	Rs.				Rs.	Rs.	
To Fixed Expenses: Source (Adm. Exp.)	Time Ratio	...	...		By Gross b/d	Sales Ratio	..	..	
• Variable Expenses (Selling Overheads)	Sales Ratio	...	...		• Specific Income (Related to pre-incorporation Period)		..	..	
• Specific Exp. (Before incorporation)		...	—		• Specific Income (Related to post-incorporation period)		..	—	
• Specific Expenses (After incorporation)		—	...						
Net Profit : • Capital Reserve		...	—				—	..	
Net Profit		—	...						
		...	...				...	...	

Note : Students may follow any one of the two methods.

Net Profit b/d						
Dividend	Actual	—	...		...
Any Income	Actual	—	...		...
Net Profit					
—Transferred to Capital Reserve		...	—	—	—
—Net Profit transferred to P & L App. A/c		—	—	...	—
		...	...	...	...

.

5.3.3 COMPUTATION OF PROFIT PRIOR TO INCORPORATION AS PER PRESCRIBED FORM.

Illustration 1:

Bidyut limited was incorporated on 1st July 2024 to acquire from Bijli as and from 1st January, the individual business carried on by him. The purchase price of the fixed assets and goodwill was agreed to be the sum equal to 80% of the profits made each year on ascertainment of the sum due.

The following Trial Balance as on 31st Dec., 2024 is presented to you to enable you to prepare a Balance sheet as at that date.

Particulars	Dr.	Cr.
	Rs	Rs.
Share Capital- 1,500 equity share of Rs 100 each, Rs 80 paid up		1,20,000
Sundry debtors	82,000	
Stock on 31st Dec,2024	67,000	
Cash at bank and in hand	24,000	
Directors' fee	3,000	
Preliminary expenses	24,000	
Sundry creditors		32,000
Net Profit for the year after providing for all expenses under agreement entered into with Bijli		48,000
	....	....
	2,00,000	2,00,000

Solution

Balance sheet of M/s Bidyut Ltd. As on 31st Dec., 2012

	Particulars	Notes	Rs
	Equity and Liabilities		
1.	**Shareholders' funds**		
	Share capital	1	1,20,000
A	Reserves and surplus	2	21, 000
B			
2.	**Current liabilities**		
A	Trade Payables		32,000
B	Other current liabilities		38,400
			....
			2,11,400
	Total		....
	Assets		
1	Non-current assets		
A	Fixed assets	3	38,400
2	Current assets		
A	Inventories		67,000
B	Trade receivables		82,000
C	Cash and cash equivalents		24,000
			....
	Total		**2,11,400**
			....

Notes to accounts

				Rs
1. **Share Capital**				
Equity share capital				
Issued and Subscribed capital				
1,500 Equity shares of Rs 100 each Rs 80 paid up				1,20,000
2. **Reserves and Surplus**				
Capital reserve (Pre incorporation profit)				24,000
Profit and loss Account				
Net Profit for the Year			24,000	
Less: Directors' fee	3,000			
Preliminary Expenses	24,000		(27,000)	(3000)
	-------------		------------	--------------
Total				21,000
				---------------
3. **Fixed assets**				38, 400
Goodwill and fixed assets (Working Note)				

WORKING NOTE

	Rs

Amount Payable to Bijli: Profit for the year 80% due as cost of goodwill, assets, etc.	 48,000 38,400

Illustration 2:

Inder and Vishnu working in partnership registered a joint stock company under the name of Fellow Travelers Ltd. on May 31, 2024 to take over their existing business. It was agreed that they would take over the assets of the partnership for a sum of Rs 3,00,000 as from Jan 1st 2024 and that until the amount was discharged, they would pay interest on the amount at rate of 6% per annum. The amount was paid on June, 30th 2024. Discharge the purchase consideration, the company issued 20,000 equity shares of Rs 10 each at a premium of re 1 each and allotted 7% debentures of the face value of Rs 1,50,000 to the vendors at par.

The summarized profit and loss account of the "Fellows travelers Ltd." For the year ended 31st December 2024 was as follows

	Rs		Rs
To Purchase, including stock	1,40,000	By Sales:	
To Freight and carriage	5,000	1st January to 31st May 2024	60,000
To Gross profit c/d	60,000	1st June to 31st Dec, 2024	1,20,000
		By Stock in hand	25,000
	------------		------------
	2,05,000		2,05,000
	------------		------------
To Salaries and Wages	10,000	By Gross profit b/d	60,000

To Debenture Interest To Depreciation To Interest on purchase To Consideration (up to 30-6-2024) To Selling commission To Directors' fee To Preliminary expenses To Provision for taxes To Dividend on equity shares @ 5% To Balance c/d	5,250 1,000 9,000 9,000 600 900 6,000 5,000 13,250 ----------- 60,000 -----------		----------- 60,000 -----------

Prepare statement apportioning the expenses and calculate profits/losses for the post and pre-incorporation periods and also show these figures would appear in the balance sheet of the company.

Solution **Fellow Travelers Ltd.**

Statement showing calculation of profit/losses for pre and post incorporation periods

	Ratio	**Pre-Incorporation**	**Post-Incorporation**

Gross profit allocated on the basis of sale	1:2	20,000	40,000
Less: Administrative expenses allocated on time basis:			
i) Salaries and wages 10,000			
ii) Depreciation 1000			

11,000	5:7	4,583	6,417

Selling commission on the basis of sales	1:2	3,000	6,000
interest on purchase consideration (Time basis)	5:1	7,500	1,500
Expenses application wholly to the Post-incorporation period			
Debenture interest 5,250			
			5,850
Directors' Fee 600			
-----------			900
Preliminary expenses	--------------		----------------
Balance c/d to balance sheet	4917		19,333
	---------------		-----------------

Fellow Travelers Ltd.

Extract from the Balance sheet as on 31st Dec., 2024

	Particulars	Notes	Rs

	Equity and Liabilities		
1	**Shareholders' funds**	1	2,00,000
A	Share capital	2	33,250
B	Reserves and surplus		
2	**Non-current liabilities**		
A	Long-term borrowings **Current**	3	1,50,000
3	**Liabilities**		
A	Short term provisions	4	6,000

	Total		3,89,250

Notes to account

		Rs
1. Share Capital		
20,000 equity shares of Rs10 each fully paid		2,00,000
2. Reserves and Surplus		
Profit prior to incorporation		4,917
Securities premium account		20,000
Profit and loss account	19,333	
Less: Provision for Tax	(6,000)	
Dividend on equity share	(5000)	8,333
	----------------	-----------
Total		33,250
3. Long term borrowings		-----------
Secured		
7% Debentures		

4. Other current liabilities Provision for taxes	1,50,000 6000

Illustration 3:

Rama Udyog Limited was incorporated on August 1, 2024. It had acquired a running business of Rama & Co. with effect from April 1, 2024. During the year 2023-24, the total sales were ` 36,00,000. The sales per month in the first half year were half of what they were in the later half year. The net profit of the company, 2,00,000 was worked out after charging the following expenses:

(i) Depreciation: 1,23,000

(ii) Directors' fees: 50,000,

(iii) Preliminary expenses: 12,000

(iv) Office expenses: 78,000

(v) Selling expenses: 72,000 and

(vi) Interest to vendors up to August 31, 2024: 5,000.

Please ascertain pre-incorporation and post-incorporation profit for the year ended 31st March, 2024.

Solution

Statement showing pre and post incorporation profit for the year ended 31st March, 2024

Particulars	Total Amount	Basis of Allocation	Pre-incorporation	Post-incorporation
Gross Profit (W.N.3)	5,40,000	2:7	1,20,000	4,20,000
Less: Depreciation	(1,23,000)	1:2	41,000	82,000
Director's Fees	50,000 (Post)	-	50,000	
Preliminary Expenses	12,000 (Post)	-	12,000	

Office Expenses	78,000	1;2	26,000	52,000
Selling Expenses	72,000	2:7	16,000	56,000
Interest to vendors				
Net Profit (` 33,000 being pre-incorporation profit is transferred to capital reserve Account)	2,00,000		33,000	1,67,000

Working Notes:

1.Sales ratio

The sales per month in the first half year were half of what they were in the later half year. If in the later half year, sales per month is x then it should be 5 x per month in the first half year.

So, sales for the first four months (i.e., from 1st April, 2024 to 31st July, 2024) will be 4 *0.50 = 2 and for the last eight months (i.e., from 1st August, 20 X1 to 31st March, 20X2) will be (2 × .50 + 6 × 1) = ` 7. Thus, sales ratio is 2:7.

2.Time ratio

1st April, 20X1 to 31st July, 2024: 1st August, 2024 to 31st March, 2025

= 4 months: 8 months = 1:2 Thus, time ratio is 1:2.

3.Gross profit

Gross profit = Net profit + All expenses

= 2,00,000 + (1,23,000+50,000+12,000+78,000+72,000+5,000)

= 2,00,000 + 3,40,000 = 5,40,000.

Illustration 4: Lotus Ltd. was incorporated on 1st July, 2024 to acquire a running business of Feel goods with effect from 1st April, 2024. During the year 2024-2025, the total sales were

48,00,000 of which 9,60,000 were for the first six months. The Gross profit of the company ` 7,81,600. The expenses charged to the Profit & Loss Statement included:

(i) Director's fees ` 60,000

(ii) Bad debts ` 14,400

(iii) Advertising ` 48,000 (under a contract amounting to ` 4,000 per month)

(iv) Salaries and General Expenses 2,56,000

(v) Preliminary Expenses written off 20,000

(vi) Donation to a political party given by the company 20,000.

Prepare a statement showing pre-incorporation and post-incorporation profit for the year ended 31st March, 2024.

Solution

Statement showing the calculation of Profits for the pre-incorporation and post-incorporation periods for the year ended 31st March, 2024

Particulars	Total Amount	Basis of Allocation	Pre-incorporation	Post-incorporation
Gross Profit	7,81,600	Sales	78,160	7,03,440
Less: Directors' fees	60,000	Post		60,000
Bad debts	14,400	Sales	1,440	12,960
Advertising	48,000	Time	12,000	36,000
Salaries and general expenses	2,56,000	Time	64,000	1,92,000
Preliminary	20,000	Post		20,000
expenses	20,000	Post		
	______		______	______

Donation to Political Party Net Profit	3,63,200 __________		720 __________	3,62,480 __________

Working Notes:

1.Sales ratio

Particulars `

Sales for period up to 30.06.2024 (9,60,000 x 3/6) = 4,80,000

Sales for period from 01.07.20X1 to 31.03.20X2 (48,00,000 – 4,80,000) = 43,20,000

Thus, Sales Ratio = 1: 9

2.Time ratio

1st April, 2024 to 30 June, 2024: 1st July, 2024 to 31st March, 2025

= 3 months: 9 months = 1: 3

Thus, Time Ratio is 1: 3

Illustration: 5 The partners of Maitri Agencies decided to convert the partnership into a private limited company called MA (P) Ltd. with effect from 1st January, 2024. The consideration was agreed at 1,17,00,000 based on the firm's Balance Sheet as at 31st December, 24. However, due to some procedural difficulties, the company could be incorporated only on 1st April, 2024. Meanwhile the business was continued on behalf of the company and the consideration was settled on that day with interest at 12% per annum. The same books of account were continued by the company which closed its account for the first time on 31st March, 2025 and gives the following information:

Sales	2,34,00,000
Cost of goods sold	1,63,80,000

Expenses:	
Salaries	11,70,000
Depreciation	1,80,000
Advertisement	7,02,000
Discounts	11,70,000
Managing Director’s remuneration	90,000
Miscellaneous office expenses	1,20,000
Office-cum-show room rent	7,20,000
Interest	9,51,000

The company’s only borrowing was a loan of ` 50,00,000 at 12% p.a. to pay the purchase consideration due to the firm and for working capital requirements.

The company was able to double the average monthly sales of the firm, from 1st April, 2024 but the salaries tripled from that date. It had to occupy additional space from 1st July, 2024 for which rent was 30,000 per month.

Prepare statement of apportioning cost and revenue between pre-incorporation and post-incorporation periods and calculation of profits/losses for such periods

Solution

MA (P) Ltd.

Statement showing calculation of profit/losses for pre and post incorporation periods

Particulars	**Basis of incorporation**	**Pre-incorporation**	**Post-incorporation**
Sales	Sales ratio Sales ratio	26,00,000 18,20,000	2,08,00,000 1,45,60,000

Less: cost of goods			
sold	W. NO. 4	90,000	10,80,000
Salaries	Time ratio	36,000	1,44,000
Depreciation	Sale ratio	78,000	6,24,000
Advertisement	Sale ratio	1,30,000	10,40,000
Discounts	Post- incorporation	_	90,000
M.D ‘s			
remuneration	Time ratio	24,000	96,000
Misc. office	W. NO. 5	90,000	6,30,000
expenses	Time ratio	3,51,000	6,00,000
Rent			
Interest		(19,000)	19,36,000
Net profit / (loss)			

Working Notes:

(1) Calculation of Sales ratio and time ratio:

Let the average sales per month in pre-incorporation period be x.

Then the average sales in post-incorporation period are 2x.

Thus, total sales are (3 × x) + (12 × 2x) or 27x.

Ratio of sales will be 3 x: 24x or 1:8.

Time ratio is 3 months: 12 months or 1:4

(2) Expenses apportioned on turnover ratio basis are cost of goods sold, advertisement, discounts.

(3) Expenses apportioned on time ratio basis are Depreciation, and misc. office expenses.

(4) Ratio for apportionment of Salaries:

If pre-incorporation monthly average is x, for 3 months 3x.

Average for balance 12 months 3x, for 12 months 36x.

Hence ratio for division, 1:12.

(5) Apportionment of Rent:		
Total Rent		7,20,000
Additional rent for 9 months (From 1st July 20X2 to 31st March, 20X3)		(2,70,000)
Rent for old premises for 15 months at 30,000 p.m.		4,50,000
	Pre-inc.	
Post-inc.		
Old Premises	90,000	3,60,000
Additional rent	—	2,70,000
	90,000	6,30,000

(6) Apportionment of interest:

Total interest 9,51,000

Less: Interest for post incorporation (50,00,000 x 12%) 6,00,000

Interest apportioned to pre incorporation period 3,51,000

2. CHECK YOUR PROGRESS

TRUE OR FALSE

1.Expenses incurred solely for the company after incorporation (e.g., preliminary expenses) are charged entirely to the pre-incorporation period.
Answer: False

2. Gross profit for the full year is first determined without regard to the date of incorporation.
Answer: True

3. Selling commission and other distribution costs are usually apportioned on a sales basis.
Answer: True

4. Provision for income tax must always be split between periods on a time basis.
Answer: False

5. The trading account is prepared for the entire year and then profits are split between periods.
Answer: True

5.4 LET US SUM UP

Profit or loss of a business for the period prior to the date the company came into existence is referred to as Pre-Incorporation Profits and Losses. Generally, there are two methods of computing Profit and Loss prior to incorporation. One is to close off old books and open new books with the assets and liabilities as they existed at the date of incorporation. In this way automatically the result to that date will be adjusted. Other is to split up the profit of the year of the transfer of the business to the company between ‘pre’ and ‘post’ incorporation periods. This is done either on the time basis or on the turnover basis or by a method which combines the two. A company taking over a running business may also agree to collect its debts as an agent for the vendor and may further undertake to pay the credit on behalf of the vendors. In such a case the debtors and creditors of the vendors will be included in the accounts for the company by debit or credit to separate total accounts in the general ledger to distinguish them from from the debtors and creditors of the business and contra entries will be made in corresponding Suspense Accounts. Also details of debtors and creditors balance will be kept in separate ledger.

The vendor is treated as a creditor for the cash received by the purchasing company in respect of the debts due to the vendor, just as if he has himself collected cash from his debtors and remitted the proceeds to the purchasing company. The vendor is considered a debtor in respect of cash paid to the creditors by the purchasing company. The balance of the cash collected, less paid will represent the amount due to or by the vendor, arising from debtors and creditors balances which have been taken over, subject to any collection expenses. The balance in the suspense accounts will be always equal to the amount of debtors and creditors taken over remaining unadjusted at any time. Profit and loss of a business for the period prior to the date company into existence is referred to as Pre-Incorporation profit and losses. In simple words prior period item are those items which is done before incorporation of the company. Profit and loss of prior period and post period is divided separately because the prior period profit and loss is always credit and charged from capital reserve A/c. Post period profit and loss are credited and charged from Profit & Loss A/c. Thus, any profit/loss made before the incorporation is known as "Profit (Loss) Prior to Incorporation" which is treated as a capital profit and the same cannot be distributed as business profit. Hence, it cannot be distributed by way of dividend. The same is to be transferred to Capital Reserve or may be adjusted against Goodwill. "Loss prior to incorporation" is treated as a capital loss and, hence, the same is shown under the head "Miscellaneous Expenditure" in the assets side of the Balance Sheet. Business is very often taken over by a company from a date earlier than the date of its incorporation or date of commencement of business. The profit of the company up to the date of its incorporation/commencement of business, cannot be treated as Trading Profit of the company. Thus, the profit arising to the company from the date of purchase, up to the date of incorporation/commencement of business is known as pre-incorporation profit. This pre-incorporation profit being considered as capital profit is transferred to Capital Reserve or adjusted with Goodwill. When a business is taken over and working continued, usually same set of books is used and ultimately, the total profit for the year is divided between pre and post incorporation periods. At times, this division is made on some estimation. The usual practice is to prepare the profit and loss account only at the end of the year and then to allocate the profits between the two periods in the following manner: Gross profit and expenses connected with sales to be apportioned according to the ratio of sales for the two periods. Salaries, rent, interest etc. should be apportioned on the basis of ratio of time before incorporation and after. Expenses solely incurred for the company on and after its incorporation e.g., preliminary expenses, directors' fees, etc. should be charged wholly to the post-incorporation period. Amount of sales should be calculated for the pre-incorporation and post-incorporation periods. It is calculated after considering the time period, i.e., one is required to calculate the period falling between the date of purchase and the date of incorporation and the period between the date of incorporation and the date of presenting final accounts.

5.5 KEYWORDS

- **Profit prior to incorporation** is the profit earned or loss suffered during the period before incorporation. It is a capital profit and is not legally available for distribution as dividend because a company cannot earn a profit before it comes into existence. Profit earned after incorporation is revenue profit, which is available for dividend".

- **Gross Profit** should be allocated for the two periods on the basis of sales ratio which will present the gross profit for the two separate periods, viz. pre-incorporation and post-incorporation.

- **Fixed Expenses** or expenses incurred on the basis of time, viz., Rent, Salary, Depreciation, Interest, etc. should be allocated for the two periods on the basis of time ratio.

• **Variable Expenses** or expenses connected with sales should be allocated for the two periods on the basis of sales ratio.

5.6 SELF ASSESSMENT QUESTIONS

1. The Sai Deep Ltd. was incorporated on 1st August 2024, to take over the running business of Krishna Bros. with effect from 1st April 2024. The company received the certificate for commencement of business on 1st October 2024. The following P&L A/c was prepared for the year ended 31.3.2025.

Profit and Loss Account for the year ended 31.03.1997

Particulars	*Amt. (Rs.)*	*Particulars*	*Amt. (Rs.)*
To Office Salaries	21,000	By Gross Profit b/d	80,000
To Partners Salaries	6,000	By Share Transfer Fee	1,000
To Advertisement	4,400		
To Printing & Stationery	1,500		
To Travelling expenses	4,000		
To Office Rent	9,600		
To Electricity Charges	900		
To Auditors Charges	600		
To Directors Charges	1,000		
To Bad Debts	1,200		
To Commission on Sales	4,000		
To Preliminary Expenses	700		
To Debenture Interest	1,600		
To Interest on Capital	1,800		
To Depreciation	2,100		
To Net Profit	20,600		
	81,000		81,000

Additional information:

(1) Total Sales for the year, which amounted to Rs. 8,00,000 arose evenly up to the date of certificate of commencement, where after they recorded an increase of 2/ 3 during the year. Gross profit was at a uniform rate of 10% of selling price throughout the year and a commission of 0.5% was paid on sales.

(2) Office Rent was paid @ Rs. 8,400 p.a. up to 30th September 1996, and thereafter it was paid @ Rs. 10,800 p.a.

(3) Travelling Expenses include Rs. 1,600 towards sales promotion

(4) Bad Debts written off –

(a) A debt of Rs. 400 taken over from the vendor.

(b) A debt of Rs. 800 in respect of goods sold in September 1996. Depreciation includes Rs. 600 for assets acquired in the post-incorporation period.

Show the "pre" and "post" incorporation results and also state how the results of pre and post-incorporation is dealt with.

2. X company limited purchased a business on 1st April 2010. The company obtained certificate to commence business on 31st July 2010. From the following particulars for the year ending 31st March 2011, ascertain profit prior to incorporation and divisible profits.

a) Total sales up to 31st March 2011 Rs 10,00,000. Sales from 1st April 2010 to 31st July 2010 Rs 2,50,000.

b) Gross Profit for the Year Rs 2,12,000.

c) Expenses debited to profit and loss account.

Rent	6,000
Insurance	1,500

Salaries	27,000
Selling Expenses	9,000
Advertisement	8,000
Interest on Debentures	4,000
Audit Fees	1,200
Printing and Stationery	4,200
Depreciation on Machinery	30,000
Commission on Sales	12,600

Bad Debts (Rs 850 related to prior to incorporation) 2400

General Expenses	4,800
Directors Fees	2,600
Preliminary Expenses	7,200

Interest paid to vendors up to 1st September 2010 5,000

3. Explain the concept of profit prior to incorporation in detail.

5.7 LESSON AND EXERCISE

1. ABC Ltd. took over a running business with effect from 1st April, 2024. The company was incorporated on 1st August, 2024. The following information for the year ended 31.3.2025 is given:

Gross profit	3,20,000
Expenses:	
Salaries	48,000
Stationery	4,800
Travelling expenses	16,800
Advertisement	16,000
Miscellaneous trade expenses	37,800
Rent (office buildings)	26,400
Electricity charges	4,200
Director's fee	11,200
Bad debts	3,200
Commission to selling agents	16,000
Tax Audit fee	6,000
Debenture interest	3,000

Interest paid to vendor	4,200
Selling expenses	25,200
Depreciation on fixed assets	9,600
Net profit	87,600

Additional information:

(a) Total sales for the year, which amounted to ` 19,20,000 arose evenly up to the date of 30.9.2024 Thereafter they recorded an increase of two-third during the rest of the year.

(b) Rent of office building was paid @ ` 2,000 per month up to September, 2024 and thereafter it was increased by 400 per month.

(c) Travelling expenses include 4,800 towards sales promotion.

(d) Depreciation include ` 600 for assets acquired in the post incorporation period.

(e) Purchase consideration was discharged by the company on 30th September, 2024 by issuing equity shares of 10 each.

Prepare Statement showing calculation of profits and allocation of expenses between pre and post incorporation.

Ques: The promoters of Glorious Ltd. took over on behalf of the company a running business with effect from 1st April, 2024. The company got incorporated on 1st August, 2025. The annual accounts were made up to 31st March, 2025 which revealed that the sales for the whole year totaled 1,600 lakhs out of which sales till 31st July, 2024 were for 400 lakhs. Gross profit ratio was 25%. The expenses from 1st April 20X1, till 31st March, 20X2 were as follows:

(` in lakhs)	
Salaries	69
Rent, Rates and Insurance	24
Sundry Office Expenses	66
Travellers' Commission	16
Discount Allowed	12
Bad Debts	4
Directors' Fee	25
Tax Audit Fee	9
Depreciation on Machinery	12
Debenture Interest	11

Prepare a statement showing the calculation of Profits for the pre-incorporation and post-incorporation periods.

Ques: Sneha Ltd. was incorporated on 1st July, 2024 to acquire a running business of Atul Sons with effect from 1st April, 2024. During the year 2024-25, the total sales were 24,00,000 of which 4,80,000 were for the first six months. The Gross profit of the company 3,90,800. The expenses debited to the Profit & Loss Account included:

Director's fees ` 30,000

Bad debts ` 7,200

Advertising ` 24,000 (under a contract amounting to ` 2,000 per month)

Salaries and General Expenses ` 1,28,000

Preliminary Expenses written off ` 10,00

Donation to a political party given by the company ` 10,000.

Prepare a statement showing pre-incorporation and post-incorporation profit for the year ended 31st March, 2024.

5.8 SUGGESTED READING

- s.P. Jain and K.L. Narang. Corporate accounting. Kalyani Publication.
- S.N. Maheshwari, and. S. K. Maheshwari. Financial Accounting. Vikas Publishing House, New Delhi.

UNIT- 2 **LESSON NO. 6**

COURSE CODE: BCG 301

MEANING OF BANKING COMPANIES, IMPORTANT TERMS IN BANKING

Structure:

6.7 Lesson End Exercise

6.8 Suggested Reading

6.0 LEARNING OBJECTIVES AND OUTCOMES

Learning objectives

After going through this lesson, you should be able to know:

- Concept and meaning of banking companies.
- Important terms related with banking.
- Prepare books, accounts and balance sheet and schedules of banking companies.

Learning outcomes

- Concept and meaning of banking companies.
- Important terms related with banking.

6.1 INTRODUCTION

Bank is legal financial institution that accepts money which can be withdrawn anytime as per the customer's demand; as well as it also lends money to individuals and institutions whenever they need it. In other words, it acts as a link between clients that have capital deficits and clients that have capital surplus as explained in figure 1 below. In India, Banks and their activities are regulated by Banking Regulation Act 1949. According to this Act, banking means, Accepting deposits of money from public for the purpose of lending. These deposits are repayable on demand and can be withdrawn by cheque, draft or otherwise. Banking in India originated in the last decades of the 18th century. The first banks were The General Bank of India which started in 1786, and the Bank of Hindustan, both of which are now defunct. The oldest bank in existence in India is the State Bank of India, which originated in the Bank of Calcutta in June 1806, which almost immediately became the Bank of Bengal. This was one of the three presidency banks, the other two being the Bank of Bombay and the Bank of Madras, all three of which were established under charters from the British East India Company. Indian merchants in Calcutta established the Union Bank in1839, but it failed in 1848 as consequence of the economic crisis of 1848-49. The Allahabad Bank, established in 1865 and still functioning today, is the oldest Joint Stock bank in India. The presidency banks dominated banking in India but there were also some exchange banks and a number of Indian joint stock banks. All these banks operated in different segments of the economy. The exchange banks, mostly owned by Europeans, concentrated on financing foreign trade. Indian joint stock banks were generally undercapitalized and lacked the experience and maturity to compete with the presidency and exchange banks. The first entirely Indian joint stock bank was the Oudh Commercial Bank, established in 1881 in Faizabad. It failed in 1958. The next was the Punjab National Bank, established in Lahore in 1895, which has survived to the present and is now one of the largest banks in India. According to the schedule II of the Reserve Bank of India Act 1934, hereafter called RBI Act, banks can be categorized into two main types: a) Scheduled Bank According to section 2(e) of the RBI Act, a bank included in the Act's second schedule is termed as Scheduled Bank. Following conditions should be fulfilled by the banks to be included in the Scheduled list: The minimum paid up capital and reserves should be 25,00,000, and No activity of the bank should adversely affect the depositor's interest. A bank is a commercial institution, permitted to accept, collect, transfer, lend and exchange money and claims to money both the domestically and internationally and thereby conduct smooth banking activities. Banking companies are governed by the Banking Regulation Act of 1949 and also subject to the companies act. 1956. The accepting, for the purpose of lending or investment, of deposit of money from the public repayable on demand or otherwise and withdraw able by cheque, draft, order or otherwise. Business of Banking Companies: As per section 6 of the Act, banking companies may engage in the following business in addition to their usual banking business. 1) In the case of Banking Company incorporated outside India. If it has a place or places of business in the city of Bombay or Calcutta or both Rs. 20 lakhs. If the places of business are other than Bombay or Calcutta Rs. 15 lakhs. In addition 20% of the profits earned in India must be added to the sums mentioned above. 2) In the case of a banking company incorporated in India. a) If it has places of business in more than one state and it has a place or places of business in Bombay or Calcutta or both Rs. 10 lakhs. b) It is has places of business in more than one state but not in Bombay or Calcutta Rs. 5 lakhs. c) If it has places of business in one state but not in Bombay or Calcutta. Rs. 1 lakhs in respect of its principle place plus Rs. 10,000 for each of its other places of business in the same district and Rs. 25,000 in respect of each place of business outside the district. The total need not exceed Rs. 5 lakhs. In case there is only one place of business Rs. 50,000. (In case of companies, which have commenced business after the commencement of the Banking Companies (Amendment) Act of 1962, a minimum of Rs. 5 lakhs is required) d) If it has all its places of business in one state / Rs. 5 lakhs and if the places of business are also in / plus Rs. 25,000 Bombay or Calcutta. / In respect of each place of business situated outside the city of Bombay or Calcutta. The total need not exceed Rs. 10 lakhs.

6.2 MEANING AND CONCEPT OF BANKING COMPANIES

6.2.1 Meaning of Banking Companies:

A bank is a commercial institution, permitted to accept, collect, transfer, lend and exchange money and claims to money both the domestically and internationally and thereby conduct smooth banking activities.

Definition:

Banking companies are governed by the Banking Regulation Act of 1949 and also subject to the companies act. 1956.

According to Banking Regulation act, 1949 Banking means – "The accepting, for the purpose of lending or investment, of deposit of money from the public repayable on demand or otherwise and withdraw able by cheque, draft, order or otherwise.''

6.2.2 Business of Banking Companies:

As per section 6 of the Act, banking companies may engage in the following business in addition to their usual banking business.

1. The borrowing, raising or taking up on money, the lending or advancing of money either upon or without security, the drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, 'bandies', promissory notes, drafts, bills of lading, railways receipt, warrants, debentures, certificates, scrip's and other instruments and securities whether transferable or negotiable or not; granting and issuing of letters of credit, traveler's cheques and circular notes; the buying, selling and dealing in bullion and specie; the buying and selling of foreign exchange including foreign bank notes; the acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares, debentures, debenture stock bonds, obligations, securities and investments of all kinds; the purchasing and selling of bonds, scrip or other forms of securities on behalf of constituents or other, the negotiating of loans and advances; the receiving of all kinds of bonds, scrip or valuables on deposit or for safe custody or otherwise; the providing of safe deposit vaults; the collecting and transmitting of money and securities.
2. **Acting as agents** for any Government or local authority or any other person or persons; the carrying on of agency business of any description including the clearing and forwarding of goods, giving of receipts and discharges and otherwise acting as on attorney on behalf of customers but excluding the business of (managing agent or secretary and treasurer) of a company.

3. Contracting for public and private loans and negotiating and issuing the same.

4. The effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private of state, municipal or other loans or of shares, stock, debentures or debenture stock of any Company Corporation or association and of the lending of money for the purpose of any such issue.

5. Carrying on and transacting every kind of guarantee and indemnity business.

6. Managing, selling and realizing any property which may come into the possession of the company in satisfaction or part satisfaction of any of its claims.

7. Acquiring and holding and generally dealing with any property or any right, title or interest in any such property which may form the security or part of the security for any loans or advances which may be connected with any such security.

8. Undertaking and executing trusts.

9. Undertaking the administration of estates as executor, trustee or otherwise.

10. Establishing and supporting or aiding in the establishment and support of associations, institutions, funds, trusts and conveniences calculated to benefit employees or ex-employees of the company or the dependents or connections of such persons; granting pensions and allowances and making payments towards insurance; subscribing to or guaranteeing moneys for charitable or benevolent objects or for any exhibition or for any public, general or useful object.

11. The acquisition, construction maintenance and alteration of any building or works necessary or convenient for the purpose of the company.

12. Selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into account or otherwise dealing with all or any part of the property and rights of the company.

13. Acquiring and undertaking the whole or any part of the business of any person or company, when such business is of a nature enumerated or described in section 6.
14. Doing all such other things as are incidental or conclusion to the promotion oradvancement of the business of the company.
15. Any other form of business which the central Government may by notification in the official Gazette, specify as a form of business in which it is lawful for a banking company to engage.

No Banking Company shall engage in any form of business other than those referred to in section 6.

6.2.3 Restrictions on Business:

The Banking Companies are restricted from conducting certain activities.

A bank cannot directly or indirectly deal in the buying or selling or bartering of goods, except in connection with the realization of security given to or held by it, or engage in any trade or buy or sell of barter goods for others otherwise than in connection with bills of exchange, immovable property, except that required for its own use, however acquired, must be disposed of within seven years from the date of acquisition.

6.2.4 Important accounting provisions of banking regulation act 1949.

Minimum Capital and reserves – Section 11.

According to the provision of section 11 (2) of the Banking Regulation Act 1949 the following are the limits imposed on value of paid up Capital and Reserves of a banking Company.

1) In the case of Banking Company incorporated outside India. If it has a place or places of business in the city of Bombay or Calcutta or both Rs. 20 lakhs. If the places of business are other than Bombay or Calcutta Rs. 15 lakhs. In addition 20% of the profits earned in India must be added to the sums mentioned above.

2) In the case of a banking company incorporated in India.

   a) If it has places of business in more than one state and it has a place or places of business in Bombay or Calcutta or both Rs. 10 lakhs.

   b) It is having places of business in more than one state but not in Bombay or Calcutta Rs. 5 lakhs.

   c) If it has places of business in one state but not in Bombay or Calcutta. Rs. 1 lakh in respect of its principle place plus Rs. 10,000 for each of its other places of business in the same district and Rs. 25,000 in respect of each place of business outside the district. The total need not exceed Rs. 5 lakhs. In case there is only one place of business Rs. 50,000. (In case of companies, which have commenced business after the commencement of the Banking Companies (Amendment) Act of 1962, a minimum of Rs. 5 lakhs is required) d) If it has all its places of business in one state / Rs. 5 lakhs and if the places of business are also in / plus Rs. 25,000 Bombay or Calcutta. In respect of each place of business situated outside the city of Bombay or Calcutta. The total need not exceed Rs. 10 lakhs.

6.2.5 Restriction on commission Brokerage, Discount, etc. on sale of shares-section B: A Banking company is not allowed to pay directly or indirectly commission, Brokerage, Discount or remuneration in any form in respect of any shares issued by it, any amount exceeding two and one-half person of the paid-up value of the said shares.

6.2.6 Restriction on payment of dividend – section 15: A Banking company shall not pay dividend unless all of its capitalized expenses (including preliminary expenses, organization expenses, share selling commission, Brokerage, amount of losses incurred and any other item. Of expenditure not represented by tangible assets) have been completely write-off. However, a banking company may pay dividend on its shares without writing off.

6.2.7 Restrictions on loans and Advances –section 20:

A Bank cannot

i) Grant loans and advances on the security of its own shares and ii) Grant or agree to grant loan or advance to or on behalf of

a) Any of its directors;

b) Any firm in which any of its directors is interested as partner, manager or guarantor;

c) Any company of which any of its directors is a director manager, employee or guarantor or in which he holds substantial interest; or

d) Any individual in respect of whom any of its directors is a partner or guarantor.

Books of accounts

In order to have immediate entry of voluminous transaction and enables continuous internal check on the record of these transactions, Banks are required to maintain subsidiary books along with its principal books of accounts.

A) Subsidiary books

i. Receiving cashier's counter cash book;

ii. Paying cashier's counter cash book;

iii. Current accounts ledger.

iv. Savings bank accounts ledger

v. Fixed deposit accounts ledger

vi. Investments Ledger

vii. Loans Ledger

viii. Bills discounted and purchased ledger

ix. Customer's acceptances endorsements and guarantee ledger

B) Principal Books

i. **Cash book:** It records all cash transactions

ii. **General Leger:** It contains control Accounts of all subsidiary ledgers and different assets and liabilities account.

1. CHECK YOUR PROGRESS

TRUE OR FALSE

Banking companies can engage in trading of goods freely.
ANSWER False

The Bank of Hindustan is still operational today. –
ANSWER False

No banking company shall pay dividend unless capitalized expenses are fully written off.
ANSWER True

Banking companies can accept deposits but cannot lend money.
ANSWER False

Banking companies are governed only by the Companies Act, 1956.
ANSWER False

6.3 IMPORTANT TERMS IN BANKING BUSINESS

Statutory Reserve – Section 17:

Section 17 of the act lays down that every banking company should create a reserve fund by transferring to it at least 20 percent of its annual profit as disclosed by its profit and loss account before any declaration of dividend, such reserve is known as statutory Reserve. The transfer of profit to reserve fund should be continued even after the accumulated amount of reserve fund and share premium account together exceed its paid-up capital. Unless the central government grant on exemption in this regard on the recommendation of Reserve Bank of India.

Cash Reserves – Section 18:

Every Banking Company requires to maintain a balance equal to 3 percent of its time and demand liabilities with RBI (a non-scheduled bank has to keep similar balances either in cash or deposit with RBI)

Cash credit

Whereby, some money is lent by the bank up to a specified limit against the pledge or hypothecation of some security. Borrowers can withdraw the whole amount immediately or in instalments as and when required, since the bank keeps the whole amount always ready for withdrawals.

Bills for collection

A bank may receive bills for collection on due dates (like electricity bills). The bank keeps the bills to be collected on behalf of its customer (like here NDPL) till the date of maturity or realization of cash and then hand over the cash to its customer (after deducting its commission). Bank records particulars of the bills in the bills for collection register. These bills for collection are both an asset as well as a liability for the bank, and the bank accordingly prepare two separate accounts simultaneously, namely Bills for collection (Asset) account and Bills for collection (Liability) account. The journal entries involved are:

a) **On receipt of Bills for collection:**

Bills for collection (Asset) account ……Dr.

To Bills for collection (Liability) account

b) **On maturity, when bills are realized and cash is collected and the bank receives its commission, the entry is:**

Cash account ……Dr.

To Customer's account

To Commission account

The bank will also make a contra entry for cancelling the amount which has been honored,the entry for which is:

Bills for collection (Liability) account ……Dr. (with amount honored)

To Bills for collection (Asset) account (with amount honored)

If some bills are still outstanding, same are shown as footnote in balance sheet.

c) If bills are dishonored on maturity, the bank will make a contra entry: Bills for collection (Liability) account ……Dr. (with amount dishonored)

To Bills for collection (Asset) account (with amount dishonored)

The format for Bills for collection (Asset) a/c and Bills for collection (liability) a/c can be shown as follows:

Format for Bills for collection (Asset) account

Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
----	Balance b/d	----	---	Bills for collection (Liability) a/c (being bills received for collection)	
----	Bills for collection (Liability) a/c (bills against which cash is collected)	-----	----	Bills for collection (Liability) a/c (bills against which cash couldn't be collected and are dishonored)	

Format for Bills for collection (Liability) account

Date	Particulars	Amount	Date	Particulars	Amount
----	Bills for collection (Asset) a/c (Bills against which cash is collected)	----	---	Balance b/d	
----	Bills for collection (Asset) a/c (bills against which cash couldn't be collected and are dishonored)	-----	----	Bills for collection (Asset) a/c (being bills received for collection)	

Purchase or discounting of bills:

Purchasing a bill and making payment for it before its maturity is called discounting of bills. The accounting entries done by banks with respect to discounting of bills are given as follows:

a. When bills are discounted

Discounted bills account ……. Dr. (Gross value of the bill)

To Discount on bills account (amount of commission)

To customer's account (after deducting commission from gross value)

b. On collection/realization of the bills Cash account ……Dr.

To Discounted bills account

Discounted bills are assets shown in the Balance Sheet under the head "advances" (schedule 9). Discount is an income item and shown in interest earned (schedule 13) of the profit and loss account.

Rebate on bills discounted

As explained above, when the bank purchases and makes payment for a bill before its maturity, it is called discounting. At the time of discounting the bank credit the income earned in relation to discounting of bills. Rebate here refers to that part of this income (discount) which relates to the unexpired term of the bill at year end. For example, if total term of the bill is 10 days of which 6 days falls in the next accounting period, then 60% of the discount earned should be treated as a rebate. Its treatment is same as that of interest/ discount received in advance. It's a personal account. Rebate on bills discounted is shown under the head "other liability and provisions" in the balance sheet. The accounting entries involved are as follows:

a. For transferring the unearned part of the discount income at the end of the accounting year:

Discount on bills account ……Dr.

To Rebate on bills Discounted account

b. For transferring back, the earned part of the discount income at the beginning of the next accounting year:

Rebate on bills Discounted account ……Dr.

To Discount on bills account

Illustration

Following information is given for Punjab National Bank:

Particulars	Amount (in lakhs)
Bills of Exchange discounted during the year 2015-2016	2000
Bills due from customer after 31st March 2016	300
Opening balance of "Rebate on bills discounted a/c	10

Interest is charged at 20% p.a. and the average period of discount is 65 days. The bills remain outstanding for an average period of 32 days after 31st March of any year.

Journalize and show the necessary ledger accounts.

Solution:

Date	**Particulars**	**(Lakhs)**
1-4-2015	Rebate on bills discounted account To Discount on bills account (Transfer the earned part of the discount income from Rebate on bills discounted account to Discount on bills account)	10 10
2015-2016	Bills purchased and discounted account To Discount on bills account To Customers a/c (Discounting of bills during the year: [2000x0.2]x65/365)	2000 356 1644
31-3-2016	Discount on bills account To Rebate on bills discounted account	5.27 5.27

	(unexpired/unearned part of discount in respect of discounted bills carried forward [300x0.2]x32/365)	
31-3-2016	Discount on bills account To Profit & Loss account (Being discount income transferred to P&L a/c)	360.73 360.73

Discount on Bills Account

Date	Particulars	Amount (Lakhs)	Date	Particulars	Amount (Lakhs)
31-3-2016	Rebate on Bills discounted account	5.27	1-4-2015	Rebate on Bills discounted account	10
31-3-2016	Profit & Loss account	360.73	31-3-2016	Bills purchased and discounted account	356
		366			366

Rebate on Bills Discounted Account

Date	**Particulars**	**Amount (Lakhs)**	**Date**	**Particulars**	**Amount (Lakhs)**
31-3-2016	Discount on Bills a/c	10	1-4-2015	Balance b/d	10
31-3-2016	Balance c/d	5.27	30-3-2016	Discount on bills a/c	5.27
		15.27			15.27

Acceptances, Endorsements and other Obligations

When a bank accepts or endorses a bill on behalf of its customers, then the bank a) is liable towards the party receiving such a bill, and b) has a corresponding claim against the customer on whose behalf it has accepted or endorsed the bill. Following points may be noticed in case of acceptance and endorsements:

1) **Record:** The particulars of such acceptances and endorsements (including securities, if any), are recorded in the Bills Accepted Register.

2) **Disclosure:** Outstanding liabilities and the corresponding assets arising out of acceptances and endorsements are disclosed as contingent items.

3) **Accounting treatment**: The bank pays such bills at maturity and collects the amount from the customer. If the customer doesn't pay on demand, the bank disposes off the security deposited by the customer.

The journal entries involved are:

a) For making payment (to the seller) on behalf of the customer on default or **otherwise:**

Customer's account

To Cash account

b) For commission receivable from customer:

Customer's account

To Commission on acceptances & endorsement account

c) When customers make the payment:

Cash account

To Customer's account

Inter-office Adjustments

Inter-office adjustments are the adjustments related to the transactions between head office and its branches. The Bank prepares a Branch Adjustment account whose balance may either be a debit or a credit balance. The Branch Adjustment Account with a credit balance is shown in the balance sheet under schedule 5 “other liabilities and provisions”, while a debit balance under the schedule 11 “other assets”.

Interest on Doubtful Debts

Banks provide loan to customers on which the customers are supposed to pay interest. The journal entries which the bank may pass regarding such interest can be summarized as follows.

a) When the customer’s position is good and he pays the interest on loan to the bank, then the bank records the interest through the following entry:

Customer’s Loan account
To Interest account

b) If financial position of the customer is not good and there is doubt on his ability to pay the interest on loan, then the bank opens an interest suspense account and the following entry is passed to record interest on doubtful debts:

Customer’s account
To Interest Suspense account

Interest suspense account is included in schedule 5 of the liabilities side of the balance sheet.

c) If the customer repays the loan, the amount of interest received is transferred to
interest account and the entries to be passed by the bank are: For payment received:

Cash account
To Customer’s Loan account

For transferring interest:

Interest Suspense account
To Interest account

d) If any amount of interest is unrealized, then the unrealized portion of loan is transferred to customer's loan account:

Interest Suspense account (unrealized interest)

Bad Debts account (unrealized portion of loan)

To Customer's Loan account

2. CHECK YOUR PROGRESS

IDENTIFY THE SCHEDULE (CLASSIFICATION IN BALANCE SHEET)

Item	**Schedule**	**Shown As**
Discounted bills	Schedule 9	Advances
Rebate on bills discounted	Schedule 5	Other Liabilities and Provisions
Interest suspense	Schedule 5	Other Liabilities and Provisions
Inter-office debit balance	Schedule 11	Other Assets

Commission from acceptances	Schedule 13	Interest Earned

6.4 LET US SUM UP

This section covered key **accounting treatments and regulatory requirements** applicable to banking companies under the **Banking Regulation Act, 1949**. Important provisions and concepts include:

- **Statutory Reserve**: Mandatory transfer of 20% of profit before dividend (Section 17).
- **Cash Reserve Ratio (CRR)**: Maintenance of 3% of time and demand liabilities with RBI (Section 18).
- **Bills for Collection**: Assets and liabilities are created when a bank collects bills on behalf of customers.
- **Discounting of Bills**: Banks purchase bills before maturity at a discount and show them under "Advances."

- **Rebate on Bills Discounted**: Part of discount income unearned at year-end; treated as a liability.
- **Acceptances and Endorsements**: Contingent liabilities shown off-balance sheet.
- **Inter-office Adjustments**: Reflect transactions between head office and branches.
- **Interest on Doubtful Debts**: Interest not realized is transferred to Interest Suspense Account.

6.5 KEYWORDS

- Statutory Reserve: A compulsory reserve created by transferring 20% of the bank's profits before declaring dividends.
- Cash Reserve: A percentage (3%) of the time and demand liabilities that banks must maintain with the Reserve Bank of India.
- Bills for Collection: Bills received by banks for collection on behalf of customers, creating both asset and liability accounts.
- Discounted Bills: Bills purchased by banks before their maturity at a discounted value, recorded as advances.
- Rebate on Bills Discounted: The portion of discount income that relates to the next accounting period; considered unearned and recorded as a liability.
- Acceptances and Endorsements: A form of bank guarantee where the bank accepts bills on behalf of customers, resulting in contingent liabilities.
- Inter-office Adjustments: Entries related to internal transactions between head office and branches, shown under other assets or liabilities.

3. CHECK YOUR PROGRESS

Assertion and Reasoning (Write: True/False)

1. **Assertion (A):** Bills discounted are shown under “Advances” in the balance sheet.
   Reason (R): Because they represent receivables that the bank will collect on maturity.

   Answer: True, True – and Reason is correct explanation.

2. **Assertion (A):** Rebate on bills discounted represents an earned income.
   Reason (R): It is income earned during the current accounting period

   Answer: False, False – it is unearned income carried forward.

3. **Assertion (A):** Acceptances and endorsements are disclosed as contingent liabilities.
   Reason (R): Because the bank has a potential obligation in case the customer defaults.

   Answer: True, True – and Reason is correct explanation.

6.6 SELF-ASSESSMENT QUESTIONS

1. A bill of ₹5,00,000 is received for collection by HDFC Bank. What journal entry should the bank pass on receipt of the bill.

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2. What is the contra entry passed when a collected bill is honored on maturity.

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3. A customer's financial position weakens and interest on a loan cannot be recognized. What is the appropriate journal entry.

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6.7 LESSON END EXERCISE

1. Journalize the following entries:

- a) Receipt of a bill for collection worth ₹1,00,000.
- b) Realization of the above bill on the due date with 2% commission.
- c) Dishonor of a bill worth ₹50,000.

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2. Calculate the unearned discount (Rebate) on the following:

Total discounted bills = ₹1,500 lakhs

Discount rate = 18% p.a.

Average term = 60 days

₹300 lakhs are due after year-end, with 24 days falling in the next period.

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3. A customer defaults on interest of ₹5,000 on a loan. Journalize:

- a) Transfer to Interest Suspense Account.
- b) Recovery of the interest in the next period.

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6.8 SUGGESTED READING

- Robert N Anthony, David Hawkins, Kenneth A. Merchant, Accounting: Text and Cases. McGraw-Hill Education, 13th Ed. 2013.
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- Tulsian, P.C. Financial Accounting, Pearson Education.

UNIT: 2 **LESSON: 7**

COURSE CODE: BCG 301

CONCEPT OF NON-PERFORMING ASSETS

7.0 LEARNING OBJECTIVES AND OUTCOMES

Learning objectives:

- Understand the concept and definition of Non-Performing Assets (NPAs).
- Learn how and when assets are classified as NPAs.
- Identify the different categories of NPAs: Sub-standard, Doubtful, and Loss assets.
- Explain the meaning of 'Out of Order' status for cash credit and overdraft accounts.
- Understand the importance of borrower-wise asset classification.
- Grasp the concept of provisioning and rates applicable to various NPA categories.
- Apply RBI's prudential norms for asset classification and income recognition.

Learning Outcomes:

On completion of this lesson, the learner will be able to:

- Define and classify bank assets into performing and non-performing.
- Distinguish between sub-standard, doubtful, and loss assets.
- Determine the conditions under which loans become NPAs.
- Interpret the term ‘Out of Order’ for overdrafts and cash credits.
- Justify why NPAs are classified borrower-wise rather than facility-wise.
- Calculate provisions required for various categories of NPAs as per RBI norms
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7.1 INTRODUCTION

- In the banking industry, loans and advances provided to customers are key income-generating assets. When borrowers repay these loans on time, they are classified as performing assets, as they contribute positively to the bank’s earnings through interest income and principal repayment. However, when a borrower fails to repay interest and/or principal for a specific period—typically 90 days—the asset ceases to yield income and becomes a Non-Performing Asset (NPA).
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- NPAs reflect the credit risk and inefficiencies in the loan recovery process of banks. Rising NPAs are a major concern because they impact the bank’s profitability, capital adequacy, and ultimately its ability to lend further. To address this, the Reserve Bank of India (RBI) has introduced prudential norms that require banks to classify, monitor, and make financial provisions for such assets in a transparent and standardized manner.
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- The concept of NPAs is not only crucial for internal risk management within banks but also forms a core part of financial statement analysis, economic policy-making, and investor confidence. Therefore, understanding the classification, accounting treatment, and provisioning of NPAs is vital for banking professionals, students of finance and accounting, and policymakers.

7.2 CONCEPT OF NON-PERFORMING ASSETS

Guidelines for classification of Assets and guidelines (Prudential Norms) for Asset

These guidelines are discussed as follows:

1) **Identification of an NPA** is to be done according to the position as on the date when the balance sheet is prepared. If an account has been regularized (by payment of the overdue/unpaid amount through genuine sources) before the balance sheet date, the account need not be treated as an NPA. The bank should, however, ensure that the account remains in order subsequently (that is, no overdue should occur again).

2) **Accounts with temporary deficiencies** Recovery record in the past should be taken into account while deciding whether an asset is an NPA or not. The asset should not be treated as NPA merely due to the existence of some deficiencies which are temporary in nature. For example, a customer has a record of paying all the dues on time in the past. If the balance outstanding in his account temporarily exceeds the limit, then it does not indicate that his account should be treated as an NPA.

3) **Asset classification** should be borrower-wise and not facility-wise. It means if any of the credit facilities provided to a customer becomes non-performing, then all facilities provided to him will be treated as non-performing without any regard to performing status of other facilities.

4) **Treatment of an asset as an NPA** The following are the rules applicable for deciding whether an asset is a Non-Performing Assets or not:

Advances

Following the international practices, RBI has introduced prudential norms on asset classification, income recognition and provisioning regarding advances, so that the public can have more consistent and transparent financial statements from the banking sector.

These prudential norms are discussed below.

7.3 PRUDENTIAL NORMS FOR ASSET CLASSIFICATION AND CONCEPT OF CLASSIFICATION OF ASSETS

Loans, advances, discounting and purchasing of bills, etc. given to customers are the assets of the bank. RBI requires all banks to classify their assets into performing or nonperforming assets. If a bank gives a loan to its customer and the customer don't pay interest or principal (or both) then the loan becomes a bad loan. The assets of the bank which don't perform (that is they don't bring any return) are called non-performing assets and those which perform (that is they bring returns) are called performing assets. Thus, assets of a bank are broadly classified into two categories:

I. Performing Assets (which are also known as standard assets)

I. Performing Assets (which are also known as standard assets)

II. Non-Performing Assets

I. Performing Assets

As defined above, performing assets are those assets which bring returns to the bank. Also known by the name of Standard assets, these assets don't carry more than normal risk attached to the business, for example, advances which are guaranteed by the government, advances against Bank's own deposits or against LIC policy, Kisan Vikas Patras (KVP) or National Saving Certificates (NSC).

II. Non-Performing Assets (NPA)

Any asset which does not provide any income to the bank is called a non-performing asset. In other words, when the bank is not able to recover the interest on loan or the principal amount or both for a period specified by RBI, the asset becomes a non-performing asset. As per the prevailing prudential norms on advances, such asset on which the bank has not received interest and/or principal and/or both for more than 90 days, is categorized as non-performing asset. If the customer has provided any security in respect of such asset to the bank, then such security should not be taken into account for the purpose of treating it as an

NPA. NPAs can further be categorized on the basis of the period for which the asset has been non-performing, into the following categories:

a) Sub-standard assets: If an asset remains in the NPA category for a period less than or equal to 12 months, it becomes a sub-standard asset. None of the security or guarantee provided is enough to ensure full recovery of amount involved. In other words, such asset can endanger the liquidation of the debt and the bank has very strong probability to incur a loss, if deficiencies are not corrected.

b) Doubtful debt: If deficiencies are still not corrected, a sub-standard asset after a period of 12 months becomes a doubtful debt. In addition to all the weaknesses of a substandard asset, a doubtful asset has an added probability that the collection of the interest and/or principal or both is highly uncertain and dubious.

c) Loss asset: If the bank/internal/external auditors identify the loss, the doubtful asset is categorized as loss asset, but the amount is not written off completely. Such an asset is considered as uncollectible, although there may be some meager amount that can be recovered from it.

The 'Non-Performing Assets' refers to those assets which fails to generate expected returns to the bank due to borrowers' default in making repayment.

In accordance with the international practice and the directives of RBI, the bank should recognized income on Non-Performing Assets (NPA) when it is actually received and not on accrual basis. Similarly, the RBI has accepted the definition of a NPA given by ***Narasimham committee from March 1995 onwards*** 'as an advance where, as on the bank's balance sheet date,

(a) interest on a term loan account is past due or

(b) a cash credit / overdraft account remains out of order or

(c) a bill purchased / discounted is unpaid or overdue or

(d) any amount to be received in respect of any other account remains past due, for a period more than 180 days.

(e) in respect of agricultural finance / advance (eg. crop loans) interest and / or instalment of principal remains overdue for two harvest seasons for a period not exceeding two half years. The period of 180 days has been reduced to 90 days effective from March 31, 2004. A 'past due' account has been defined as an amount which remains outstanding 30 days beyond the due date.

Asset's classification and provisioning

In order to make adequate provisions, assets have been classified as follows:

i. Standard assets – These are the assets which does not disclose any problems and does not carry more than normal risk attached to the business therefore no provision is to be made against them.

ii. Substandard assets – These assets exhibit problems and would include assets classified as non-performing for a period not exceeding two years. Hence the provision is to be made at the rate of 10 percent of the total outstanding amount of substandard assets.

iii. Doubtful assets – these are the assets which remain non performing for a period exceeding two years and would also include loans in respect of which installments are overdue for a period exceeding two years.

The provision for doubtful assets as follows:

Period for which the advance Has been considered as doubtful	Provision requirements (%)
Up to one year	20
One to three years	30
More than three years	50

iv. **Loss assets** – Loss assets are those assets where the loss has been identified but the amounts have not been return off.

1. CHECK YOUR PROGRESS

TRUE OR FALSE

1. A loan becomes NPA if principal or interest is overdue for more than 60 days.

ANSWER: FALSE ✕

2. A sub-standard asset is one which remains NPA for a period not exceeding 12 months

ANSWER: TRUE ☑

3. Provision for loss assets is made at 20% of the outstanding amount.

ANSWER: FALSE ✕

4. RBI allows income recognition on NPAs only on actual receipt basis.

ANSWER: TRUE ☑

5. Asset classification is done facility-wise and not borrower-wise.

ANSWER: FALSE ✕

Illustration

Exe bank ltd. having the following advances as on 31st March 2009 and provision is to be made against them.

	Bills Purchased and Discounted	**Cash credit, overdraft**	**Term loans**

1. Standard	5,150	4,925	2,375
Assets	4,000	1,500	1,000
2. Sub-standard			
Assets			
3. ii) Doubtful	--	500	1,800
Assets:	--	1,800	700
Up to one year	--	1,275	550
One to 3 years -		350	225
More than 3 years			
4. Loss Assets			
	9150	10,350	6,650

Solution

	Amount (Rs.)	**% of Provision**	**Amount of Provision (Rs)**
1. Standard	12,450	Nil	Nil
Assets	6,500	10%	650
2. Sub-standard			
Assets			
3. Doubtful	2,300	20%	460
Assets:	2,500	30%	750
Up to one year	1,825	50%	912.5
One to 3years -	575	100%	575
More than 3 years			

4. Loss Assets			
Total Provision on Advances			**3,347.5**

ASSET	**Asset treated as an NPA if:**
1. Term loan	If the interest and/or installment of the principal remain overdue for a period of 90 days.
2. Cash credit and overdraft	If the Account remains "out of order" for a period of more than 90 days. An account is treated as "out of order" if a) balance outstanding remains continuously in excess of the sanctioned limit/drawing power, or b) outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period.
3. Bills purchased and discounted	If the bills remain overdue for more than 90 days.

4. Agricultural advances for short duration crops	If the installment of principal or interest thereon remains overdue for two crop seasons. Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.
5. Agricultural advances for long duration crops	If the installment of principal or interest thereon remains overdue for one crop season.
6. Securitization Transactions	If the amount of liquidity facility remains outstanding for more than 90 Days.
7. Credit card accounts	If the minimum amount mentioned in the statement remained unpaid within 90 days from the next statement, the gap between two statements should not be more than one month.
8. Advances guaranteed by central government	If the government repudiate or reject its guarantee when called upon. Thus, central government guaranteed advances would be treated as standard assets even if overdue.

2. CHECK YOUR PROGRESS

FILL IN THE BLANKS

1. A ___________ is an asset that stops bringing income to the bank.

Answer: Non-Performing Asset

2. An asset remains sub-standard if it is non-performing for less than ___________ months.

Answer: 12

3. A doubtful asset is one that remains non-performing for more than ___________ months.

Answer: 12

4. Provision for doubtful assets more than three years is ___________ percent.

Answer: 50

5. A standard asset carries ___________ risk.

Answer: Normal

7.4 LET US SUM UP

- NPAs are assets that stop generating income for banks.
- If principal/interest is overdue for more than 90 days, it is treated as an NPA.
- NPAs are classified into:

- Sub-standard (up to 12 months)
- Doubtful (beyond 12 months)
- Loss (irrecoverable)

- Banks follow prudential norms set by RBI for classification and provisioning.
- Income from NPAs is recognized only on actual receipt basis.

7.5 KEYWORDS

Performing Asset:

An asset that generates income for the bank regularly through interest or principal repayments as scheduled.

Non-Performing Asset (NPA):

An asset (loan/advance) where the borrower has failed to pay interest and/or principal for more than 90 days. It stops generating regular income for the bank.

Standard Asset:

A performing asset that carries normal risk and is not classified as an NPA.

Sub-standard Asset:

A non-performing asset that has remained in the NPA category for 12 months or less.

Doubtful Asset:

A loan or advance that has remained in the sub-standard category for more than 12 months and where recovery is uncertain.

Loss Asset:

An asset identified as unrecoverable by auditors or the bank, but not yet written off from the books.

Out of Order:

A cash credit or overdraft account is said to be “out of order” if it exceeds the limit or shows no credit activity for 90 days to cover interest debited.

Cash Credit:

A short-term cash facility provided by banks against security, allowing the borrower to withdraw funds up to a sanctioned limit.

7.6 SELF-ASSESSMENT QUESTION

1. What are the different types of NPAs, and how are they categorized.

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2. Describe the provisioning requirements for each NPA category.

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3. Write a note on prudential norms prescribed by RBI.

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7.7 LESSON END EXERCISE

1. How are NPAs shown in the bank's balance sheet.

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2. A bank has the following classification:

- Standard assets: ₹12,000 lakh
- Sub-standard: ₹5,000 lakh
- Doubtful: ₹1,500 lakh (up to 1 year), ₹1,200 lakh (1–3 years), ₹900 lakh (>3 years)
- Loss assets: ₹600 lakh

  Compute the total provision required.

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3. Explain the criteria for term loans and overdrafts to become NPAs.

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3. CHECK YOUR PROGRESS

SHORT QUESTION ANSWERS

1.What is a Non-Performing Asset (NPA)

ANSWER: An NPA is a loan or advance where interest or principal remains unpaid

2. When does an asset become non-performing.

ANSWER: When interest/principal remains overdue for 90+ days (or specified crop season in agricultural loans).

3. What is a Sub-standard Asset.

ANSWER: An asset that remains NPA for up to 12 months.

4. What is a Doubtful Asset?

ANSWER: An asset that remains sub-standard for more than 12 months.

5. What is a Loss Asset?

ANSWER: An asset identified as uncollectible but not yet written off.

7.8 SUGGESTED READING

- Robert N Anthony, David Hawkins, Kenneth A. Merchant, Accounting: Text and Cases. McGraw-Hill Education, 13th Ed. 2013.
- Charles T. Horngren and Donna Philbrick, Introduction to Financial Accounting, Pearson Education.
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UNIT: 2 **LESSON: 8**

COURSE CODE: BCG 301

PREPARATION OF P&L A/C, CONTENTS OF SCHEDULE NO. 13,14,15,16.

8.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

- To understand the prescribed format of Profit and Loss Account for a banking company under the Banking Regulation Act, 1949.
- To identify the items under different schedules (13 to 16) such as interest earned, interest expended, other income, and operating expenses.
- To classify various incomes and expenses correctly under appropriate schedules.
- To compute net profit/loss and apply appropriate appropriations.
- To prepare a complete Profit and Loss Account of a banking company with suitable adjustments.

Learning Outcomes

- Explain the structure and significance of the Profit and Loss Account of a bank.
- Prepare banking Profit and Loss Account using real-life financial data.
- Apply RBI's prescribed schedule format in examination and practical work.
- Analyze the impact of appropriations and provisions on net profit.
- Handle adjustments like rebate on bills discounted, tax provisions, and doubtful debts in the income figures.
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8.1 INTRODUCTION

The Profit and Loss Account of a banking company is a financial statement prepared in a prescribed format as per the Third Schedule of the Banking Regulation Act, 1949. It presents the results of the bank's operations over a specific accounting period, typically a financial year. The format is standardized by the Reserve Bank of India (RBI) to ensure uniformity, clarity, and comparability. It consists of two primary components — Income (such as interest earned, commissions) and Expenditure (such as interest paid, operating expenses). The difference results in Net Profit or Loss, which is transferred to the Profit & Loss Appropriation Account for further allocation to reserves.

8.2 PREPARATION OF PROFIT AND LOSS ACCOUNT

Preparation of Profit and Loss Account

The Profit and Loss Account of a banking company is prepared in the format prescribed by the Reserve Bank of India (RBI) under the Third Schedule of the Banking Regulation Act, 1949. It reflects the bank's operating results during an accounting year and consists mainly of two parts:

1. Income
2. Expenditure

The net result is Net Profit or Loss, which is transferred to the Profit & Loss Appropriation Account

(Form 'B'

FORM OF PROFIT & LOSS ACCOUNT FOR THE YEAR ENDED 31ST MARCH

			(000's omitted)
	Schedule No.	**Year ended 31.3… (Current Year)**	**Year ended 31.3… (Previous Year)**

I. Income			
Interest earned	13		
Other income	14		
Total			
II. Expenditure	15		
Interest expended	16		
Operating expenses			
Provisions and contingencies			
Total			
III. Profit / Loss			
Net profit / Loss (-) for the year			
Profit / Loss (-) brought forward			
Total			
IV. Appropriations			
Transfer to statutory reserves			
Transfer to other reserves			
Transfer to Government / Proposed dividend			
Balance carried over to Balance			

Sheet Total			

NOTE: 1. The total income includes income of foreign branches of Rs. ______

2. The total expenditure includes expenditure of foreign branches at Rs. _____

3. Surplus / deficit of foreign branches Rs. ______

8.3 CONTENTS OF SCHEDULE

8.3.1 SCHEDULE 13- INTEREST EARNED

Particulars	**Year ended 31-3- (current year)**	**Year ended 31-3- (previous year)**
1. Interest/discount on advances/bills 2. Income on investments 3. Interest on balances with RBI and other inter-bank funds 4. Others		
TOTAL		

8.3.2 SCHEDULE 14- OTHER INCOME

Particulars	**Year ended 31-3- (Current year)**	**Year ended 31-3- (Previous year)**
I. Commission, exchange and brokerage II. Profit on sale of investment (-) loss on sale of investment III. Profit on revaluation of investment (-) loss on revaluation of investment IV. Profit on sale of land, building & other assets (-) loss on sale of land, building and other assets V. Profit on exchange transactions (-) loss on exchange transactions VI. Income earned by way of dividends etc. from subsidiaries/companies and joint venture abroad or in India		

VII. Miscellaneous income		
TOTAL		

8.3.3 SCHEDULE- 15- INTEREST EXPENDED

Particulars	**Year ended 31-3- (Current year)**	**Year ended 31-3- (Previous year)**
I. Interest on deposits II. Interest on RBI/inter-bank borrowings III. Others **Total**		

8.3.4 SCHEDULE 16- OPERATING EXPENSES

Particulars	**Year ended 31-3- (Current year)**	**Year ended 31-3-... (Previous year)**
I. Payment to and provisions for employees II. Rent, taxes and lighting III. Printing and stationary IV. Advertisement and publicity V. Depreciation on Bank's property VI. Directors' fees, allowances and expenses VII. Auditor's (including branch auditor) fees and expenses VIII. Law charges		
TOTAL		

ILLUSTRATION 1: From the following figures, prepare a Profit and Loss Account of New Era Bank Ltd. for the year ending 31st March 2025.

Particulars	**Amount (₹ in '000)**
Interest on Loans & Advances	6,000
Interest on Investments	2,500

Particulars	Amount (₹ in '000)
Interest on Balance with RBI	300
Commission, Exchange & Brokerage	600
Rent Received	100
Profit on Sale of Investments	200
Interest Paid on Deposits	4,000
Interest Paid on Borrowings	300
Salaries & Wages	900
Rent, Taxes & Lighting	250
Printing & Stationery	100
Advertisement & Publicity	75
Directors' Fees & Expenses	25
Auditors' Fees	15
Depreciation on Bank Property	135
Other Expenses	50

Prepare the **Profit and Loss Account** of the bank in the prescribed format.

Solution: New Era Bank Ltd.

Profit and Loss Account for the Year Ended 31st March, 2025

Income

Schedule 13: Interest Earned

Interest on Loans & Advances:	6000
Interest on Investments:	2,500

Interest on Balance with RBI:	300
Total (Sch. 13):	**8,800**

Schedule 14: Other Income

Commission, Exchange & Brokerage:	600
Rent Received:	100
Profit on Sale of Investments:	200
Total (Sch. 14):	**900**

Total Income = **8,800 + 900 = ₹9,700**

Expenditure

Schedule 15: Interest Expended

Interest on Deposits:	4,000
Interest on Borrowings:	300
Total (Sch. 15):	**4,300**

Schedule 16: Operating Expenses

Salaries & Wages:	900
Rent, Taxes & Lighting:	250
Printing & Stationery:	100

Advertisement & Publicity:	75
Directors’ Fees & Expenses:	25
Auditors’ Fees:	15
Depreciation:	135
Other Expenses: 50	
Total (Sch. 16):	**1,550**

Total Expenditure = **4,300 + 1,550 = ₹5,850**

Net Profit = Total Income – Total Expenditure

= ₹9,700 – ₹5,850 = **₹3,850 (‘000)** or **₹38,50,000**

ILLUSTRATION 2: From the following information, prepare Profit and Loss A/c of Dimple Bank as on 31-3-2024:

\` ’000	Item	\` ’000
2023-24		2023-24
14,27	Interest and Discount	20,45
1,14	Income from investment	1,12
1,55	Interest on Balances with RBI	1,77
7,22	Commission, Exchange and Brokerage	7,12
12	Profit on sale of investments	1,22
6,12	Interest on Deposits	8,22
1,27	Interest to RBI	1,47

7,27	Payment to and provision for employees	8,55
1,58	Rent, taxes and lighting	1,79
1,47	Printing and stationery	2,12
1,12	Advertisement and publicity	98
98	Depreciation	98
1,48	Director’s fees	2,12
1,10	Auditor’s fees	1,10
50	Law charges	1,52
48	Postage, telegrams and telephones	62
42	Insurance	52
57	Repair & maintenance	66

Also give necessary Schedules.

Other Information:

1. The following items are already adjusted with Interest and Discount (Cr.):

Tax Provision (’000 `)	1,48
Provision for Doubtful Debts (’000 `)	92
Loss on sale of investments (’000 `)	12
Rebate on Bills discounted (’000 `)	55

2. Appropriations:

25% of profit is transferred to Statutory

Reserves 5% of profit is transferred to

Revenue Reserve.

Solution

Dimple Bank
Profit and Loss Account for the year ended 31-3-2024

		Schedule No.	Year ended 31-3-2024	(` 000's) Year ended 31-3-2023
I.	**Income**			
	Interest Earned	13	25,86	16,96
	Other Income	14	8,22	7,34
	Total		34,08	24,30
II.	**Expenditure**			
	Interest Expended	15	9,69	7,39
	Operating Expenses	16	20,96	16,97
	Provisions and Contingencies		2,40	
	Total		33,05	24,36
III.	**Profit/Loss**			
	Net Profit/Loss (—) for the year		1,03	(6)
	Profit/Loss (—) brought forward		(6)	
	Total		97	(6)
IV.	**Appropriations**			
	Transfer to Statutory Reserve		25.75	
	Transfer to Other Reserve, Proposed Dividend		5.15	
	Balance carried over to Balance Sheet		66.10	
	Total		97.00	

Schedule 13 - Interest Earned

(` 000's)

		Year ended 31-3-2024	Year ended 31-3-2022
I.	Interest/Discount	22,97	14,27
II.	Income on Investments	1,12	1,14
III.	Interest on Balances with RBI and other inter-bank fund	1,77	1,55
IV.	Others		-
	Total	25,86	16,96

Schedule 14 - Other Income

(` 000's)

		Year ended 31-3-2024	Year ended 31-3-2023
I.	Commission, Exchange and Brokerage	7,12	7,22
II.	Profit on Sale of Investments	1,22	12
	Less: Loss on sale of Investments	(12)	-
	Total	8,22	7,34

Schedule 15 - Interest Expended

(` 000's)

		Year ended 31-3-2024	Year ended 31-3-2023
I.	Interest on Deposits	8,22	6,12
II.	Interest on RBI/inter-bank borrowings	1,47	1,27

	Total	9,69	7,39

Schedule 16 - Operating Expenses

(` 000's)

		Year ended *31-3-2024*	**Year ended** *31-3-2023*
I.	Payments to and provision for employees	8,55	7,27
II.	Rent, taxes and lighting	1,79	1,58
III.	Printing and stationery	2,12	1,47
IV.	Advertisement and Publicity	98	1,12
V.	Depreciation on the Bank's Property	98	98
VI.	Director's fees, allowances and expenses	2,12	1,48
VII.	Auditor's fees and expenses (including branch auditors)	1,10	1,10
VIII.	Law charges	1,52	50
IX.	Postage, telegrams, telephones etc.	62	48
X.	Repairs and maintenance	66	57
XI.	Insurance	52	42
XII.	Other Expenditure		-
	Total	20,96	16,97

ILLUSTRATION 3

From the following information, prepare Profit and Loss A/c of KC Bank for the year ended 31st March, 2021:

Items ` 000

Interest on cash credit		18,20
Interest on overdraft		7,50
Interest on term loans		15,40
Income on investments		8,40
Interest on balance with RBI		1,50
Commission on remittances and transfer		75
Commission on letters of credit	1,18	
Commission on government business	82	
Profit on sale of land and building	27	
Loss on exchange transactions	52	
Interest paid on deposit	27,20	
Auditors' fees and allowances	1,20	
Directors' fees and allowances	2,50	
Advertisements	1,80	
Salaries, allowances and bonus to employees	12,40	
Payment to Provident Fund	2,80	
Printing and stationery	1,40	
Repairs and maintenance	50	
Postage, telegrams, telephones	80	

Other Information:

(i) Interest on NPA is as follows

	Earned (` '000)	Collected (` '000)
Cash credit	8,20	4,00
Overdraft	450	1,00
Term Loans	750	2,50

(ii) Classification of Non-Performing Advances ('000 `)

Standard	30,00
Sub-standard	11,20

	Doubtful assets not covered by security	2,00
	Doubtful assets covered by security for one year	50
	Loss Assets	2,00
(iii)	Investments	27,50

Bank should not keep more than 25% of its investment as 'held-for-maturity' investment. The market value of its rest 75% investment is ` 19,75,000 as on 31-3-2021.

. CHECK YOUR PROGRESS
TRUE OR FALSE

The Profit and Loss Account of a bank is prepared as per the Companies Act, 2013.
☞ False

Schedule 14 deals with Other Income of a banking company.
☞ True

Depreciation on bank property is shown under Schedule 13.
☞ False

Profit on sale of investments is classified under Other Income.
☞ True

Rebate on bills discounted is subtracted from interest earned while calculating net interest income.
☞ True

Solution

KC Bank
Profit and Loss Account
For the year ended 31st March, 2021

	Particulars	Schedule	(` *'000'*) *Year ended 31-3-2021*
I	**Income**		
	Interest earned	13	38,30
	Other income	14	2,50
			40,80
II	**Expenditure**		
	Interest expended	15	27,20
	Operating expenses	16	23,40
	Provisions and Contingencies		6,80
			57,40
III	**Profit/Loss**		(16,60)
IV	**Appropriations**		Nil

Schedule 13 - Interest Earned

		Year ended 31-3-20X1	(` *'000'*)
I	Interest/discount on advances/bills		
	Interest on cash credit ` (18,20-420)	14,00	
	Interest on overdraft ` (750-350)	4,00	
	Interest on term loans ` (15,40-500)	10,40	28,40
II	Income on investments		8,40
III	Interest on Balance with RBI		1,50
			38,30

Interest on NPA is recognised on cash basis, hence excess reduced

Schedule 14 - Other Income

			Year ended 31-3-2021 (` *'000'*)
I	Commission, Exchange and Brokerage		
	Commission on remittances and transfer	75	
	Commission on letter of credit	1,18	
	Commission on Government business	82	2,75
II	Profit on sale of Land and Building		27
III	Loss on Exchange Transactions		(52)
			2,50

Schedule 15 - Interest Expended

		Year ended 31-3-2021
I	Interest on Deposits	27,20

Schedule 16 - Operating Expenses

			Year Ended 31-3-2021
I	Payment and provision for employees		
	Salaries, allowances and bonus	12,40	
	Provident Fund Contribution	2,80	15,20
II	Printing and Stationery		1,40
III	Advertisement and publicity		1,80
IV	Directors' fees, allowances and expenses		2,50
V	Auditors' fees and expenses		1,20
VI	Postage, telegrams, telephones etc.		80
VII	Repairs and maintenance		50
			23,40

Working Note:

Provisions and contingencies			*(` '000)*
Provision for NPA:			
Standard	3,000 × 0.40%		12
Sub-standard	1,120 × 15%*		1,68
Doubtful not covered by security	200 × 100%		2,00
Doubtful covered by security for one year	50 × 25%		12.5
Loss Assets	200 × 100%		2,00
			592.5
Depreciation on current investments			
Cost (75% of 27,50)		2,062.50	
Less: Market value		(1,975.00)	87.5
			680.00

Note: 25% of the total investments are held to maturity. In the case of Held to Maturity investments the valuation is done at cost and these are not marked to market value generally. Hence, depreciation on investments has been calculated only on other investments which can either be Held for Trading (HFT) or Available for Sale (AFS)

2. CHECK YOUR PROGRESS
TRUE OR FALSE

1. Appropriations are made before calculating net profit.
☞ False

2. Interest on deposits is shown under Interest Expended.
☞ True

3. Auditor’s fees are part of operating expenses in a bank’s P&L Account.
☞ True

4. The format of the Profit and Loss Account of a bank is optional.
☞ False

5. Loss on sale of investments increases the profit of the bank.
☞ False

8.4 LET US SUM UP

- The Profit and Loss Account of a bank is prepared under the format prescribed by RBI.
- It contains four major schedules:
    - **Schedule 13** – Interest Earned
    - **Schedule 14** – Other Income
    - **Schedule 15** – Interest Expended
    - **Schedule 16** – Operating Expenses
- Adjustments like provisions and rebate must be deducted before arriving at actual figures.
- Final net profit is appropriated to reserves and carried forward.

8.5 KEYWORDS

- **Schedule 13:** Includes income from interest, investments, and balances with RBI
- **Schedule 14:** Commissions, brokerage, profits on investments
- **Schedule 15:** Interest paid on deposits and borrowings
- **Schedule 16:** Salaries, rent, depreciation, and other operating costs
- **Appropriations:** Allocation of net profit to statutory and other reserves
- **Rebate on Bills Discounted:** Income to be reversed due to unexpired discount period

8.6 SELF-ASSESSMENT QUESTIONS

1. What is the purpose of preparing a Profit and Loss Account for a banking company.

………………………………………………………………………………………………
………………………………………………………………………………………………
………………………………………………………………………………………………

2. Name any four items that appear under Schedule 13.

………………………………………………………………………………………………
………………………………………………………………………………………………
………………………………………………………………………………………………

3. What are the components of Schedule 14.

………………………………………………………………………………………………
………………………………………………………………………………………………
………………………………………………………………………………………………

8.7 LESSON END EXERCISE

1. A bank earned ₹5,000,000 in interest and spent ₹3,200,000 on interest. Calculate net interest income.

………………………………………………………………………………………………
………………………………………………………………………………………………
………………………………………………………………………………………………

2. Explain the treatment of the following in a bank's P&L:

Rebate on bills discounted

Provision for bad and doubtful debts

………………………………………………………………………………………………
………………………………………………………………………………………………
………………………………………………………………………………………………

3. Mention any four examples of operating expenses under Schedule 16.

………………………………………………………………………………………………
………………………………………………………………………………………………
……………………………………………………………………………………………

3. CHECK YOUR PROGRESS

MATCH THE FOLLOWING

A (Items)	**B (Schedules / Categories)**
1. Interest on deposits	a. Schedule 15
2. Commission and brokerage	**b.** Schedule 14
3. Printing and stationery	c. Schedule 16
4. Interest on balances with RBI	d. Schedule 13
5. Profit on sale of investments	e. Other Income

Answers:

1 → a

2 → b

3 → c

4 → d

5 → e

8.8 SUGGESTED READING

• Robert N Anthony, David Hawkins, Kenneth A. Merchant, Accounting: Text and Cases. McGraw-Hill Education, 13th Ed. 2013.

- Charles T. Horngren and Donna Philbrick, Introduction to Financial Accounting, Pearson Education.
- J.R. Monga, Financial Accounting: Concepts and Applications. Mayur Paper Backs, New Delhi.
- M.C.Shukla, T.S. Grewal and S.C.Gupta. Advanced Accounts. Vol.-I. S. Chand & Co., New Delhi.
- S.N. Maheshwari, and. S. K. Maheshwari. Financial Accounting. Vikas Publishing House, New Delhi.
- Deepak Sehgal. Financial Accounting. Vikas Publishing H House, New Delhi.
- Bhushan Kumar Goyal and HN Tiwari, Financial Accounting, International Book House
- Goldwin, Alderman and Sanyal, Financial Accounting, Cengage Learning.
- Tulsian, P.C. Financial Accounting, Pearson Education

UNIT: 2 **LESSON: 9**

COURSE CODE:

PREPARATION OF B/S, VARIOUS CONTENTS OF SCHEDULE NO 1 TO 11

Structure:

9.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

By the end of this lesson, learners will be able:

- To explain the structure and components of bank financial statements.
- To list and describe the various schedules used in bank final accounts.
- To prepare bank balance sheets and profit and loss accounts using illustrative data.
- To understand the concept of provisions, contingencies, and contingent liabilities.

- To analyze the regulatory formats and disclosures required by banks.

  Learning Outcomes
- After studying this chapter, learners will be able to:
- Prepare a Balance Sheet and Profit & Loss Account as per statutory format.
- Identify and classify items under appropriate Schedules.
- Compute provisions for NPAs, tax, and rebate on bills discounted.
- Understand the treatment of contingent liabilities and bills for collection.
- Apply accounting policies and formats relevant to banking sector reporting.

9.1 INTRODUCTION

- The final accounts of banking companies consist of a Balance Sheet and a Profit and Loss Account, prepared in compliance with the Banking Regulation Act, 1949, particularly as per the Third Schedule (Form A and Form B). These accounts are different from non-banking entities due to the unique nature of banking operations and regulatory requirements. Each item in the financial statements is presented through designated Schedules to ensure standardization and transparency.
- Schedules forming part of Form A – Balance Sheet Schedule -
- 1. Capital Schedule
- 2. Reserves & Surplus Schedule
- 3. Deposits Schedule
- 4. Borrowings Schedule
- 5. Other Liabilities and Provisions Schedule
- 6. Cash and balances with RBI Schedule
- 7. Balances with Banks and money at call and short notice.
- 8. Investments
- 9. Advances
- 10. Fixed Assets

- 11. Other Assets
- 12. Contingent Liabilities / Bills for Collection
- Schedules forming Part of Form B – Profit and Loss Account.
- 13. Interest Earned.
- 14. Other Income.
- 15. Interest Expended.
- 16. Operating Expenses.
- 17. Schedules forming Part of Annual Report
- 18. Significant Accounting Policies.
- 19. Notes forming part of accounts.
- The Assets side of the Balance Sheet has been arranged in such a manner that liquid assets such as Cash, Balances with Banks and Investments are shown in that order. This enables the investor to quickly identify how much the Bank is liquid enough to meet its commitment towards its customers. This arrangement of Assets is from liquid to fixed assets in contrast to corporate balance sheets where the arrangement is from fixed to liquid. While preparing financial statements, banks have to follow various guidelines / directions given by RBI/Government of India governing the Financial Statements.
- Forms for the preparation and presentation of financial statements of banking companies have been given in Annexure I & II along with compliance guidelines of RBI given in Annexure III at the end of this chapter. In this unit we shall straightaway go to the problems relating to preparation of final accounts of banks.

9.2 PREPARATION OF ACCOUNTS AND BALANCE SHEET

9.2.1 FINAL ACCOUNTS

Financial Statements of Banks:

The balance sheet of a bank and its profit and loss account are together termed as bank's financial statements. These are to be prepared as per the Form A and Form B of Schedule III of Banking Regulation Act, 1949. The financial statements of a banking company are a bit different from those of a non-banking company. For the banking companies, there are in total 18 schedules out of which schedule1 to schedule 12 are annexed with the balance sheet, whereas schedule 13 to schedule 16 are annexed with the profit and loss account, schedule 17 is notes on accounts and schedule 18 is disclosure of accounting policies (AS1).

Items to be included Financial Statements of Banks:

1. Deposits: Deposits are the money received by the bank from the customers and kept in the respective customer's accounts. These deposits can be of various types:

> **a) Demand deposits:** They refer to the deposits made by the customers and repayable by the bank when demanded back by the customers. They include bank deposits from bank and from others (that is, non-bank sector). For example, savings account or current account.
>
> **b) Fixed/ Term/ Time deposits:** These are deposits repayable on the expiry of a specified period which can vary from one month to five years or more. For example, recurring deposits or annuity deposits.

2. Money at call and short notice: These are inter-bank transactions where one bank borrows money from another bank usually for 1-14 days. This item is divided into two parts, namely, money at call and short notice firstly with the banks and secondly with other institutions (like primary dealers in the money market).

3. Provisions and contingencies: Provisions include provision for Bad and doubtful debt, provision for rebate on bills discounted, provision for Income Tax etc. whereas contingencies are accumulated and only an aggregate or consolidated figure is shown in the profit and Loss account. Provisions and contingencies =Provisions for Bad and Doubtful Debts+ Provision for Diminution in Value of Investment (Other Than Held to Maturity) + Transfers to Contingencies + Provision for Tax. It is to be noted that provision for tax = tax rate x [total income – total expenditure (including provisions and contingencies but excluding provision for tax)]

ILLUSTRATION: Calculate the provisions and contingencies by considering the information given below. Provision for NPA is 623 lakhs. Total investments are 500 lakhs out of which 15% are held to maturity and market value of investments is 90%. Tax to be provided is 30%.

Particulars	Amount (in Lakhs)
Interest and discount	4200
Other income	230
Income from investments	150
Interest expended	300
Operating expenses	120

Solution:

Particulars	Amount (in lakhs)
a) Provision for NPA	623
b) Provision for diminution of investments (other than held to maturity): Investments other than held to maturity =85% of 500=425.00	42.5
Less: Market value of investments = (90% of 425)	(382.50)

c) Provision for tax:

Total income

= Interest + Other income+ Income from Investments

= 4200+ 230+ 150 4580

Less: Total Expenditures Excluding Provision for Tax

= Interest Expended +Operating Expenses+ Provision for Contingencies

= 300+120 +(623+42.5)

(1085.5)

= 300+120 +(623+42.5)	(1085.5)
	....
	3494.5
Provision for tax = 30% of 3494.5	1048.35
Total	
Provisions and contingencies (a+b+c)	**1713.85**

Bills for Collection: These are the bills which a commercial bank holds for the collection of its amount. The banker holds these bills till their date of maturity and on the realization of amount, the bank debit the cash account with total amount received and credit the customer's current account with the amount left after deducting its commission. In banks Final account, Bills held for collection are simply shown as a note to the Balance Sheet.

Advances: Advances may include:

- **Loans,** both secured and unsecured, given to customers for a specified period of time.
- **Cash credit**, whereby, some money is lent by the bank upto a specified limit against the pledge or hypothecation of some security. Borrowers can withdraw the whole amount immediately or in instalments as and when required, since the bank keeps the whole amount always ready for withdrawals.
- **Overdraft,** which is a temporary arrangement to overdraw money from one's current account up to a certain limit.

The Banking Regulation act, 1949 prescribes formats of preparing final accounts of the Banking companies. The third schedule of section 29 gives forms 'A' for the balance sheet and Form ‘B’ for Profit and loss account. The balance sheet consists of total 12 schedules. Schedule 1 to schedule 5 depicts capital and liabilities and schedule 6 to schedule 11 shows Assets of the bank and schedule 12 shows contingent liabilities and there is no specific schedule prescribes for bills for collection.

THE THIRD SCHEDULE

(See Section 29) Form ‘A’

FORM OF BALANCE SHEET

Balance Sheet of……………… (Here enter the name of the Banking Company) **Balance Sheet as on 31st March __________ (year) (000’s omitted)**			
	Schedule No.	**As on 31.3…… (Current Year)**	**As on 31.3…. (Previous Year)**
Capital & Liabilities			
Capital	1		
Reserves & Surplus	2		
Deposits	3		
Borowings	4		
Other Liabilities and Provisions	5		
Total			
Assets			
Cash and balance with Reserve Bank of India	6		
lances with banks and	7		

money at call and short notice Investments Advances Fixed Assets Other Assets Total Contingent Liabilities	 8 9 10 11 12		

9.3 SCHEDULES RELATED TO BANKING COMPANIES

VARIOUS SCHEDULES (1-16) AND THEIR CONTENTS

SCHEDULE 1- CAPITAL

Particulars	**Year ended 31-3- (Current year)**	**Year ended 31-3-... (Previous year)**
For Nationalized Banks		
For Banks Incorporated outside India		
For other banks		
Authorized Capital (Shares of RS-each)		
Issued Capital (Shares of RS-each)		
Subscribed capital (Shares of RS-each)		
Called-up capital (Shares of RS-each) Less calls unpaid Add forfeited shares		
Total		

SCHEDULE 2- RESERVES AND SURPLUS

Particulars	Year ended 31-3- (Current year)	Year ended 31-3-... (Previous year)
Statutory Reserves Opening Balance Additions during the year Deductions during the year		
Capital Reserve Opening balance Additions during the year Deductions during the year		
Share Premium Opening balance Additions during the year Deductions during the year		
Balance in profit and loss account		
TOTAL		

SCHEDULE 3- DEPOSITS

Particulars	Year ended 31-3- (Current year)	Year ended 31-3- (Previous year)
A) I. Demand Deposits a. From banks b. From others		
II. Savings Bank deposit		
III. Term Deposit a. From banks b. From others		

B) I. Deposits of branches in India II. Deposits of branches outside India		
TOTAL		

SCHEDULE 4-BORROWINGS

Particulars	**Year ended 31-3-** **(Current year)**	**Year ended 31-3-** **(Previous year)**
i. Borrowing in India a. From RBI b. From other banks c. From other Institutions and agencies		
ii. Borrowings outside India		
TOTAL		
Secured Borrowings in i and ii above		

SCHEDULE 5- OTHER LIABILITIES AND PROVISIONS

Particulars	**Year ended 31-3-** **(Current year)**	**Year ended 31-3-** **(Previous year)**
Bills payable Inter office adjustments (net) Interest accrued Others (including provisions)		
TOTAL		

SCHEDULE 6- CASH AND BALANCES WITH RESERVE BANK OF INDIA

Particulars	**Year ended 31-3-** **(Current year)**	**Year ended 31-3-...** **(Previous year)**
i. Cash in hand (including foreign currency notes)		

ii. Balances with Reserve Bank of India a. In current account b. In other accounts		
TOTAL		

SCHEDULE 7- BALANCES WITH BANKS AND MONEY AT CALL & SHORT NOTICE

Particulars	**Year ended 31-3- (Current year)**	**Year ended 31-3- (Previous year)**
I. In India 1. Balances with banks a. In current account b. In other deposit account 2. Money at calls and short notice a. With banks b. With other institutions		
TOTAL		
II. Outside India a. In current account b. In other deposit account c. Money at calls and short notice		
TOTAL		
Grand Total (India & outside India)		

SCHEDULE 8- INVESTMENTS

Particulars	**Year ended 31-3- (Current year)**	**Year ended 31-3- (Previous year)**

I. Investments in India a. Government securities b. Other Approved securities c. Shares d. Debentures and bonds e. Subsidiaries and joint ventures f. Others (to be specified)		
TOTAL		
II. Investments Outside India a. Government securities (including local authorities) b. Subsidiaries and joint ventures abroad c. Other investments (if any)		
TOTAL		
Grand Total (I+II)		

SCHEDULE 9- ADVANCES

Particulars	**Year ended 31-3- (Current year)**	**Year ended 31-3- (Previous year)**
I. a) Bills purchased and discounted b) Cash credits, overdrafts and loans repayable on demand c) Term loans		
TOTAL		
II. a) Secured by tangible assets b) Covered by bank/ government guarantee c) Unsecured		
TOTAL		
III. A) Advances in India a. Priority sectors b. Public sectors c. Banks d. Others		
TOTAL		

SCHEDULE 10- FIXED ASSETS

Particulars	Year ended 31-3- (Current year)	Year ended 31-3- (Previous year)
A. Premises At cost as on 31st March of the preceding year Additions during the year Deductions during the year Depreciation to date		
B. Other Fixed Assets At cost as on 31st March of the preceding year Additions during the year Deductions during the year Depreciation to date		
Total (A+B)		

SCHEDULE 11- OTHER ASSETS

Particulars	Year ended 31-3- (Current year)	Year ended 31-3-... (Previous year)
1) Inter-office adjustments (net)		
2) Interest accrued		
3) Tax paid in advance/tax deducted at source		
4) Stationery and stamps		
5) Non-banking assets acquired in satisfaction of claims		

6) Others (in case there is any unadjusted balance of loss)		
TOTAL		

SCHEDULE 12-CONTINGENT LIABILITY

Particulars	**Year ended 31-3- (Current year)**	**Year ended 31-3-... (Previous year)**
A) Claims against the banks not acknowledged as debts		
B) Liability for partially paid investments		
C) Liability on account of outstanding forward exchange contracts		
D) Guarantees given on behalf of constituents a. In India b. Outside India		
E) Acceptance, endorsements and other obligations		
F) Other items for which the bank is contingently liable		
TOTAL		

1. CHECK YOUR PROGRESS

1. Final accounts of banking companies are prepared as per the __________ of the Banking Regulation Act.

ANSWER: Third Schedule

2. The Balance Sheet is presented in ________ form.

ANSWER: Form A

3. Schedule 4 relates to ________.

ANSWER: Borrowings

4. Provision for _________ is included in provisions and contingencies.
ANSWER: Tax

5. Bills for collection are shown as a ________ to the balance sheet.

ANSWER: Note

9.4 SOLVED PROBLEMS

ILLUSTRATION 1: From the following information, prepare a Balance Sheet of ADT International Bank as on 31st March, 2021 giving the relevant schedules and also specify at least four important Principal Accounting Polices:

` in lakhs

	Dr.	Cr.
Share Capital		198.00
Statutory Reserve		231.00
Net Profit before Appropriation		150.00

Profit and Loss Account		412.00
Fixed Deposit Account		517.00
Savings Deposit Account		450.00
Current Accounts	28.00	520.12
Bills Payable		0.10
Cash credits	812.10	
Borrowings from other Banks		110.00
Cash in Hand	160.15	
Cash with RBI	37.88	
Cash with other Banks	155.87	
Money at Call	210.12	
Gold	55.23	
Government Securities	110.17	
Premises	155.70	
Furniture	70.12	
Term Loan	792.88	
	2,588.22	2,588.22

Additional Information:

Bills for collection	18,10,000
Acceptances and endorsements	14,12,000
Claims against the Bank not acknowledged as debt	55,000
Depreciation charges—Premises	1,10,000
Furniture	78,000

50% of the Term Loans are secured by Government guarantees. 10% of cash credit is unsecured. Transfer 25% of its profit to the reserve fund.

SOLUTION: Balance Sheet of ADT International Bank

As on 31st March, 2013

(` in lacs)

Capital and Liabilities	Schedule	As on 31.3.13	As on 31.3.12
Share Capital Reserves and	1	1,98.00	

Surplus Deposits Borrowings Other liabilities and provisions	2 3 4 5	7,93.00 14,87.12 1,10.00 0.10	
		25,88.22	
ASSETS:			
Cash and balances with RBI Balances with banks and money at call and short notice	6 7	219.63 344.39	
Investments Advances Fixed Assets Other Assets	8 9 10 11	1,65.40 16,32.98 2,25.82 -	
		25,88.22	
Contingent liabilities Bills for collection	12	14.67 18.10	

Schedule 1— Capital

Authorized Capital Issued, Subscribed and Paid up Capital	–
19,80,000 Shares of ` 10 each	1,98.00

Schedule 2— Reserves and Surplus

(1)	Statutory Reserve- Opening balance Additions during the year	 2,31.00 37.50	

			268.50
(2)	Balance in Profit & Loss Account *(W.N. 1)*		524.50
			7,93.00

Schedule 3— Deposits

(i)	Demand deposits from others	5,20.12
(ii)	Saving bank deposits	4,50.00
(iii)	Fixed Deposits	5,17.00
		14,87.12

Schedule 4— Borrowings

Borrowing in India- Other banks	1,10.00

Schedule 5— Other Liabilities and Provisions

Bills Payable	0.10

Schedule 6— Cash and balances with RBI

(i)	Cash in hand	1,60.15
(ii)	Balances with RBI	
	In current account *(W.N. 2)*	59.48
		219.63

Schedule 7—Balances with banks and money at call and short notice

1.	In India	
	(i) Balances with banks	
	(a) in current accounts *(W.N. 3)*	1,34.27
	(ii) Money at call and short notice	2,10.12
		344.39

Schedule 8— Investments

(1)	Investment in India in	
	(i) Government securities	1,10.17
	(ii) Others—Gold	55.23
		1,65.40

Schedule 9— Advances

A.	(i)	Cash credits, overdrafts (includes Dr Bal in Current A/c as ODs)	8,40.10
	(ii)	Term Loans	7,92.88
			16,32.98
B	(i)	Secured by tangible assets (balancing fig)	11,52.53
	(ii)	Secured by bank/government guarantees	3,96.44
	(iii)	Unsecured	84.01
			16,32.98

Schedule 10— Fixed Assets

1.	Premises	
	At cost	156.80
	Depreciation to date	1.10
		155.70
2.	Other Fixed Assets	
	Furniture at cost	70.90
	Depreciation to date	0.78
		70.12
	Total (1 + 2)	2,25.82

Schedule 11— Other Assets

Nil

Schedule 12— Contingent Liabilities

(` in lakhs)

(i)	Claims against bank not acknowledged as debts	0.55
(ii)	Acceptances, endorsements	14.12
		14.67

Working Note:

(1) Balance in Profit & Loss Account: (` in lakhs)

Profit and Loss Account	4,12.00
Add: Net Profit before appropriation (Profit for the year)	1,50.00
	5,62.00
Less: Transfer to statutory reserve	
(25% of 150.00)	(37.50)
	524.50

(2) Transfer from Cash with other banks to Cash with RBI (when CRR is required to be maintained at 4% of deposits w.e.f. January 29, 2013)

Cash reserve required (14,87.12 x 4%)	59.48
Cash with RBI	(37.88)
Transfer needed to maintain cash reserve	21.60

(3) Liquid Assets:

Cash on hand	1,60.15
Cash with other Banks	1,55.87
Money at call and short notice	2,10.12
Gold	55.23
Government securities	1,10.17
	6,91.54
Excess liquidity [6,91.54 – (1487.12 x 23%)] or (6,91.54 – 342.04)	349.50

The excess liquidity enables the transfer as per (2) above.

After the transfer, Cash with other Banks = ` (in lakhs) (1,55.87 - 21.60) = 134.27.

ILLUSTRATION 2: The following are the ledger balances (in Rupee's thousands) extracted from the books of Vaishnavi Bank as on March 31, 20X1:

	Dr.	Cr.
Share Capital		19,00,00
Current accounts control		9,70,00

Employee security deposits		74,20
Investments in Govt. of India Bonds	9,43,70	
Gold Bullion	1,51,30	
Silver	20,00	

*** It is assumed that sub-standard asset is fully secured.**

Constituent liabilities for acceptances and endorsements	5,65,00	5,65,00
Borrowings from banks		7,72,30
Building	6,50,00	
Furniture	50,00	
Money at call and short notice	2,60,00	
Commission & brokerage		2,53,00
Saving accounts		1,50,00
Fixed deposits		2,30,50
Balances with other banks	4,63,50	
Other investments	5,56,30	
Interest accrued on investments	2,46,20	
Reserve Fund		14,00,00
P & L A/c		65,00
Bills for collection	4,35,00	4,35,00
Interest		6,20,00
Loans	18,10,00	
Bills discounted	1,25,00	
Interest	79,50	
Discounts		4,20,00
Rents		6,00
Audit fees	50,00	
Depreciation reserve (furniture)		2,00
Salaries	2,12,00	

Rent, rates and taxes	1,20,00	
Cash in hand and with Reserve Bank	7,50,00	
Miscellaneous income		39,00
Depreciation reserve (building)		8,00
Directors' fees	10,00	
Postage	12,50	
Loss on sale of investments	2,00,00	
Branch adjustments	2,00,000	
	79,10,00	

Other Information:

The bank's Profit and Loss Account for the year ended and Balance Sheet as on 31st March, 20X1 are required to be prepared in appropriate form. Further information (in Rupees thousands) available is as follows —

(a) Rebate on bills discounted to be provided 40,00

(b) Depreciation for the year

Building 50,00

Furniture 5,00

(c) Included in the current accounts' ledger are accounts overdrawn to the extent of 25,00.

Transfer to Statutory Reserve 25% of the Net Profits for the current year.

SOLUTION: Balance Sheet of Vaishnavi Bank as on 31st March, 20X1

(` ‘000)

Capital and Liabilities	*Schedule*	*As on 31-3-20X1*	*As on 31-3-20X0*
Capital	1	19,00,00	
Reserves & Surplus	2	20,24,00	

Deposits	3	13,75,50	
Borrowings	4	7,72,30	
Other liabilities and provisions	5	1,14,20	
Total		61,86,00	

Assets	*Schedule*	*As on* 31-3-20X1	*As on* 31-3-20X0
Cash and balance with Reserve Bank of India	6	7,50,00	
Balances with bank and Money at call and short notice	7	7,23,50	
Investments	8	16,71,30	
Advances	9	19,60,00	
Fixed Assets	10	6,35,00	
Other Assets	11	4,46,20	
Total		61,86,00	
Contingent liabilities	12	5,65,00	
Bills for collection		4,35,00	

Vaishnavi Bank
Profit and Loss Account for the year ended 31-3-20X1

(` '000)

I.	**Income**		
	Interest & Discount	13	10,00,00
	Other income	14	98,00
			10,98,00
II.	**Expenditure**		
	Interest Expended	15	79,50
	Operating Expenses	16	4,59,50
	Provisions and Contingencies		-
			5,39,00

III.	**Profits/Loss**		
	Net profit for the year		5,59,00
	Profit b/f		65,00
			6,24,00

IV.	**Appropriations**		
	Transfer to Statutory Reserve		1,39,75
	Balance carried over to Balance Sheet		4,84,25
			6,24,00

Schedule 1 - Capital

(` '000)

		As on 31-3-20X1
I.	For Other Banks	
	Authorised Capital	
	Shares of ` ... each	-
	Issued Capital	
	Shares of ` ... each	-
	Subscribed Capital	
	Shares of ` ... each	-
	Called up capital	
	Shares of ` ... each	19,00,00
		19,00,00

Schedule 2 - Reserves & Surplus

		As on 31-3-20X1
I.	Statutory Reserves	
	Opening Balance	14,00,00
	Additions during the year	1,39,75
		15,39,75
II.	Balance in Profit and Loss Account	4,84,25
	Total	20,24,00

Schedule 3 - Deposits (` *'000*)

	As on 31-3-20X1
A. I. Demand Deposits	9,95,00
II. Saving Bank Deposits	1,50,00
III. Term Deposits	2,30,50
	13,75,50

Current Accounts Control A/c shows a Credit Balance of ` 9,70,000/-. In the additional information it is mentioned that in the above balance an OD of ` 25,000/- is included. Hence for presentation of the Balance Sheet the entries will be as under:

Current Accounts 9,95,000 to be shown under deposits

ODs in Current Accounts To be shown as Advances along with cash credits & T Loans

Schedule 4 - Borrowings

		As on 31-3-20X1
I.	Borrowings in India	
	(ii) Other banks	7,72,30
	Total	7,72,30

Schedule 5 - Other liabilities and provisions

		As on 31-3-20X1
I.	Other liabilities including provisions:	
	Rebate on bills discounted	40,00
	Employees Security Deposit	74,20
	Total	1,14,20

Schedule 6 - Cash and Balances with Reserve Bank of India

		As on 31-3-20X1
I.	Cash in hand (including foreign currency notes)	3,50,00
II.	Balances with Reserve Bank of India:	
	(i) In Current Account	3,20,00

(ii) In Other Account	80,00
Total	7,50,00

(Details are not based on figures given in the question)

Schedule 7 - Balances with Banks & Money at Calls & Short Notice

	As on 31-3-20X1
I. (i) In India Balances with banks	
(*a*) in Current accounts	
(*b*) in Other accounts	2,63,50
(ii) Money at call and short notice	2,00,00
(*a*) with banks	2,30,00
(*b*) with other institutions	30,00
Total (i + ii)	7,23,50

Schedule 8 - Investments

(` *'000*)

	As on 31-3-20X1
I. Investments in India in	
(i) Government securities	9,43,70
(ii) Shares (assumed)	5,56,30
(iii) Gold	1,51,30
(iv) Silver	20,00
Total	16,71,30

Schedule 9 - Advances

	As on 31-3-20X1
A. (i) Bills purchased and discounted	1,25,00
(ii) Cash credits, overdrafts and loans repayable on demand	18,35,00

			19,60,00
B.	(i)	Secured by tangible assets	12,00,00
	(ii)	Secured by Bank/Govt. Securities	2,00,00
	(iii)	Unsecured	5,60,00
			19,60,00

C.	I.	Advances in India	
	(i)	Priority sector	8,00,00
	(ii)	Public sector	1,00,00
	(iii)	Banks	20,00
	(iv)	Others	10,40,00
		Total	19,60,00

(Details are assumed)

Schedule 10 - Fixed Assets

			As on 31-3-20X1
I.	Premises		
	At cost as on 31st March, 20X0	6,42,00	
	Depreciation to date	(50,00)	5,92,00
II.	Other fixed articles (including Furniture and Fixture)		
	At cost as on 31st March, 20X0	48,00	
	Depreciation to date	(5,00)	43,00
	Total (I & II)		6,35,00

Schedule 11 - Other Assets

		As on31-3-20X1
I.	Inter-office adjustments (net)	2,00,00
II.	Interest accrued	2,46,20
		4,46,20

Schedule 12 - Contingent Liabilities

		Year ended 31-3-20X1
I.	Acceptances, endorsements and other obligations	5,65,00
	Total	5,65,00

Schedule 13 - Interest Earned

	Year ended 31-3-20X1
I. Interest/discount on advances, bills (6,20,00 + 4,20,00 –40,00)	10,00,00
Total	10,00,00

Schedule 14 - Other Income

			Year ended 31-3-20X1
I.	Commission, Exchange and Brokerage	2,53,00	
II.	Profit on sale of investments		
	Less : Loss on sale on investments	(2,00,00)	53,00
III.	Miscellaneous Income		
	Rent and Other Receipts		45,00
	Total		98,00

Schedule 15 - Interest Expended

		Year ended 31-3-20X1
I.	Interest on Deposits	79,50
	Total	79,50

Schedule 16 - Operating Expenses

		Year ended 31-3-20X1
I.	Payments to and provisions for employees	2,12,00
II.	Rent, Taxes and Lighting	1,20,00
III.	Depreciation on Bank's property	55,00
IV.	Director's fees, allowances and expenses	10,00
V.	Auditor's fees and expenses	50,00
VI.	Postage, Telegrams, Telephones etc.	12,50
	Total	4,59,50

2. CHECK YOUR PROGRESS
True or False

1. The final accounts of a banking company include only the profit and loss account.

ANSWER— **False**

2. Schedule 9 relates to Advances.

ANSWER — **True**

3. Provision for tax is not a part of provisions and contingencies.

ANSWER— **False**

4. Bills for collection are shown as a note and not included in the balance sheet total.

ANSWER— **True**

5. Contingent liabilities are shown under Schedule 11.

ANSWER— **False**

9.5 LET US SUM UP

- Banking companies prepare financial statements as per Form A (Balance Sheet) and Form B (Profit & Loss A/c) of the Third Schedule of the Banking Regulation Act.
- The Balance Sheet consists of 12 Schedules (1–12), and the Profit & Loss Account includes 4 Schedules (13–16).
- Additional disclosures are made in Schedule 17 (Notes on Accounts) and Schedule 18 (Accounting Policies).
- Special care is taken in preparing Schedules for capital, reserves, deposits, advances, investments, borrowings, and fixed assets.
- Contingent liabilities are disclosed as notes and not included in the balance sheet totals.

9.6 KEYWORDS

- **Final Accounts:** Financial statements prepared at the end of an accounting period, consisting of the Balance Sheet and Profit and Loss Account, to show the financial position and performance of the bank.
- **Third Schedule:** A part of the Banking Regulation Act that provides the format for preparing the Balance Sheet (Form A) and Profit and Loss Account (Form B) of a banking company.
- **Form A and Form B:** Prescribed formats in the Third Schedule:
  • Form A – For the Balance Sheet
  • Form B – For the Profit and Loss Account
- **Schedules:** Detailed annexures to financial statements that classify and present specific information. For example, Schedule 1 – Capital, Schedule 3 – Deposits, etc.
- **Contingent Liabilities:** Potential obligations that may arise depending on the outcome of a future event (e.g., lawsuits, guarantees). They are disclosed in Schedule 12 but not included in total liabilities.

- **Provisions and Contingencies:** Amounts set aside from profits to cover known or estimated future liabilities (e.g., NPA provisions, tax, investment losses). They are part of the P&L account.
- **Rebate on Bills Discounted:** An adjustment for unearned income on bills discounted that are still outstanding at the year-end. It is treated as a liability.
- **Statutory Reserves:** Reserves banks are required to maintain under law (Section 17 of the Banking Regulation Act) by transferring a portion of net profits every year.
- **Bills for Collection:** Bills received by the bank for collection on behalf of customers. These are not bank's own assets and are shown as a note to the Balance Sheet.

9.7 SELF-ASSESSMENT QUESTIONS

1. Calculate provision for tax using:

Total Income: ₹5,000,000;

Expenditure excluding tax: ₹3,000,000;

Tax rate: 30%

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…………………………………………………………………………………………………

2. From the following information find out the amount of provisions to be shown in the Profit and Loss Account of a Commercial Bank:

Assets	(` in lakhs)
Standard	4,000
Sub-standard	2,000
Doubtful up to one year	900
Doubtful up to three years	400
Doubtful more than three years	300
Loss Assets	500

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3. From the following details, prepare Schedule 2:

Statutory Reserve: ₹10,00,000

Profit this year: ₹4,00,000

Transfer to Reserve: 25%

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…………………………………………………………………………………………………
…………………………………………………………………………………………………

9.8 LESSON END EXERCISE

From the following particulars, prepare the Profit and Loss Account of X Bank Ltd. for the year ending 31st March, 2025:

Particulars	**₹ (in '000)**
Interest and Discount Received	8,500
Interest Paid on Deposits	3,000
Commission, Exchange and Brokerage	400
Rent Received	200
Salaries and Allowances	1,200
Directors' Fees and Allowances	100
Rent, Taxes and Lighting	300
Depreciation on Bank Property	150
Stationery, Printing and Advertisement	80
Provision for Taxation	500
Rebate on Bills Discounted (adjustment)	Opening: ₹100; Closing: ₹150

…………………………………………………………………………………………………
…………………………………………………………………………………………………
…………………………………………………………………………………………………

2. From the following details, prepare the Balance Sheet of Y Bank Ltd. as on 31st March, 2025:

Particulars	₹ (in '000)
Capital (Authorized ₹20 lakh, Issued ₹10 lakh)	10,000
Reserves and Surplus	2,500
Deposits	50,000
Borrowings	5,000
Cash in Hand	1,500
Balance with RBI	2,000
Investments	20,000
Loans and Advances	35,000
Fixed Assets (at cost)	3,000
Other Assets	1,000
Bills for Collection (Assets)	4,000
Bills for Collection (Liabilities)	4,000

Prepare the Balance Sheet in the vertical format prescribed under **Form A of Schedule III**, with appropriate **schedules**.

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………………………………………………………………………………………………
………………………………………………………………………………………………

3. Define contingent liabilities with an example.

………………………………………………………………………………………………
………………………………………………………………………………………………
………………………………………………………………………………………………

3. CHECK YOUR PROGRESS

Match the Following (5 Items)

Column A	Column B	Answer
1. Schedule 1	A. Deposits	1 → C
2. Schedule 3	B. Advances	2 → A
3. Schedule 9	C. Capital	3 → B
4. Rebate on Bills Discounted	D. Unearned discount on bills	4 → D
5. Bills for Collection	E. Shown as a note to the Balance Sheet	5 → E

9.9 SUGGESTED READING

- Robert N Anthony, David Hawkins, Kenneth A. Merchant, Accounting: Text and Cases. McGraw-Hill Education, 13th Ed. 2013.
- Charles T. Horngren and Donna Philbrick, Introduction to Financial Accounting, Pearson Education.
- J.R. Monga, Financial Accounting: Concepts and Applications. Mayur Paper Backs, New Delhi.
- M.C.Shukla, T.S. Grewal and S.C.Gupta. Advanced Accounts. Vol.-I. S. Chand & Co., New Delhi.
- S.N. Maheshwari, and. S. K. Maheshwari. Financial Accounting. Vikas Publishing House, New Delhi.
- Deepak Sehgal. Financial Accounting. Vikas Publishing H House, New Delhi.
- Bhushan Kumar Goyal and HN Tiwari, Financial Accounting, International Book House
- Goldwin, Alderman and Sanyal, Financial Accounting, Cengage Learning.
- Tulsian, P.C. Financial Accounting, Pearson Education

UNIT: 2 **LESSON: 10**

COURSE CODE:

Treatment of contingent liabilities as per schedule no. 12.

STRUCTURE:

10.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

By the end of this lesson, learners will be able to:

- Understand the meaning and nature of contingent liabilities.
- Identify the types of contingent liabilities in banking companies.
- Learn how these liabilities are disclosed as per Schedule 12 of the final accounts.
- Distinguish between recorded liabilities and contingent liabilities.

Learning Outcomes

After completing this lesson, learners will be able to:

- Define contingent liabilities and explain their importance in banking.
- Classify various forms of contingent liabilities.
- Accurately prepare and present Schedule 12 in a bank's financial statements.
- Analyze the financial implication of off-balance sheet items.
-
-

10.1 Introduction

- In the dynamic environment of banking and finance, risk management is a crucial concern. One major area of financial risk that banks must acknowledge, even if not immediately accountable for, is *contingent liabilities*. These are potential obligations that may arise in the future depending on the outcome of specific uncertain events. While not recorded in the main totals of the balance sheet, contingent liabilities are required to be disclosed transparently as per statutory guidelines.
- The Banking Regulation Act, 1949, through its **Third Schedule**, mandates a structured format for the preparation of final accounts of banking companies. Schedule 12, in particular, is dedicated to listing all types of contingent liabilities. Although these do not represent actual liabilities at the balance sheet date, they possess the potential to affect the bank's financial position in the future. These disclosures ensure that stakeholders—such as regulators, shareholders, depositors, and analysts—can evaluate the *off-balance sheet risks* that the bank is exposed to.
- Examples of such liabilities include legal claims not acknowledged as debt, guarantees issued on behalf of clients, outstanding forward contracts, acceptances, and endorsements. For instance, a bank might guarantee a customer's payment to a third party. If the customer defaults, the bank becomes liable. Hence, such guarantees are contingent liabilities.
- The rationale behind their disclosure lies in *prudence, transparency,* and *regulatory compliance*. By showing these separately in Schedule 12, banks provide a clearer

picture of financial exposure beyond the conventional balance sheet items, thus enhancing the credibility of financial statements.

10.2 MEANING OF CONTINGENT LIABILITIES

Contingent liabilities are those liabilities which may or may not become actual liabilities, depending on the occurrence of one or more uncertain future events. They are **not recognized in the balance sheet totals**, but are **disclosed separately** as part of Schedule 12 for transparency and statutory compliance.

10.3 TYPES OF CONTINGENT LIABILITIES

Types of Contingent Liabilities (As per Schedule 12)

Particulars	Explanation
A. Claims against the bank not acknowledged as debts	Legal claims where the bank has not accepted liability.
B. Liability for partly paid investments	The unpaid portion of investments that may become due.
C. Outstanding forward exchange contracts	Contracts where the bank has promised to exchange currency in future.
D. Guarantees on behalf of constituents	Bank guarantees issued to third parties on behalf of customers.
E. Acceptances, endorsements, and other obligations	Bills accepted by the bank or endorsed on behalf of customers.
F. Other items	Any other items not covered above, e.g., performance guarantees.

10.4 FORMAT OF SCHEDULE 12: CONTINGENT LIABILITIES

Format of Schedule 12: Contingent Liabilities		
Schedule 12 – Contingent Liabilities	**Current Year (₹)**	**Previous Year (₹)**
A. Claims not acknowledged as debts		
B. Liability for partly paid investments		
C. Outstanding forward exchange contracts		
D. Guarantees on behalf of constituents:		
• In India		
• Outside India		
E. Acceptances, endorsements and other obligations		
F. Other items for which the bank is contingently liable		
Total		

1. CHECK YOUR PROGRESS
TRUE OR FALSE

- Contingent liabilities are recorded in the bank's balance sheet total.

ANSWER– **False**

- Guarantees given on behalf of clients are contingent liabilities.

ANSWER– **True**

- Schedule 12 includes deposits and advances.

ANSWER– **False**

- Acceptances and endorsements are a form of contingent liability.

ANSWER– **True**

2. CHECK YOUR PROGRESS

Fill in the Blanks

1. Contingent liabilities are presented under Schedule ___.

ANSWER→ **12**

2. A liability for partly paid investments is a type of ______ liability.

ANSWER→ **Contingent**

3. Forward exchange contracts are shown in ______ liabilities.

ANSWER→ **Contingent**

3. CHECK YOUR PROGRESS

Match the Following

Column A	Column B
1. Schedule 12	A. Off-balance sheet items
2. Bank Guarantees	B. Guarantees on behalf of clients
3. Forward Exchange Contracts	C. Foreign currency obligations
4. Acceptances and Endorsements	D. Bills accepted or endorsed
5. Claims not acknowledged	E. Legal claims

☑ **Answers**: 1 → A, 2 → B, 3 → C, 4 → D, 5 → E

10.5 Treatment in Final Accounts

- Not included in the main total of the balance sheet.
- Shown as a separate Schedule (Schedule 12) immediately after the Balance Sheet.
- Properly footnoted or explained, especially for significant contingent obligations.
- Treated as off-balance sheet items that may affect the financials in the future.

Example

From the books of XYZ Bank Ltd:

Particulars	Amount (₹ in ‘000)
Claims not acknowledged as debt	80
Guarantees in India	120
Acceptances and endorsements	150
Forward exchange contracts	100
Other items (e.g., performance guarantees)	50

Solution

Schedule 12 would show a **total contingent liability** of ₹500,000 (‘000 omitted as per format).

10.6 Let Us Sum Up

- Contingent liabilities are future uncertain obligations.
- They are disclosed under Schedule 12 of the balance sheet.
- They help stakeholders assess the financial risk.
- Examples include guarantees, endorsements, and claims.

10.7 KEYWORDS

- **Contingent Liability**: A possible obligation that may arise depending on the outcome of a future uncertain event. It is not recorded in the accounts but disclosed in the notes or under Schedule 12.

- **Schedule 12:** A specific schedule in the final accounts of a banking company that lists all the contingent liabilities as required under the Third Schedule of the Banking Regulation Act, 1949.

- **Acceptances and Endorsements:** Obligations accepted by the bank on behalf of customers, such as bills accepted or endorsed for collection, which may become liabilities if the customer fails to pay.

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10.8 SELF-ASSESSMENT QUESTIONS

1.Explain the importance of disclosing contingent liabilities in a bank's final accounts.

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Describe any four items covered under Schedule 12 of the final accounts of a banking company.

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3.Contingent liabilities are not actual liabilities but still important for stakeholders." Justify this statement with examples.

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10.9 LESSON END EXERCISE

1. Prepare a specimen format of Schedule 12, listing at least five typical items with fictitious figures.

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2.From the following details, prepare Schedule 12 (₹ in ’000):

Claims against the bank not acknowledged as debt – 60

Guarantees in India – 200

Acceptances and Endorsements – 150

Liability for partly paid investments – 90

Outstanding forward exchange contracts – 180

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UNIT- 3 **Lesson no. 11**

COURSE CODE:

MEANING AND CONCEPT OF INSURANCE

STRUCTURE:

11.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

After going through this lesson, you should be able to know:

- Concept and meaning of insurance companies.
- Features and functions of insurance.
- Principals of insurance

Learning outcomes

- Concept and meaning of insurance companies.
- Features and functions of insurance.
- Principals of insurance

11.1 INTRODUCTION

The IASB Proposal for International Insurance Accounting Standards:

IASB's aim in establishing accounting standards for the insurance industry is to facilitate the understanding of insurers' financial statements. Insurance contracts had been excluded from the scope of international financial reporting standards, in part because accounting practices for insurance often differ substantially from those in other sectors — both noninsurance financial services and nonfinancial businesses, and from country to country. **The Pradhan Mantri Fasal Bima Yojana** (Prime Minister's Crop Insurance Scheme) was launched by Prime Minister of IndiaNarendra Modi on 18 February 2016. It envisages a uniform premium of only 2 per cent to be paid by farmers for Kharif crops, and 1.5 per

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cent for Rabi crops. The premium for annual commercial and horticultural crops will be 5 per cent. Prime Minister Narendra Modi has asked for integration. This scheme is dedicated to bring in more than 50% of the farmers under its wing within the next 2–3 years. Around 25% of the claims will be sent to the farmer's direct account. Also, the scheme will remain as it is. This means that there will be no cap on coverage. Also there won't be any cap on the reduction in the insured sum. This insurance scheme, unlike the previous ones, covers local calamities too, such as landslide, hailstorm, inundation, etc. inundation was not covered by the previous schemes. The government has proposed that there will only be one insurance company for the entire state. Mostly the private as well as the national agricultural insurance companies will be approached to implement it.

Comprehensive Crop Insurance Scheme(CCIS) covered 15 states and 2 union territories. Participation in the scheme was voluntary. Around 5 million farmers and between 8-9 million hectares were annually covered by this scheme. If the actual yield in any area covered by the scheme fell short of the guaranteed yield, the farmers were entitled to an indemnity on compensation to the extent of the shortfall in yield. The General Insurance Corporation of India administered the scheme on behalf of the Ministry of Agriculture, Government of India.

Experimental Crop Insurance scheme was introduced in 1997-98, covering non-loanee small and marginal farmers growing specified crops in selected districts. The premium was subsidized. The premium collected was about 3 crore (US$450,000) and the claims amounted to Rs. 40 crore (US$5.9 million). The Government discontinued the scheme during 1997-98 itself. **Farm Income Insurance Scheme.** The Central Government formulated the Farm Income Insurance Scheme (FIIS) during 2003-04. The two critical components of a farmer's income are yield and price. FII S targeted these two components through a single insurance policy so that the insured farmer could get a guaranteed income. The scheme provided income protection to the farmers by insuring production and market risks. The insured farmers were ensured minimum guaranteed income (that is, average yield multiplied by the minimum support price). If the actual income was less than the guaranteed income, the insured would be compensated to the extent of the shortfall by the Agriculture Insurance Company of India. Initially, the scheme would cover only wheat and rice and would be compulsory for farmers availing crop loans. NAIS (explained in the section below) would be withdrawn for the crops covered under FIIS, but would continue to be applicable for other crops. The FIIS was withdrawn in 2004. The recent attempt by the Gujarat government to reintroduce the Farm Income Insurance Scheme (FIIS) can reform agricultural insurance and prevent farm-level distress. **National Agriculture Insurance Scheme (NAIS)** The Government of India experimented with a comprehensive crop insurance scheme which failed. The Government then introduced in 1999-2000, a new scheme titled "**National Agricultural Insurance Scheme**" (NAIS) or "**Rashtriya Krishi Bima Yojana" (RKBY)**. NAIS envisages coverage of all food crops (cereals and pulses), oilseeds, horticultural and commercial crops. It covers all farmers, both loanees and non-loanees, under the scheme. The premium rates vary from 1.5 percent to 3.5 percent of sum assured for food crops. In the case of horticultural and commercial crops, actuarial rates are charged. Small and marginal farmers are entitled to a subsidy of 50 percent of the premium charged- the subsidy is shared equally between the Government of India and the States. The subsidy is to be phased out over a period of 5 years. NAIS operates on the basis of Area approach-defined areas for each notified crop for widespread calamities. On individual basis- for localized calamities such as hailstorms, landslides, cyclones and floods.

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Under the scheme, each state is required to reach the level Gram Panchayat as the unit of insurance in a maximum period of 3 years. Agriculture Insurance Corporation of India is implementing the scheme.

11.2 MEANING AND CONCEPT OF INSURANCE

Insurance is a contract, a risk transfer mechanism whereby a company (Underwriter) promised to compensate or indemnify another party (Policyholder) upon the payment of reasonable premium to the insurance company to cover the subject-matter of insurance. If you are well conversant with these principles, you will be in a better position in negotiating you insurance needs.

Insurance is a means of protection from financial loss. It is a form of risk management primarily used to hedge against the risk of a contingent, uncertain loss.

An entity which provides insurance is known as an insurer, insurance company, or insurance carrier. A person or entity who buys insurance is known as an insured or policyholder. The insurance transaction involves the insured assuming a guaranteed and known relatively small loss in the form of payment to the insurer in exchange for the insurer’s promise to compensate the insured in the event of a covered loss. The loss may or may not be financial, but it must be reducible to financial terms, and must involve something in which the insured has an insurable interest established by ownership, possession, or pre-existing relationship.

The insured receives a contract, called the insurance policy, which details the conditions and circumstances under which the insured will be financially compensated. The amount of money charged by the insurer to the insured for the coverage set forth in the insurance policy is called the premium. If the insured experiences a loss which is potentially covered by the insurance policy, the insured submits a claim to the insurer for processing

11.2.1 Historical Background

The concept of insurance is ancient, with origins tracing back to early civilizations. In Babylon, around 1750 BCE, traders would distribute goods among multiple ships to reduce the risk of total loss. In ancient India and China, forms of mutual aid and cooperative risk sharing existed. However, the modern insurance industry began to develop in Europe during the 17th century, particularly in the context of marine insurance and fire insurance.

11.3 Basic Principles of Insurance

Insurance functions based on several fundamental principles:

1. Principle of utmost good faith (Uberrima Fides)

Like in other contracts, the insurance contract must be based on good faith. If the insurance contract is obtained by way of fraud or misrepresentation it is void. It means utmost good faith, this principle stated that the parties to insurance contract must disclose accurately and fully all the facts material to the risk being proposed. That is to say that the insured must make known to the insurer all facts regarding the risk to be insured. Likewise, the underwriter must highlight and explain the terms, conditions and exceptions of the insurance policy. And the policy must be void of 'small prints'.

2. Principle of Indemnity

The insurance contract should always be a contract of indemnity only and nothing more. According to this principle, the insurance contract should be such that in case of

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loss due to the eventialities mentioned in the contract, the insured should be neither better off nor worse off after receiving the insured amount. The main object of this principle is to ensure that the insured is not able to use this contract for speculation or gambling. It stated that following a loss, the insurer should ensure that they placed the insured in the exact financial position he enjoyed prior to the loss. To “indemnify” means to make whole again, or to be reinstated to the position that one was in, to the extent possible, prior to the happening of a specified event or peril. Accordingly, life insurance is generally not considered to be indemnity insurance, but rather “contingent” insurance (i.e., a claim arises on the occurrence of a specified event). There are generally three types of insurance contracts that seek to indemnify an insured:

1. A “reimbursement” policy
2. A “pay on behalf” or “on behalf of policy”
3. An “indemnification” policy

From an insured’s standpoint, the result is usually the same: the insurer pays the loss and claims expenses.

If the Insured has a “reimbursement” policy, the insured can be required to pay for a loss and then be “reimbursed” by the insurance carrier for the loss and out of pocket costs including, with the permission of the insurer, claim expenses.

Under a “pay on behalf” policy, the insurance carrier would defend and pay a claim on behalf of the insured who would not be out of pocket for anything. Most modern liability insurance is written on the basis of “pay on behalf” language which enables the insurance carrier to manage and control the claim.

Under an "indemnification" policy, the insurance carrier can generally either "reimburse" or "pay on behalf of", whichever is more beneficial to it and the insured in the claim handling process.

An entity seeking to transfer risk (an individual, corporation, or association of any type, etc.) becomes the 'insured' party once risk is assumed by an 'insurer', the insuring party, by means of a contract, called an insurance policy. Generally, an insurance contract includes, at a minimum, the following elements: identification of participating parties (the insurer, the insured, the beneficiaries), the premium, the period of coverage, the particular loss event covered, the amount of coverage (i.e., the amount to be paid to the insured or beneficiary in the event of a loss), and exclusions (events not covered). An insured is thus said to be "indemnified" against the loss covered in the policy.

When insured parties experience a loss for a specified peril, the coverage entitles the policyholder to make a claim against the insurer for the covered amount of loss as specified by the policy. The fee paid by the insured to the insurer for assuming the risk is called the premium. Insurance premiums from many insureds are used to fund accounts reserved for later payment of claims – in theory for a relatively few claimants – and for overhead costs. So long as an insurer maintains adequate funds set aside for anticipated losses (called reserves), the remaining margin is an insurer's profit.

3. Principle of Contribution

In a situation where two or more insurers is covering a particular risk, if a loss occurred, the insurers must contribute towards the settlement of the claim in accordance with their rateable proportion.

4. Principle of Subrogation

It has often been said that contribution and subrogation are corollary of indemnity, which means that these two principles operates so that indemnity does not fail. Subrogation operates mainly on motor insurance. When an accident occurred involving two or more vehicles, there must be someone who is responsible for accident. On this basis, the insurer covering the policyholder who was not at fault can recover their outlay from the underwriter of the policyholder who is responsible for the incidence.

5. Principle of Insurable Interest

Insurable interest means that the person opting for insurance must have pecuniary interest in the property he is going to get insured and will suffer financial loss on the occurrence of the insured event. This is one of the essential requirements of any insurance contract. Therefore, a person can go for insurance of only those properties where he stands to benefit by the safety of the property, and will suffer loss, damage, injury if any harm takes place to such property. Thus, if you want to ensure Taj Mahal or Red Fort, you will not be allowed to do so as you do not have any pecuniary interest in these properties. This is the financial or monetary interest that the owner or possessor of property has in the subject-matter of insurance. The mere fact that it might be detrimental to him should a loss occurred because of his financial stake in that assets gives him the ability to insure the property.

6. Principle of Material Facts Disclosure

In the Insurance contract, the proposer is required to disclose to the insurer all the material facts in respect of the proposed insurance. This duty of disclosing the material facts not only applies to the material facts which are known to him but also extends to material facts which he is supposed to know. Thus, in case of Life Insurance the proposer must disclose the true age and details of the existing illnesses / diseases. Similarly, in case of the insurance of a building against fire, the proposer must disclose the details of the goods stored if such goods are of hazardous nature.

1. CHECK YOUR PROGRESS

Match the Following

A	B
1. Principle of Utmost Good Faith	a. Recovery of claim amount from third party
2. Principle of Subrogation	b. Risk-sharing between multiple insurers
3. Reinsurance	c. Disclosure of material facts
4. Premium	d. Payment made to insurer by policyholder
5. Agriculture Insurance Company	e. Implements PMFBY and NAIS

Answer Key:
1 → c
2 → a
3 → b
4 → d
5 → e

11.4 FEATURES OF INSURANCE

Risk which can be insured by private companies typically shares seven common characteristics.

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1. **Large number of similar exposure units**: Since insurance operates through pooling resources, the majority of insurance policies are provided for individual members of large classes, allowing insurers to benefit from the law of large numbers in which predicted losses are similar to the actual losses. However, all exposures will have particular differences, which may lead to different premium rates.
2. **Definite loss**: The loss takes place at a known time, in a known place, and from a known cause. The classic example is death of an insured person on a life insurance policy. Fire, automobile accidents, and worker injuries may all easily meet this criterion. Other types of losses may only be definite in theory. Occupational disease, for instance, may involve prolonged exposure to injurious conditions where no specific time, place, or cause is identifiable. Ideally, the time, place, and cause of a loss should be clear enough that a reasonable person, with sufficient information, could objectively verify all three elements.
3. **Accidental loss**: The event that constitutes the trigger of a claim should be fortuitous, or at least outside the control of the beneficiary of the insurance. The loss should be pure, in the sense that it results from an event for which there is only the opportunity for cost. Events that contain speculative elements such as ordinary business risks or even purchasing a lottery ticket are generally not considered insurable.
4. **Large loss**: The size of the loss must be meaningful from the perspective of the insured. Insurance premiums need to cover both the expected cost of losses, plus the cost of issuing and administering the policy, adjusting losses, and supplying the capital needed to reasonably assure that the insurer will be

able to pay claims. For small losses, these latter costs may be several times the size of the expected cost of losses. There is hardly any point in paying such costs unless the protection offered has real value to a buyer.

5. **Affordable premium**: If the likelihood of an insured event is so high, or the cost of the event so large, that the resulting premium is large relative to the amount of protection offered, then it is not likely that the insurance will be purchased, even if on offer. Furthermore, as the accounting profession formally recognizes in financial accounting standards, the premium cannot be so large that there is not a reasonable chance of a significant loss to the insurer. If there is no such chance of loss, then the transaction may have the form of insurance, but not the substance (see the U.S. Financial Accounting Standards Board pronouncement number 113: "Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts").

6. **Calculable loss**: There are two elements that must be at least estimable, if not formally calculable: the probability of loss, and the attendant cost. Probability of loss is generally

   an empirical exercise, while cost has more to do with the ability of a reasonable person in possession of a copy of the insurance policy and a proof of loss associated with a claim presented under that policy to make a reasonably definite and objective evaluation of the amount of the loss recoverable as a result of the claim.

7. **Limited risk of catastrophically large losses**: Insurable losses are ideally independent and non-catastrophic, meaning that the losses do not happen all at once and individual losses are not severe enough to bankrupt the insurer;

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- insurers may prefer to limit their exposure to a loss from a single event to some small portion of their capital base. Capital constrains insurers' ability to sell earthquake insurance as well as wind insurance in hurricane zones. In the United States, flood risk is insured by the federal government. In commercial fire insurance, it is possible to find single properties whose total exposed value is well in excess of any individual insurer's capital constraint. Such properties are generally shared among several insurers, or are insured by a single insurer who syndicates the risk into the reinsurance market.

2. CHECK YOUR PROGRESS

FILL IN THE BLANKS

1. Insurance is a method of __________ management.
2. The __________ is the amount paid by the insured to the insurer.
3. __________ regulates insurance activities in India.
4. The __________ scheme was launched in 2016 to protect farmers against crop loss.
5. In insurance, the person who receives the policy is called the __________.

ANSWERS: 1. risk

2. premium

3. IRDAI

4.Pradhan Mantri Fasal Bima Yojana (PMFBY)

5. policyholder

11.5 TYPES OF INSURANCE

In accordance with study books of The Chartered Insurance Institute, there are the following types of insurance:

1. **Co-insurance** – risks shared between insurers
2. **Dual insurance** – risks having two or more policies with same coverage (Both the individual policies would not pay separately- a concept named contribution, and would contribute together to make up the policyholder's losses. However, in case of contingency insurances like Life insurance, dual payment is allowed)
3. **Self-insurance** – situations where risk is not transferred to insurance companies and solely retained by the entities or individuals themselves
4. **Reinsurance** – situations when Insurer passes some part of or all risks to another Insurer called Reinsurer

11.6 SOCIAL EFFECT OF INSURANCE

Insurance can have various effects on society through the way that it changes who bears the cost of losses and damage. On one hand it can increase fraud; on the other it can help societies and individuals prepare for catastrophes and mitigate the effects of catastrophes on both households and societies.

Insurance can influence the probability of losses through moral hazard, insurance fraud, and preventive steps by the insurance company. Insurance scholars have typically used moral hazard to refer to the increased loss due to unintentional carelessness and insurance fraud to refer to increased risk due to intentional

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carelessness or indifference. Insurers attempt to address carelessness through inspections, policy provisions requiring certain types of maintenance, and possible discounts for loss mitigation efforts. While in theory insurers could encourage investment in loss reduction, some commentators have argued that in practice insurers had historically not aggressively pursued loss control measures—particularly to prevent disaster losses such as hurricanes—because of concerns over rate reductions and legal battles. However, since about 1996 insurers have begun to take a more active role in loss mitigation, such as through building codes.

11.7 FUNCTIONS AND BENEFITS OF INSURANCE

Insurance has many functions and benefits, some of which we may describe as primary and others as ancillary or secondary, as follows:

(a) **Primary functions/benefits:** Insurance is essentially a risk transfer mechanism, removing, for a premium, the potential financial loss from the individual and placing it upon the insurer. The primary benefit is seen in the financial compensation made available to insured victims of the various insured events. On the commercial side, this enables businesses to survive major fires, liabilities, etc. From a personal point of view, the money is of great help in times of tragedy (life insurance) or other times of need.

(b) **Ancillary functions/benefits:** Insurance contributes to society directly or indirectly in many different ways. These will include:

(i) Employment: the insurance industry is a significant factor in the local workforce;

(ii) Financial services: since the relative decline in manufacturing in Hong Kong, financial services have assumed a much greater role in the local economy, insurance being a major element in the financial services sector;

(iii)Loss prevention and loss reduction (collectively referred to as 'loss control'): the practice of insurance includes various surveys and inspections related to risk management. These are followed by requirements (conditions for acceptance of risk) and/or recommendations to improve the 'risk'. As a consequence, we may say that there are fewer fires, accidents and other unwanted happenings; **(iv)Savings/investments**: life insurance, particularly, offers a convenient and effective way of providing for the future. With the introduction of the Mandatory Provident Fund Schemes in 2000, the value of insurance products in providing for the welfare of people in old age or family tragedy is very evident;

(v) Economic growth/development: it will be obvious that few people would venture their capital on costly projects without the protection of insurance (in most cases, bank financing will just not be available without insurance cover). Thus, developments of every kind, from erection of bridges to building construction and a host of other projects, are encouraged and made possible partly because insurance is available.

11.8 LET US SUM UP

- Insurance is a financial mechanism that provides protection against potential future losses through risk pooling and transfer.
- It is based on a legal contract where the insurer promises to indemnify the insured in exchange for a premium.

- The principles of insurance include utmost good faith, indemnity, insurable interest, contribution, subrogation, and disclosure of material facts.
- Insurance helps manage uncertainty and promotes financial security, economic stability, and savings.
- There are two major categories: Life Insurance and General Insurance. Life insurance deals with risks related to human life, while general insurance includes health, fire, marine, and motor insurance.
- The IASB (International Accounting Standards Board) works toward globally harmonized accounting practices in the insurance industry.
- In India, insurance regulation is governed by the IRDAI, and several government schemes like PMFBY, NAIS, and FIIS provide social and crop insurance to farmers.
- Insurance also contributes to the economic and social development of a country by enabling investment, creating employment, and supporting national projects.
- Agricultural insurance schemes such as PMFBY and NAIS are vital in protecting farmers from income loss due to natural calamities and price risks.

11.9 KEYWORDS

1. **Insurance:** A financial contract that provides protection against future risks in exchange for a premium.
2. **Premium:** The amount paid by the insured to the insurer for covering risk.
3. **Indemnity:** A principle that ensures the insured is restored to the financial position prior to the loss.
4. **Subrogation:** The insurer's right to recover claim amounts from third parties responsible for the loss.
5. **Insurable Interest:** A financial or legal interest in the subject matter of insurance.

3. CHECK YOUR PROGRESS

TRUE OR FALSE

1. Insurance removes all kinds of risk.

False

2. The principle of indemnity ensures compensation without profit.

True

3. Life insurance is a form of general insurance.

False

4. Insurance helps in promoting economic growth.

True

5. NAIS was introduced in 2003.

False

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11.10 SELF-ASSESSMENT QUESTIONS

1. Define insurance. Explain its key characteristics.

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2. List and briefly explain three principles of insurance.

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3. What are the functions of insurance in society.

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11.11 LESSON END EXERCISE

1. Discuss the principles of indemnity and contribution with suitable examples.

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2. What are the different types of insurance, and how do they differ in purpose

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3. Explain the economic and social impacts of insurance on national development.

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11.12 SUGGESTED READING

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UNIT- 3 **Lesson no. 12**

COURSE CODE: BCG 301

TYPES OF INSURANCE,

STRUCTURE:

12.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

After going through this lesson, you should be able to know:

- Types of insurance companies

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- **Learning outcomes**
  - Types of insurance companies

12.1 INTRODUCTION

he IASB Proposal for International Insurance Accounting Standards: IASB's aim in establishing accounting standards for the insurance industry is to facilitate the understanding of insurers' financial statements. Insurance contracts had been excluded from the scope of international financial reporting standards, in part because accounting practices for insurance often differ substantially from those in other sectors — both noninsurance financial services and nonfinancial businesses, and from country to country. **The Pradhan Mantri Fasal Bima Yojana** (Prime Minister's Crop Insurance Scheme) was launched by Prime Minister of IndiaNarendra Modi on 18 February 2016. It envisages a uniform premium of only 2 per cent to be paid by farmers for Kharif crops, and 1.5 per cent for Rabi crops. The premium for annual commercial and horticultural crops will be 5 per cent. Prime Minister Narendra Modi has asked for integration. This scheme is dedicated to bring in more than 50% of the farmers under its wing within the next 2–3 years. Around 25% of the claims will be sent to the farmer's direct account. Also, the scheme will remain as it is. This means that there will be no cap on coverage. Also there won't be any cap on the reduction in the insured sum. This insurance scheme, unlike the previous ones, covers local calamities too, such as landslide, hailstorm, inundation, etc. inundation was not covered by the previous schemes. The government has proposed that there will only be one insurance company for the entire state. Mostly the private as well as the national agricultural insurance companies will be approached to implement it. **Comprehensive Crop Insurance Scheme(CCIS)** covered 15 states and 2 union territories. Participation in the scheme was voluntary. Around 5 million farmers and between 8-9 million hectares were annually covered by this scheme. If the actual yield in any area covered by the scheme fell short of the guaranteed yield, the farmers were entitled to an indemnity on compensation to the extent of the shortfall in yield. The General Insurance Corporation of India administered the scheme on behalf of the Ministry of Agriculture, Government of India. **Experimental Crop Insurance** scheme was introduced in 1997-98, covering non-loanee small and marginal farmers growing specified crops in selected districts. The premium was subsidized. The premium collected was about 3 crore (US$450,000) and the claims amounted to Rs. 40 crore (US$5.9 million). The Government discontinued the scheme during 1997-98 itself. **Farm Income Insurance Scheme.** The Central Government formulated the Farm Income Insurance Scheme (FIIS) during 2003-04. The two critical components of a farmer's income are yield and price. FII S targeted these two components through a single insurance policy so that the insured farmer could get a guaranteed income. The scheme provided income protection to the farmers by insuring production and market risks. The insured farmers were ensured minimum guaranteed income (that is, average yield multiplied by the minimum support price). If the actual income was less than the guaranteed income, the insured would be compensated to the extent of the shortfall by the Agriculture Insurance Company of India. Initially, the scheme would cover only wheat and rice and would be compulsory for farmers availing crop loans. NAIS (explained in the section below) would be withdrawn for the crops covered under FIIS, but would continue to be applicable for other crops. The FIIS was withdrawn in 2004. The recent attempt by the Gujarat government to reintroduce the Farm Income Insurance Scheme (FIIS) can reform agricultural insurance and prevent farm-level distress. **National Agriculture Insurance**

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Scheme (NAIS) The Government of India experimented with a comprehensive crop insurance scheme which failed. The Government then introduced in 1999-2000, a new scheme titled "**National Agricultural Insurance Scheme**" (NAIS) or "**Rashtriya Krishi Bima Yojana" (RKBY)**. NAIS envisages coverage of all food crops (cereals and pulses), oilseeds, horticultural and commercial crops. It covers all farmers, both loanees and non-loanees, under the scheme. The premium rates vary from 1.5 percent to 3.5 percent of sum assured for food crops. In the case of horticultural and commercial crops, actuarial rates are charged. Small and marginal farmers are entitled to a subsidy of 50 percent of the premium charged- the subsidy is shared equally between the Government of India and the States. The subsidy is to be phased out over a period of 5 years. NAIS operates on the basis of Area approach- defined areas for each notified crop for widespread calamities. On individual basis- for localized calamities such as hailstorms, landslides, cyclones and floods. Under the scheme, each state is required to reach the level Gram Panchayat as the unit of insurance in a maximum period of 3 years. Agriculture Insurance Corporation of India is implementing the scheme.

12.2 TYPES OF INSURANCE

Any risk that can be quantified can potentially be insured. Specific kinds of risk that may give rise to claims are known as perils. An insurance policy will set out in detail which perils are covered by the policy and which are not. Below are non-exhaustive lists of the many different types of insurance that exist. A single policy that may cover risks in one or more of the categories set out below. For example, vehicle insurance would typically cover both the property risk (theft or damage to the vehicle) and the liability risk (legal claims arising from an accident). A home insurance policy in the United States typically includes coverage for damage to the home and the owner's belongings, certain legal claims against the owner, and even a small amount of coverage for medical expenses of guests who are injured on the owner's property.

Business insurance can take a number of different forms, such as the various kinds of professional liability insurance, also called professional indemnity (PI), which are discussed below under that name; and the business owner's policy (BOP), which packages into one policy many of the kinds of coverage that a business owner needs, in a way analogous to how homeowners' insurance packages the coverages that a homeowner needs.

Health insurance policies

Health insurance policies cover the cost of medical treatments. Dental insurance, like medical insurance, protects policyholders for dental costs. In most developed countries, all citizens receive some health coverage from their governments, paid for by taxation. In most countries, health insurance is often part of an employer's benefits.

Income protection insurance

Long-term disability insurance covers an individual's expenses for the long term, up until such time as they are considered permanently disabled and thereafter Insurance companies will often try to encourage the person back into employment in preference to and before declaring them unable to work at all and therefore totally disabled.

- **Disability overhead insurance** allows business owners to cover the overhead expenses of their business while they are unable to work.

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- **Total permanent disability insurance** provides benefits when a person is permanently disabled and can no longer work in their profession, often taken as an adjunct to life insurance.
- **Workers' compensation** insurance replaces all or part of a worker's wages lost and accompanying medical expenses incurred because of a job-related injury.

Life insurance

Life insurance provides a monetary benefit to a decedent's family or other designated beneficiary, and may specifically provide for income to an insured person's family, burial, funeral and other final expenses. Life insurance policies often allow the option of having the proceeds paid to the beneficiary either in a lump sum cash payment or an annuity. In most states, a person cannot purchase a policy on another person without their knowledge.

Annuities provide a stream of payments and are generally classified as insurance because they are issued by insurance companies, are regulated as insurance, and require the same kinds of actuarial and investment management expertise that life insurance requires. Annuities and pensions that pay a benefit for life are sometimes regarded as insurance against the possibility that a retiree will outlive his or her financial resources. In that sense, they are the complement of life insurance and, from an underwriting perspective, are the mirror image of life insurance.

Certain life insurance contracts accumulate cash values, which may be taken by the insured if the policy is surrendered or which may be borrowed against. Some policies, such as annuities and endowment policies, are financial instruments to accumulate or liquidate wealth when it is needed.

In many countries, such as the United States and the UK, the tax law provides that the interest on this cash value is not taxable under certain circumstances. This leads to widespread use of life insurance as a tax-efficient method of saving as well as protection in the event of early death.

In the United States, the tax on interest income on life insurance policies and annuities is generally deferred. However, in some cases the benefit derived from tax deferral may be offset by a low return. This depends upon the insuring company, the type of policy and other variables (mortality, market return, etc.). Moreover, other income tax saving vehicles (e.g., IRAs, 401(k) plans, Roth IRAs) may be better alternatives for value accumulation.

Property

Property insurance provides protection against risks to property, such as fire, theft or weather damage. This may include specialized forms of insurance such as fire insurance, flood insurance, earthquake insurance, home insurance, inland marine insurance or boiler insurance. The term property insurance may, like casualty insurance, be used as a broad category of various subtypes of insurance, some of which are listed below:

- **Aviation insurance** protects aircraft hulls and spares, and associated liability risks, such as passenger and third-party liability. Airports may also appear under this subcategory, including air traffic control and refuelling operations for international airports through to smaller domestic exposures.

- **Boiler insurance** (also known as boiler and machinery insurance, or equipment breakdown insurance) insures against accidental physical damage to boilers, equipment or machinery.

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- **Builder's risk insurance** insures against the risk of physical loss or damage to property during construction. Builder's risk insurance is typically written on an "all risk" basis covering damage arising from any cause (including the negligence of the insured) not otherwise expressly excluded. Builder's risk insurance is coverage that protects a person's or organization's insurable interest in materials, fixtures or equipment being used in the construction or renovation of a building or structure should those items sustain physical loss or damage from an insured peril.[29]

- **Crop insurance** may be purchased by farmers to reduce or manage various risks associated with growing crops. Such risks include crop loss or damage caused by weather, hail, drought, frost damage, insects, or disease.[30]

- **Earthquake insurance** is a form of property insurance that pays the policyholder in the event of an earthquake that causes damage to the property. Most ordinary home insurance policies do not cover earthquake damage. Earthquake insurance policies generally feature a high deductible. Rates depend on location and hence the likelihood of an earthquake, as well as the construction of the home.

- **Fidelity bond** is a form of casualty insurance that covers policyholders for losses incurred as a result of fraudulent acts by specified individuals. It usually insures a business for losses caused by the dishonest acts of its employees.

- **Flood insurance** protects against property loss due to flooding. Many U.S. insurers do not provide flood insurance in some parts of the country. In response to this, the federal government created the National Flood Insurance Program which serves as the insurer of last resort.

- **Home insurance** also commonly called hazard insurance or homeowners insurance (often abbreviated in the real estate industry as HOI), provides coverage for damage or destruction of the policyholder’s home. In some geographical areas, the policy may exclude certain types of risks, such as flood or earthquake, that require additional coverage. Maintenance-related issues are typically the homeowner’s responsibility. The policy may include inventory, or this can be bought as a separate policy, especially for people who rent housing. In some countries, insurers offer a package which may include liability and legal responsibility for injuries and property damage caused by members of the household, including pets.[31]

- **Landlord insurance** covers residential and commercial properties which are rented to others. Most homeowners’ insurance covers only owner-occupied homes.

- **Marine insurance** and marine cargo insurance cover the loss or damage of vessels at sea or on inland waterways, and of cargo in transit, regardless of the method of transit. When the owner of the cargo and the carrier are separate corporations, marine cargo insurance typically compensates the owner of cargo for losses sustained from fire, shipwreck, etc., but excludes losses that can be recovered from the carrier or the carrier’s insurance. Many marine insurance underwriters will include “time element” coverage in such policies, which extends the indemnity to cover loss of profit and other business expenses attributable to the delay caused by a covered loss.

- **Supplemental natural disaster insurance** covers specified expenses after a natural disaster renders the policyholder’s home uninhabitable. Periodic

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- payments are made directly to the insured until the home is rebuilt or a specified time period has elapsed.

- **Surety bond insurance** is a three-party insurance guaranteeing the performance of the principal.
- **Volcano insurance** is a specialized insurance protecting against damage arising specifically from volcanic eruptions.
- **Windstorm insurance** is an insurance covering the damage that can be caused by wind events such as hurricanes.
- **Liability insurance** is a very broad superset that covers legal claims against the insured. Many types of insurance include an aspect of liability coverage. For example, a homeowner's insurance policy will normally include liability coverage which protects the insured in the event of a claim brought by someone who slips and falls on the property; automobile insurance also includes an aspect of liability insurance that indemnifies against the harm that a crashing car can cause to others' lives, health, or property. The protection offered by a liability insurance policy is twofold: a legal defense in the event of a lawsuit commenced against the policyholder and indemnification (payment on behalf of the insured) with respect to a settlement or court verdict. Liability policies typically cover only the negligence of the insured, and will not apply to results of willful or intentional acts by the insured.

1. CHECK YOUR PROGRESS

TRUE OR FALSE

1. Liability insurance covers both negligence and intentional acts.
2. Annuities are usually considered a form of insurance.
3. Flood insurance is commonly included in regular home insurance policies.
4. Crop insurance protects against losses due to pests and weather conditions.
5. Life insurance always pays out a lump sum.

ANSWERS: 1. False 2. True 3. False 4. True 5. False

12.3 LET US SUM UP

- **Health Insurance** covers medical and dental expenses.
- **Income Protection Insurance** includes disability benefits and wage replacement.
- **Life Insurance** provides financial security to beneficiaries after the policyholder’s death.
- **Property Insurance** includes coverage for homes, crops, equipment, and more.

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- **Liability Insurance** covers legal obligations from accidental harm or damage to others.
- **Specialized Insurance** includes aviation, marine, earthquake, flood, volcano, and builder's risk insurance.

2. CHECK YOUR PROGRESS

Match the Following

A	**B**
1. Health Insurance	a. Loss during construction
2. Builder's Risk Insurance	b. Financial security after death
3. Life Insurance	c. Medical expenses
4. Annuity	d. Regular payments post-retirement
5. Workers' Compensation Insurance	e. Covers job-related injuries

ANSWERS: 1 C, 2 A, 3 B, 4 D, 5 E

12.4 KEYWORDS

- **Premium:** A periodic payment made to the insurer for coverage.
- **Health Insurance:** Insurance that covers medical and hospital expenses.
- **Disability Insurance:** Covers income loss due to illness or injury.
- **Life Insurance:** Provides financial compensation to beneficiaries upon the policyholder's death.

- **Annuity:** A financial product offering regular payments, often after retirement.
- **Property Insurance:** Protects against damage or loss to physical assets.
- **Crop Insurance:** Provides protection to farmers against crop loss or damage.
- **Liability Insurance:** Covers legal liabilities for damages or injuries caused to others.
- **Fidelity Bond:** Insurance against losses from employee dishonesty.

12.5 SELF-ASSESSMENT QUESTIONS

1. Define insurance and explain its importance.

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2.What are the different categories of risk that insurance can cover

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3. Write short notes on:

- a. Health Insurance
- b. Life Insurance
- c. Property Insurance
- d. Liability Insurance

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12.6 LESSON END EXERCISE

1. Compare and contrast health insurance and income protection insurance.

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2. Evaluate the relevance of specialized insurances in today's risk environment (e.g., aviation, builder's risk, volcano).

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3. Discuss the role and impact of insurance in economic and social development.

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3. CHECK YOUR PROGRESS

FILL IN THE BLANKS

1. The specific event or risk covered by an insurance policy is called a _________.
2. A person pays a _________ to obtain coverage from an insurance company.
3. Insurance that protects against financial loss due to medical expenses is called _________.
4. _________ insurance provides a stream of income during retirement.
5. _________ insurance protects a business from losses caused by dishonest employees.

ANSWERS: 1. Peril, 2. Premium, 3. Health insurance 4. Annuity 5. Fidelity bond

12.7 SUGGESTED READING

- John Clay and Stephen Holton, “Guide to Preparing Financial Statements” (Practitioners Publishing, 1997)
- Peter Atrill and Eddie McLaney, “Accounting and Finance for Non-Specialists” (Prentice Hall, 1997)
- Leopold Bernstein and John Wild, “Analysis of Financial Statements” (McGraw-Hill, 2000)

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○ • Daniel L. Jensen, “Advanced Accounting” (McGraw-Hill College Publishing, 1997)

• Martin Mellman et. al., “Accounting for Effective Decision Making” (Irwin Professional Press, 1994)

• Eric Press, “Analyzing Financial Statements” (Lebahar-Friedman, 1999)

• Gerald I. White, “The Analysis and Use of Financial Statements” (John Wiley & Sons, 1997)

• SK Gupta, Foreign Exchange Law and Practice, Taxmann

• SS Gulshan, Mercantile Law, excel Books

• Rustam S. Davar, Khorshed D.P. (Davar) Madon, General Principles of Indian Law, Progressive Corp.

UNIT- 3 **Lesson no. 13**

COURSE CODE: BCG 301

IMPORTANT TERMS IN INSURANCE

STRUCTURE:

13.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

After going through this lesson, you should be able to know:

- Important terms in insurance

Learning outcomes

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- ○ • Important terms in insurance

13.1 INTRODUCTION

- **The IASB Proposal for International Insurance Accounting Standards:** IASB's aim in establishing accounting standards for the insurance industry is to facilitate the understanding of insurers' financial statements. Insurance contracts had been excluded from the scope of international financial reporting standards, in part because accounting practices for insurance often differ substantially from those in other sectors — both noninsurance financial services and nonfinancial businesses, and from country to country. **The Pradhan Mantri Fasal Bima Yojana** (Prime Minister's Crop Insurance Scheme) was launched by Prime Minister of IndiaNarendra Modi on 18 February 2016. It envisages a uniform premium of only 2 per cent to be paid by farmers for Kharif crops, and 1.5 per cent for Rabi crops. The premium for annual commercial and horticultural crops will be 5 per cent. Prime Minister Narendra Modi has asked for integration. This scheme is dedicated to bring in more than 50% of the farmers under its wing within the next 2–3 years. Around 25% of the claims will be sent to the farmer's direct account. Also, the scheme will remain as it is. This means that there will be no cap on coverage. Also, there won't be any cap on the reduction in the insured sum. This insurance scheme, unlike the previous ones, covers local calamities too, such as landslide, hailstorm, inundation, etc. inundation was not covered by the previous schemes. The government has proposed that there will only be one insurance company for the entire state. Mostly the private as well as the national agricultural insurance companies will be approached to implement it. **Comprehensive Crop Insurance Scheme (CCIS)** covered 15 states and 2 union territories. Participation in the scheme was voluntary. Around 5 million farmers and between 8-9 million hectares were annually covered by this scheme. If the actual yield in any area covered by the scheme fell short of the guaranteed yield, the farmers were entitled to an indemnity on compensation to the extent of the shortfall in yield. The General Insurance Corporation of India administered the scheme on behalf of the Ministry of Agriculture, Government of India. **Experimental Crop Insurance** scheme was introduced in 1997-98, covering non-loanee small and marginal farmers growing specified crops in selected districts. The premium was subsidized. The premium collected was about 3 crore (US$450,000) and the claims amounted to Rs. 40 crore (US$5.9 million). The Government discontinued the scheme during 1997-98 itself. **Farm Income Insurance Scheme.** The Central Government formulated the Farm Income Insurance Scheme (FIIS) during 2003-04. The two critical components of a farmer's income are yield and price. FII S targeted these two components through a single insurance policy so that the insured farmer could get a guaranteed income. The scheme provided income protection to the farmers by insuring production and market risks. The insured farmers were ensured minimum guaranteed income (that is, average yield multiplied by the minimum support price). If the actual income was less than the guaranteed income, the insured would be compensated to the extent of the shortfall by the Agriculture Insurance Company of India. Initially, the scheme would cover only wheat and rice and would be compulsory for farmers availing

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○ crop loans. NAIS (explained in the section below) would be withdrawn for the crops covered under FIIS, but would continue to be applicable for other crops. The FIIS was withdrawn in 2004. The recent attempt by the Gujarat government to reintroduce the Farm Income Insurance Scheme (FIIS) can reform agricultural insurance and prevent farm-level distress. **National Agriculture Insurance Scheme (NAIS)** The Government of India experimented with a comprehensive crop insurance scheme which failed. The Government then introduced in 1999-2000, a new scheme titled "**National Agricultural Insurance Scheme**" (NAIS) or "**Rashtriya Krishi Bima Yojana" (RKBY)**. NAIS envisages coverage of all food crops (cereals and pulses), oilseeds, horticultural and commercial crops. It covers all farmers, both loanees and non-loanees, under the scheme. The premium rates vary from 1.5 percent to 3.5 percent of sum assured for food crops. In the case of horticultural and commercial crops, actuarial rates are charged. Small and marginal farmers are entitled to a subsidy of 50 percent of the premium charged- the subsidy is shared equally between the Government of India and the States. The subsidy is to be phased out over a period of 5 years. NAIS operates on the basis of Area approach- defined areas for each notified crop for widespread calamities. On individual basis- for localized calamities such as hailstorms, landslides, cyclones and floods. Under the scheme, each state is required to reach the level Gram Panchayat as the unit of insurance in a maximum period of 3 years. Agriculture Insurance Corporation of India is implementing the scheme.

13.2 IMPORTANT TERMS IN INSURANCE

Premium- This is the actual cost of your insurance plan. Keep in mind that the higher the premium, the higher your coverage and thus, the less you will have to pay in medical bills throughout the year.

Deductible- The Deductible is the amount that you must pay out of your own pocket before the insurance company will begin paying towards any covered expenses. The deductible affects how much money you will pay to the doctor or hospital, and is typically paid at the time of treatment.

Accidental Death Benefit - In a life insurance policy, benefit in addition to the death benefit paid to the beneficiary, should death occur due to an accident. There can be certain exclusions as well as time and age limits.

Actual Cash Value- Cost of replacing damaged or destroyed property with comparable new property, minus depreciation and obsolescence. For example, a 10-year-old sofa will not be replaced at current full value because of a decade of depreciation.

Adjustable Rate- An interest rate that changes based on changes in a published marketrate index.

Agent -Individual who sells and services insurance policies in either of two classifications:

Aggregate Limit - Usually refers to liability insurance and indicates the amount of coverage that the insured has under the contract for a specific period of time, usually the contract period, no matter how many separate accidents might occur.

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Annuity - An agreement by an insurer to make periodic payments that continue during the survival of the annuitant(s) or for a specified period.

Automobile Liability Insurance - Coverage if an insured is legally liable for bodily injury or property damage caused by an automobile.

Benefit Period - In health insurance, the number of days for which benefits are paid to the named insured and his or her dependents. For example, the number of days that benefits are calculated for a calendar year consists of the days beginning on Jan. 1 and ending on Dec. 31 of each year.

Broker - Insurance salesperson that searches the marketplace in the interest of clients, not insurance companies.

Broker-Agent - Independent insurance salesperson who represents particular insurers but also might function as a broker by searching the entire insurance market to place an applicant's coverage to maximize protection and minimize cost. This person is licensed as an agent and a broker.

Captive Agent - Representative of a single insurer or fleet of insurers who is obliged to submit business only to that company, or at the very minimum, give that company first refusal rights on a sale. In exchange, that insurer usually provides its captive agents with an allowance for office expenses as well as an extensive list of employee benefits such as pensions, life insurance, health insurance, and credit unions.

Casualty Insurance - That type of insurance that is primarily concerned with losses caused by injuries to persons and legal liability imposed upon the insured for such injury or for damage to property of others. It also includes such diverse forms as plate glass, insurance against crime, such as robbery, burglary and forgery, boiler and machinery insurance and Aviation insurance. Many casualty companies also write surety business.

Claim - A demand made by the insured, or the insured's beneficiary, for payment of the benefits as provided by the policy.

Coinsurance - In property insurance, requires the policyholder to carry insurance equal to a specified percentage of the value of property to receive full payment on a loss. For health insurance, it is a percentage of each claim above the deductible paid by the policyholder. For a 20% health insurance coinsurance clause, the policyholder pays for the deductible plus 20% of his covered losses. After paying 80% of losses up to a specified ceiling, the insurer starts paying 100% of losses.

Collision Insurance - Covers physical damage to the insured's automobile (other than that covered under comprehensive insurance) resulting from contact with another inanimate object.

Comprehensive Insurance - Auto insurance coverage providing protection in the event of physical damage (other than collision) or theft of the insured car. For example, fire damage or a cracked windshield would be covered under the comprehensive section.

Coverage - The scope of protection provided under an insurance policy. In property insurance, coverage lists perils insured against, properties covered, locations covered, individuals insured, and the limits of indemnification. In life insurance, living and death benefits are listed.

Copayment - A predetermined, flat fee an individual pays for health-care services, in addition to what insurance covers. For example, some HMOs require a $10

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copayment for each office visit, regardless of the type or level of services provided during the visit.

Creditable Coverage - Term means that benefits provided by other drug plans are at least as good as those provided by the new Medicare Part D program. This may be important to people eligible for Medicare Part D but who do not sign up at their first opportunity because if the other plans provide creditable coverage, plan members can later convert to Medicare Part D without paying higher premiums than those in effect during their open enrollment period.

Death Benefit - The limit of insurance or the amount of benefit that will be paid in the event of the death of a covered person.

Deductible - Amount of loss that the insured pays before the insurance kicks in.

Defense Base Act Insurance:- Required insurance per FAR 52.228-3 for all federally funded public works contracts overseas (OCONUS). Provides contractually required protection for the contractor's civilian employees for medical expenses, lost wages, disability, and or death, including War Hazard, arising from work related injury or occupational illness.

Direct Writer - An insurer whose distribution mechanism is either the direct selling system or the exclusive agency system.

Earned Premium - The amount of the premium that as been paid for in advance that has been "earned" by virtue of the fact that time has passed without claim. A three-year policy that has been paid in advance and is one year old would have only partly earned the premium.

Employers Liability Insurance - Coverage against common law liability of an employer for accidents to employees, as distinguished from liability imposed by a workers' compensation law.

Errors & Omissions Insurance - Also known as Professional Liability Insurance protects your organization from claims if your client holds you liable for errors, or failure to deliver work as promised in the contract.

Exclusions - Items or conditions that are not covered by the general insurance contract.

General Liability Insurance - Insurance designed to protect business owners and operators from a wide variety of liability exposures. Exposures could include liability arising from accidents resulting from the insured's premises or operations, products sold by the insured, operations completed by the insured, and contractual liability.

Grace Period - The length of time (usually 31 days) after a premium is due and unpaid during which the policy, including all riders, remains in force. If a premium is paid during the grace period, the premium is considered to have been paid on time. In Universal Life policies, it typically provides for coverage to remain in force for 60 days following the date cash value becomes insufficient to support the payment of monthly insurance costs.

Hazard - A circumstance that increases the likelihood or probable severity of a loss. For example, the storing of explosives in a home basement is a hazard that increases the probability of an explosion.

Health Maintenance Organization (HMO) - Prepaid group health insurance plan that entitles members to services of participating physicians, hospitals and clinics.

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Emphasis is on preventative medicine, and members must use contracted health-care providers.

Indemnity - Restoration to the victim of a loss by payment, repair or replacement.

Insurable Interest - Interest in property such that loss or destruction of the property could cause a financial loss.

Liability Insurance - Insurance that pays and renders service on behalf of an insured for loss arising out of his responsibility, due to negligence, to others imposed by law or assumed by contract.

Medical Loss Ratio - Total health benefits divided by total premium.

Mortgage Insurance Policy - In life and health insurance, a policy covering a mortgagor with benefits intended to pay off the balance due on a mortgage upon the insured's death, or to meet the payments due on a mortgage in case of the insured's death or disability.

National Association of Insurance Commissioners (NAIC) - Association of state insurance commissioners whose purpose is to promote uniformity of insurance regulation, monitor insurance solvency and develop model laws for passage by state legislatures.

Personal Accident Insurance: Provides your employees and beneficiaries with financial compensation in the unfortunate event of an accident during an international trip or living and working overseas. It offers 24 hour cover for Accidental Death and Dismemberment (AD&D), Disablement and pays for Medical Expense, Medical Evacuation and Repatriation. Personal Accident benefits are payable in addition to DBA or Workers Compensation benefits.

Personal Injury Protection - Pays basic expenses for an insured and his or her family in states with no-fault auto insurance. No-fault laws generally require drivers to carry both liability insurance and personal injury protection coverage to pay for basic needs of the insured, such as medical expenses, in the event of an accident.

Policy - The written contract effecting insurance, or the certificate thereof, by whatever name called, and including all clause, riders, endorsements, and papers attached thereto and made a part thereof.

Premium - The price of insurance protection for a specified risk for a specified period of time.

Reinsurance - In effect, insurance that an insurance company buys for its own protection. The risk of loss is spread so a disproportionately large loss under a single policy doesn't fall on one company. Reinsurance enables an insurance company to expand its capacity; stabilize its underwriting results; finance its expanding volume; secure catastrophe protection against shock losses; withdraw from a line of business or a geographical area within a specified time period.

Renewal - The automatic re-establishment of in-force status effected by the payment of another premium.

Replacement Cost - The dollar amount needed to replace damaged personal property or dwelling property without deducting for depreciation but limited by the maximum dollar amount shown on the declarations page of the policy.

Risk Class - Risk class, in insurance underwriting, is a grouping of insureds with a similar level of risk. Typical underwriting classifications are preferred, standard and substandard, smoking and nonsmoking, male and female.

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Risk Management - Management of the pure risks to which a company might be subject. It involves analyzing all exposures to the possibility of loss and determining how to handle these exposures through practices such as avoiding the risk, retaining the risk, reducing the risk, or transferring the risk, usually by insurance.

Term Life Insurance - Life insurance that provides protection for a specified period of time. Common policy periods are one year, five years, 10 years or until the insured reaches age 65 or 70. The policy doesn't build up any of the non-forfeiture values associated with whole life policies.

Transit and Cargo Insurance: Covers goods in transit across high-risk regions by land, air or sea. Our War and Terrorism extension provides transit coverage against acts of war.

Umbrella Policy - Coverage for losses above the limit of an underlying policy or policies such as homeowners and auto insurance. While it applies to losses over the dollar amount in the underlying policies, terms of coverage are sometimes broader than those of underlying policies.

Unearned Premiums - That part of the premium applicable to the unexpired part of the policy period.

Whole Life Insurance - Life insurance which might be kept in force for a person's whole life and which pays a benefit upon the person's death, whenever that might be.

1. CHECK YOUR PROGRESS

FILL IN THE BLANKS

1. ______ is the portion of the premium that applies to the expired period of coverage.
2. A policyholder must pay the ______ before the insurance coverage begins.
3. ______ provides compensation for bodily injury due to an accident.
4. ______ insurance pays benefits to the policyholder’s family upon their death.
5. ______ coverage protects goods in transit by sea, land, or air.

ANSWERS: 1. Earned premium 2. Deductible 3. Personal Accident Insurance

4. Life insurance 5. Marine cargo

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2. CHECK YOUR PROGRESS

TRUE OR FALSE

1. A captive agent can sell policies for multiple insurance companies. (_____)
2. Coinsurance means the insurer pays the entire bill after the deductible. (_____)
3. The grace period allows the policy to remain active after a missed premium. (_____)
4. Exclusions are the benefits provided by an insurance policy. (_____)
5. Property insurance includes liability coverage for personal injury to others. (_____)

ANSWERS: 1. False

2. False

3. True

4. False

5.True

3. CHECK YOUR PROGRESS

Match the Following

A	B
1. Term Life Insurance	a. Periodic payments for life support
2. Annuity	b. Loss or damage during transport
3. Marine Cargo Insurance	c. Temporary life protection
4. Broker-Agent	d. Represents both insurer and client
5. Medical Loss Ratio	e. Health benefits ÷ premium ratio

Match the Following – Answer Key

A	B
1. Term Life Insurance	**c. Temporary life protection**
2. Annuity	**a. Periodic payments for life support**
3. Marine Cargo Insurance	**b. Loss or damage during transport**
4. Broker-Agent	**d. Represents both insurer and client**
5. Medical Loss Ratio	**e. Health benefits ÷ premium ratio**

13.3 LET US SUM UP

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Insurance is a vital component of modern financial systems, enabling individuals and organizations to manage risk and protect themselves from financial losses due to unforeseen events. A deep understanding of insurance terminology is essential for policyholders, insurers, and students of commerce and finance. This lesson covered essential terms such as premium, deductible, claim, benefit period, and annuity, as well as specialized insurance concepts like reinsurance, coinsurance, property and casualty insurance, life and health insurance, and liability coverage. It also included technical definitions like earned and unearned premium, exclusions, endorsements, and grace periods. Understanding these terms enhances the ability to analyze policy features, make informed decisions, and comprehend the obligations and rights within various types of insurance contracts.

13.4 KEYWORDS

- **Premium:** Price paid for insurance protection over a specified period.
- **Accidental Death Benefit:** Additional payment if death occurs due to an accident.
- **Annuity:** Regular payments made by insurer during a specific time or lifetime.
- **Agent:** Person authorized to sell and service insurance policies.
- **Claim:** A demand for payment under an insurance policy.
- **Coverage:** Scope of protection provided under an insurance policy.
- **Coinsurance:** Sharing of covered costs between the insured and insurer.
- **Reinsurance:** Insurance purchased by insurers to reduce risk exposure.
- **Exclusions:** Items or conditions not covered by a policy.
- **Grace Period:** Time after due date when a policy remains active without penalty.

- **Whole Life Insurance:** Life insurance providing lifelong coverage with cash value.
- **Term Insurance:** Temporary life insurance for a specified period without cash value.

13.5 SELF-ASSESSMENT QUESTIONS

1.What is the difference between premium and deductible in an insurance policy.

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2. Define Accidental Death Benefit. When is it applicable.

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3. Explain the concept of **Coinsurance** with an example.

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13.6 LESSON END EXERCISE

1. What is the role of a **broker-agent** in the insurance industry.

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2. What does **"exclusions"** mean in the context of an insurance policy

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3. What is **grace period** and why is it important.

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13.7 SUGGESTED READING

- John Clay and Stephen Holton, "Guide to Preparing Financial Statements" (Practitioners Publishing, 1997)
- Peter Atrill and Eddie McLaney, "Accounting and Finance for Non-Specialists" (Prentice Hall, 1997)
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- Rustam S. Davar, Khorshed D.P. (Davar) Madon, General Principles of Indian Law, Progressive Corp.

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UNIT- 3 **Lesson no. 14**

COURSE CODE:

PREPARATION OF REVENUE ACCOUNT

STRUCTURE:

14.0 Learning Objectives and Outcomes

14.1 Introduction

14.4 Meaning of Revenue Account

14.3 Structure of Revenue Account

14.4 Schedules related to Revenue Account

14.5 Let Us Sum Up

14.6Keywords

14.7 Self-Assessment Questions

14.8 Lesson End Exercise

14.9 Suggested Readings

14.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

After completing this lesson, you will be able to:

- Understand the structure and purpose of a Revenue Account in insurance companies.
- Identify and classify various incomes and expenditures in the Revenue Account.
- Prepare the Revenue Account for both life and general insurance businesses.
- Understand treatment of reinsurance, reserves, and commission.

Learning outcomes

- Understand the structure and purpose of a Revenue Account in insurance companies.
- Identify and classify various incomes and expenditures in the Revenue Account.
- Prepare the Revenue Account for life insurance businesses.
- Understand treatment of reinsurance, reserves, and commission.

14.1 INTRODUCTION

Insurance companies are financial institutions that manage and pool risk. Unlike regular commercial businesses, their financial reporting follows a different structure due to the unique nature of their operations. The Revenue Account is a

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key part of their financial statements, which reflects the operating income and expenses related to the insurance business for a specific period.

According to the Insurance Regulatory and Development Authority (IRDA) regulations, insurance companies in India must prepare:

- Separate revenue accounts for each class of business (life, fire, marine, etc.)

Financial statements following formats prescribed in IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002.

14.2 MEANING OF REVENUE ACCOUNT

In the context of insurance companies, a **Revenue Account** is a financial statement that provides a **summary of all revenues and expenses** associated with underwriting insurance business during an accounting period (usually a financial year).

It is similar to the **Profit and Loss Account** in other business entities but specifically tailored to suit the nature of insurance operations. This account is prepared **separately for each class of insurance business**, such as:

- **Life insurance**
- **General insurance** (fire, marine, motor, health, etc.)

14.3 STRUCTURE OF REVENUE ACCOUNT

A. Income

1. Premium Income (Gross)
2. Income from Investments
3. Consideration for Annuities
4. Other Income (Surrender Charges, etc.)

B. Expenditure

1. Benefits Paid:
    - Claims by Death
    - Maturity Benefits
    - Surrender Benefits
    - Bonus in Cash
2. Commission:
    - Agents’ and Brokers’ Commission
3. Operating Expenses:
    - Admin and Marketing Costs
4. Change in Life Assurance Fund
    - This is the balancing figure
    - Transferred to Balance Sheet under Liabilities

Example Format

XYZ Life Insurance Company Ltd.
Revenue Account for the Year Ended 31st March 20XX

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Particulars	**₹ (Amount)**
Income	
Premium Earned	XX,XXX
Consideration for Annuities	X,XXX
Interest, Dividend & Rent	X,XXX
Total (A)	XX,XXX
Expenditure	
Claims and Benefits Paid	XX,XXX
Commission	X,XXX
Operating Expenses	X,XXX
Total (B)	XX,XXX
Change in Life Assurance Fund (A – B)	X,XXX

14.4 SCHEDULES RELATED TO REVENUE ACCOUNT

Schedule 1: Premium Earned (Net)

Particulars	**Current Year ₹**	**Previous Year ₹**
Premium from Direct Business written		
Add: Premium on Reinsurance Accepted		
Less: Premium on Reinsurance Ceded		
Net Premium		

Schedule 2: Commission Expenses

Particulars	Current Year ₹	Previous Year ₹
Commission on Direct Business		
Add: Commission on Reinsurance Accepted		
Less: Commission on Reinsurance Ceded		
Net Commission		

Schedule 3: Operating Expenses Related to Insurance Business

Particulars	Current Year ₹	Previous Year ₹
Employees' remuneration and welfare benefits		
Travel, conveyance, and vehicle expenses		
Training expenses		
Rent, rates, and taxes		
Repairs		
Printing and stationery		
Communication expenses		
Legal and professional charges		
Others (specify)		
Total		

Schedule 4: Benefits Paid (Net)

Particulars	Current Year ₹	Previous Year ₹
Claims by Death		
Claims by Maturity		
Annuities Paid		

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Particulars	Current Year ₹	Previous Year ₹
Surrenders		
Bonuses in cash		
Less: Reinsurance Claims Recovered		
Net Benefits Paid		

ILLUSTRATION 1: From the following information of XYZ Life Insurance Co. Ltd. for the year ending 31st March 2025, prepare the Revenue Account:

Given Data:

- Premium received (net of reinsurance): ₹14,00,000
- Commission paid: ₹1,00,000
- Interest and dividend on investments: ₹3,20,000
- Profit on sale of investments: ₹40,000
- Other income (miscellaneous receipts): ₹25,000
- Salaries and office expenses: ₹2,30,000
- Legal charges: ₹20,000
- Audit fees: ₹10,000
- Advertisement: ₹30,000
- Death claims paid: ₹3,00,000
- Maturity claims paid: ₹2,50,000
- Surrender value paid: ₹50,000
- Bonus paid in cash: ₹70,000
- Reinsurance recoveries on claims: ₹80,000
- Change in valuation of life assurance fund: Increase of ₹2,00,000

Solution:

XYZ Life Insurance Co. Ltd.

Revenue Account for the year ending 31st March 2025

Particulars	Schedule	Amount (₹)
1. Premiums Earned (Net)	1	14,00,000
2. Income from Investments		
a. Interest, Dividend and Rent – Gross		3,20,000
b. Profit on Sale of Investments		40,000
3. Other Income		25,000
Total (A)		17,85,000
4. Commission	2	1,00,000
5. Operating Expenses Related to Insurance Business	3	
a. Salaries and Office Expenses		2,30,000
b. Legal Charges		20,000
c. Audit Fees		10,000
d. Advertisement		30,000
Total Operating Expenses		2,90,000
6. Benefits Paid (Net)	4	
a. Death Claims	3,00,000	
b. Maturity Claims	2,50,000	
c. Surrender Value	50,000	
d. Bonus Paid	70,000	
Total Claims Paid		6,70,000
Less: Reinsurance Recoveries		(80,000)
Net Benefits Paid		5,90,000
7. Change in Valuation of Liability in respect of Life Policies		2,00,000
Total (B)		11,80,000

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Particulars	Schedule	Amount (₹)
8. Surplus (A - B)		6,05,000
Appropriations:		
Transfer to Life Assurance Fund		6,05,000
		Nil

Notes:

- Premiums Earned (Net) = ₹14,00,000 (already net of reinsurance).
- Benefits Paid (Net) = Total claims paid (₹6,70,000) − Reinsurance (₹80,000) = ₹5,90,000.
- Operating Expenses = Sum of given operating costs (₹2,90,000).
- Valuation adjustment represents an increase in liability = expense.

1. CHECK YOUR PROGRESS

Match the Following

Column A	Column B
1. Premium Earned (Net)	a. Schedule 1
2. Commission Paid	b. Schedule 2
3. Operating Expenses	c. Schedule 3
4. Benefits Paid (Net)	d. Schedule 4
5. IRDA Regulations	e. Prescribes format for Revenue A/c

☑ Answers:

1 → a
2 → b
3 → c
4 → d
5 → e

2. CHECK YOUR PROGRESS

TRUE OR FALSE

Statement	Answer
1. Revenue Account is prepared to calculate net profit of an insurance company.	False
2. Premium received from policyholders is shown on the income side of the Revenue Account.	True
3. Commission expenses are shown in Schedule 4 of the Revenue Account.	False
4. Reinsurance recoveries are deducted from gross claims.	True
5. Investment income is included in the revenue account.	True

3. CHECK YOUR PROGRESS

FILL IN THE BLANKS

1. Revenue Account is prepared as per the format prescribed by **___________**.

☑ **Answer:** IRDA

2. **___________** is the amount paid to policyholders on account of claims.

☑ **Answer:** Benefits Paid

3. Commission paid to agents is recorded under **Schedule ________.**

☑ **Answer:** 2

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4. The increase in actuarial liability is shown as an ___________ in the Revenue Account.

☑ **Answer:** Expense

5. Net premium is calculated after deducting ___________ and adding reinsurance accepted.

☑ **Answer:** Reinsurance ceded

14.5 LET US SUM UP

- The Revenue Account of a life insurance company is prepared to determine the operating result (surplus/deficit).
- It includes premium income, investment income, commission, operating expenses, benefits paid, and change in actuarial liability.
- The format and structure are regulated by IRDA, and data must be presented in prescribed schedules (Schedule 1 to 4).
- The surplus is transferred to the Life Assurance Fund, which increases policyholder reserves.

14.6 KEYWORDS

Revenue Account: An account showing income and expenses from insurance operations.

Premium Earned (Net): Net premium after deducting reinsurance ceded and adding reinsurance accepted.

Benefits Paid (Net): Claims paid to policyholders minus reinsurance recoveries.

Commission: Remuneration paid to agents or brokers for procuring business.

Operating Expenses: Administrative and business running costs.

14.7 SELF-ASSESSMENT QUESTIONS

1. What are the steps involved in calculating the surplus in a revenue account.

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2. Prepare a format of the Revenue Account of a life insurance company and explain each item briefly

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3. List any three operating expenses shown in Schedule 3.

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14.8 LESSON END EXERCISE

1. What are the main items shown on the income side of the revenue account.

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2.List any three operating expenses shown in Schedule 3.

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3. What is the role of Schedule 4

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14.9 SUGGESTED READING

- John Clay and Stephen Holton, "Guide to Preparing Financial Statements" (Practitioners Publishing, 1997)
- Peter Atrill and Eddie McLaney, "Accounting and Finance for Non-Specialists" (Prentice Hall, 1997)
- Leopold Bernstein and John Wild, "Analysis of Financial Statements" (McGraw-Hill, 2000)

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UNIT- 3 **Lesson no. 15**

COURSE CODE: BCG-301

PREPARATION OF BALANCE SHEET OF LIFE INSURANCE COMPANY AS PER PRESCRIBED FORMAT

STRUCTURE:

15.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

After completing this lesson, you will be able to:

- Understand the structure and purpose of a balance sheet in insurance companies.
- Prepare the balance sheet for life insurance businesses.

Learning outcomes

- Understand the structure and purpose of a balance sheet in insurance companies.
- Prepare the balance sheet for life insurance businesses.

15.1 INTRODUCTION

- **The IASB Proposal for International Insurance Accounting Standards:** IASB's aim in establishing accounting standards for the insurance industry is to facilitate the understanding of insurers' financial statements. Insurance contracts had been excluded from the scope of international financial reporting standards, in part because accounting practices for insurance often differ substantially from those in other sectors — both noninsurance financial services and nonfinancial businesses, and from country to country. **The Pradhan Mantri Fasal Bima Yojana** (Prime Minister's Crop

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◦ Insurance Scheme) was launched by Prime Minister of IndiaNarendra Modi on 18 February 2016. It envisages a uniform premium of only 2 per cent to be paid by farmers for Kharif crops, and 1.5 per cent for Rabi crops. The premium for annual commercial and horticultural crops will be 5 per cent. Prime Minister Narendra Modi has asked for integration. This scheme is dedicated to bring in more than 50% of the farmers under its wing within the next 2–3 years. Around 25% of the claims will be sent to the farmer's direct account. Also, the scheme will remain as it is. This means that there will be no cap on coverage. Also there won't be any cap on the reduction in the insured sum. This insurance scheme, unlike the previous ones, covers local calamities too, such as landslide, hailstorm, inundation, etc. inundation was not covered by the previous schemes. The government has proposed that there will only be one insurance company for the entire state. Mostly the private as well as the national agricultural insurance companies will be approached to implement it. **Comprehensive Crop Insurance Scheme(CCIS)** covered 15 states and 2 union territories. Participation in the scheme was voluntary. Around 5 million farmers and between 8-9 million hectares were annually covered by this scheme. If the actual yield in any area covered by the scheme fell short of the guaranteed yield, the farmers were entitled to an indemnity on compensation to the extent of the shortfall in yield. The General Insurance Corporation of India administered the scheme on behalf of the Ministry of Agriculture, Government of India. **Experimental Crop Insurance** scheme was introduced in 1997-98, covering non-loanee small and marginal farmers growing specified crops in selected districts. The premium was subsidized. The premium collected was about 3 crore (US$450,000) and the claims amounted to Rs. 40 crore

(US$5.9 million). The Government discontinued the scheme during 1997-98 itself. **Farm Income Insurance Scheme.** The Central Government formulated the Farm Income Insurance Scheme (FIIS) during 2003-04. The two critical components of a farmer's income are yield and price. FII S targeted these two components through a single insurance policy so that the insured farmer could get a guaranteed income. The scheme provided income protection to the farmers by insuring production and market risks. The insured farmers were ensured minimum guaranteed income (that is, average yield multiplied by the minimum support price). If the actual income was less than the guaranteed income, the insured would be compensated to the extent of the shortfall by the Agriculture Insurance Company of India. Initially, the scheme would cover only wheat and rice and would be compulsory for farmers availing crop loans. NAIS (explained in the section below) would be withdrawn for the crops covered under FIIS, but would continue to be applicable for other crops. The FIIS was withdrawn in 2004. The recent attempt by the Gujarat government to reintroduce the Farm Income Insurance Scheme (FIIS) can reform agricultural insurance and prevent farm-level distress. **National Agriculture Insurance Scheme (NAIS)** The Government of India experimented with a comprehensive crop insurance scheme which failed. The Government then introduced in 1999-2000, a new scheme titled "**National Agricultural Insurance Scheme**" (NAIS) or "**Rashtriya Krishi Bima Yojana" (RKBY)**. NAIS envisages coverage of all food crops (cereals and pulses), oilseeds, horticultural and commercial crops. It covers all farmers, both loanees and non-loanees, under the scheme. The premium rates vary from 1.5 percent to 3.5 percent of sum assured for food crops. In the case of horticultural and commercial

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○ crops, actuarial rates are charged. Small and marginal farmers are entitled to a subsidy of 50 percent of the premium charged- the subsidy is shared equally between the Government of India and the States. The subsidy is to be phased out over a period of 5 years. NAIS operates on the basis of Area approach- defined areas for each notified crop for widespread calamities. On individual basis- for localized calamities such as hailstorms, landslides, cyclones and floods. Under the scheme, each state is required to reach the level Gram Panchayat as the unit of insurance in a maximum period of 3 years. Agriculture Insurance Corporation of India is implementing the scheme.

15.2 PREPARATION OF BALANCE SHEET

PREPARATION OF BALANCE SHEET OF LIFE INSURANCE COMPANIES AS PER PRESCRIBED FORM

FINAL ACCOUNTS OF INSURANCE COMPANIES

Insurance is a form of contract under which one party agrees in return of a consideration to pay an agreed amount of money to another party to compensate for a loss, damage or some uncertain event. There are two types of insurance i.e., Life insurance and General Insurance.

Life Insurance – under this type of insurance the corporation guarantees to pay a certain sum of money to the policy holder on reaching a certain age or on his death whichever is earlier. Life insurance has an element both of protection and investment. General Insurance – it includes all other types of insurance except life insurance. e.g. – Fire, Marine, Accident, Theft.etc. Under this type of insurance, the insurer undertakes to indemnify the loss suffered by the insured on happening of a certain event in consideration for a fixed premium. Insurance Regulatory and Development Authority (IRDA) In order to regulate the insurance business, the government set up in 1996, the Insurance Regulatory Authority (IRA). Now this authority is known as the Insurance Regulatory and Development Authority. In 2002, the authority came with regulations for the preparation of the financial statement of insurance companies.

Accounts of insurance companies

1. **IRDA** has prescribed in specified formats for preparation of financial statements of insurance business in part V of 'schedule A' of IRDA regulations 2002.

2. **Financial statements** have to be in conformity with the accounting standards issued by the Institute of Charted Accountants of India (ICAI). IRDA Act,1999 provide legal framework of insurance accounting in India.

3. Books for Maintenance of Accounts

1. Statutory Book:

The Insurance Act, 1938, requires the following books to be maintained by all insurance company –

I. Register of Policies – It contains all the details in respect of each policy such as name and address of the policy holder, the date when the policy was effected and a record of any assignment of the policy.

II. Register of claims – All the particulars of claims are recorded – date of claim, name and address of claimant, the date on which the claim was discharged, the case of a claim which is rejected and reasons for rejection.

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- **III.Register of agents** – It contains all the information of licensed insurance agents such as name and address of the agent, date of appointment, etc.

2. Subsidiary Book:

Apart from statutory books, the insurance companies also maintain the following books

I. Ledgers – Life insurance Fund ledger; revenue ledger and miscellaneous ledger II. Cash books – Receipts cash books and expenditure cash books.

III. Journal – Journal for recording transactional relating to outstanding premium andclaims and inter-departmental transfer.

IV. First year premium book

V. Renewal premium book

VI. Surrender policy book

This book consists of 3 registers & Register of claims:- contains date of claim, names address of policy holder, date of policy etc. & Register of licensed insurance:name of Insurance agent, address, no. of license, commission due etc.

Register of proposal, premium register, general cash book, commission register, cash receipt register address of claimant etc.

4. FINAL ACCOUNTS OF LIFE INSURANCE COMPANIES

1. REVENUE ACCOUNT

Sets out all income & expenses relating to the insurance business. income includes a) Premium after adjusting reinsurance ceded & reinsurance accepted b)

Income from investments Expenses includes a) Commission b) Operating expenses c) Benefits paid d) Bonus paid e) Change in valuation of liability against life policies in force.

2. PROFIT AND LOSS ACCOUNT

All income and expenses relating to shareholder’s account. income comprises of-

a. Depreciation relating to assets held by shareholder’s fund, investment expenses, directors fund.
b. Transfer of funds to policy holder’s fund.
c. Preliminary expenses written off.

3. BALANCE SHEET

Balance sheet includes:

a) Shareholder’s fund

b) Policy holder’s fund

c) Investments related to policy holder’s fund.

4. RECEIPTS AND PAYMENTS ACCOUNT CASH FLOW STATEMENTS

This statement of insurance company needs to be worked out as directed method as per IRDA requirements. Major items are: -

a) **Operating activities**: - Receipts and payments from policy holders, payment to reinsurers agent, employee expenses & investment income.

b) **Investing activities: -**Purchase and sales of investment, purchase of fixed assets

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c) **Financing activities: -** Issue of share capital or raising of funds from other sources.

5. FINAL ACCOUNTS OF GENERAL INSURANCE COMPANIES

a) Revenue account: A separate revenue account is prepared for each type of business. eg. fire, marine etc. It records: incomes & expenses of particular business, profit/ loss is transferred to profit & loss account.

b) Profit & loss account: It records incomes & expenses of general nature and it show how profit has been appropriated in addition to profit/loss of different business. Its balance is shown in balance sheet.

c) Balance sheet: It records various assets and liabilities of General insurance companies.

PREPARATION OF FINANCIAL STATEMENTS

Insurers assume and manage risk in return for a premium. The premium for each policy, or contract, is calculated based in part on historical data aggregated from many similar policies and is paid in advance of the delivery of the service. The actual cost of each policy to the insurer is not known until the end of the policy period (or for some insurance products long after the end of the policy period), when the cost of claims can be calculated with finality. The insurance industry is divided into two major segments: property/casualty, also known as general insurance or nonlife, particularly outside the United States, and life/ health. Broadly speaking, property/casualty policies cover homes, autos and businesses; life/health insurers sell life, long-term care and disability insurance, annuities and health insurance. U.S. insurers submit financial statements to state regulators using statutory accounting principles, but there are significant differences between the accounting practices of property/casualty and life insurers due to the nature of their products. These include:

Financial Statements

An insurance company's annual financial statement is a lengthy and detailed document that shows all aspects of its business. In statutory accounting, the initial section includes a balance sheet, an income statement and a section known as the Capital and Surplus Account, which sets out the major components of policyholders' surplus and changes in the account during the year. As with GAAP accounting, the balance sheet presents a picture of a company's financial position at one moment in time—its assets and its liabilities—and the income statement provides a record of the company's operating results from the previous period. An insurance company's policyholders' surplus—its assets minus its liabilities—serves as the company's financial cushion against catastrophic losses and as a way to fund expansion. Regulators require insurers to have sufficient surplus to support the policies they issue. The greater the risks assumed, and hence the greater the potential for claims against the policy, the higher the amount of policyholders' surplus required.

Asset Valuation

Property/casualty companies need to be able to pay predictable claims promptly and also to raise cash quickly to pay for a large number of claims in case of a hurricane or other disaster. Therefore, most of their assets are high quality, income-paying government and corporate bonds that are generally held to maturity. Under SAP, they are valued at amortized cost rather than their current

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market cost. This produces a relatively stable bond asset value from year to year (and reflects the expected use of the asset.)

However, when prevailing interest rates are higher than bonds' coupon rates, amortized cost overstates asset value, producing a higher value than one based on the market. (Under the amortized cost method, the difference between the cost of a bond at the date of purchase and its face value at maturity is accounted for on the balance sheet by gradually changing the bond's value. This entails increasing its value from the purchase price when the bond was bought at a discount and decreasing it when the bond was bought at a premium.) Under GAAP, bonds may be valued at market price or recorded at amortized cost, depending on whether the insurer plans to hold them to maturity (amortized cost) or make them available for sale or active trading (market value). The second largest asset category for property/ casualty companies, preferred and common stocks, is valued at market price. Life insurance companies generally hold a small percentage of their assets in preferred or common stock. Some assets are "nonadmitted" under SAP and therefore assigned a zero value but are included under GAAP. Examples are premiums overdue by 90 days and office furniture. Real estate and mortgages make up a small fraction of a property/casualty company's assets because they are relatively illiquid. Life insurance companies, whose liabilities are longer term commitments, have a greater portion of their investments in commercial mortgages. The last major asset category is reinsurance recoverables. These are amounts due from the company's reinsurers. (Reinsurers are insurance companies that insure other insurance companies, thus sharing the risk of loss.) Amounts due from reinsurance companies are categorized according to whether they are overdue and, if so, by how many days. Those recoverables deemed uncollectible are reported as a surplus penalty on the liability side of the balance sheet, thus reducing surplus.

Liabilities and Reserves

Liabilities, or claims against assets, are divided into two components: reserves for obligations to policyholders and claims by other creditors. Reserves for an insurer's obligations to its policyholders are by far the largest liability. Property/casualty insurers have three types of reserve funds: unearned premium reserves, or pre-claims liability; loss and loss adjustment reserves, or post claims liability; and other.

Unearned premiums are the portion of the premium that corresponds to the unexpired part of the policy period. Premiums have not been fully "earned" by the insurance company until the policy expires. In theory, the unearned premium reserve represents the amount that the company would owe all its policyholders for coverage not yet provided if one day the company suddenly went out of business. If a policy is canceled before it expires, part of the original premium payment must be returned to the policyholder.

Loss reserves are obligations that an insurance company has incurred – from claims that have been or will be filed on the exposures the insurer protected. Loss adjustment reserves are funds set aside to pay for claims adjusters, legal assistance, investigators and other expenses associated with settling claims. Property/casualty insurers set up claim reserves only for accidents and other events that have happened.

Some claims, like fire losses, are easily estimated and quickly settled. But others, such as products liability and some workers compensation claims, may be

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settled long after the policy has expired. The most difficult to assess are loss reserves for events that have already happened but have not been reported to the insurance company, known as "incurred but not reported" (IBNR). Examples of IBNR losses are cases where workers inhaled asbestos fibers but did not file a claim until their illness was diagnosed 20 or 30 years later. Actuarial estimates of the amounts that will be paid on outstanding claims must be made so that profit on the business can be calculated. Insurers estimate claims costs, including IBNR claims, based on their experience. Reserves are adjusted, with a corresponding impact on earnings, in subsequent years as each case develops and more details become known.

Revenues, Expenses and Profits

Profits arise from insurance company operations (underwriting results) and investment results. Policyholder premiums are an insurer's main revenue source. Under SAP, when a property/casualty policy is issued, the pre-claim liability or unearned premium is equal to the written premium. (Written premiums are the premiums charged for coverage under policies written regardless of whether they have been collected or "earned." Each day the policy remains in force, one day of unearned premium is earned, and the unearned premium falls by the amount earned. For example, if a customer pays $365 for a one-year policy starting January 1, the initial unearned premium reserve would be $365, and the earned premium would be $0. After one day, the unearned premium reserve would be $364, and the earned premium would be $1.

Under GAAP, policy acquisition expenses, such as agent commissions, are deferred on a pro-rata basis in line with GAAP's matching principle. This principle states that in determining income for a given period, expenses must be matched to revenues. As a result, under GAAP (and assuming losses and other expenses are experienced as contemplated in the rate applied to calculate the premium) profit is generated steadily throughout the duration of the contract. In contrast, under SAP, expenses and revenues are deliberately mismatched. Expenses associated with the acquisition of the policy are charged in full as soon as the policy is issued but premiums are earned throughout the policy period. SAP mismatches the timing of revenues and acquisition expenses so the balance sheet is viewed more conservatively. By recognizing acquisition expenses before the income generated by them is earned, SAP forces an insurance company to finance those expenses from its policyholders' surplus. This appears to reduce the surplus available to pay unexpected claims. In effect, this accounting treatment requires an insurer to have a larger safety margin to be able to fulfill its obligation to policyholders.

Preparing a Balance Sheet

When someone, whether a creditor or investor, asks you how your company is doing, you'll want to have the answer ready and documented. The way to show off the success of your company is a balance sheet. A balance sheet is a documented report of your company's assets and obligations, as well as the residual ownership claims against your equity at any given point in time. It is a cumulative record that reflects the result of all recorded accounting transactions since your enterprise was formed. You need a balance sheet to specifically know what your company's net worth is on any given date. With a properly prepared balance sheet, you can look at a balance sheet at the end of each accounting period and know if your business has more or less value, if your debts are higher or lower, and if your working capital is higher or lower. By analyzing your balance sheet, investors, creditors and others can assess your ability to meet short-term

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obligations and solvency, as well as your ability to pay all current and long-term debts as they come due. The balance sheet also shows the composition of assets and liabilities, the relative proportions of debt and equity financing and the amount of earnings that you have had to retain. Collectively, this information will be used by external parties to help assess your company's financial status, which is required by both lending institutions and investors before they will allot any money toward your business.

I. Balance Sheet Many people and organizations are interested in the financial affairs of your company, whether you want them to be or not. You of course want to know about the progress of your enterprise and what's happening to your livelihood. However, your creditors also want assurance that you will be able to pay them when they ask. Prospective investors are looking for a solid company to bet their money on, and they want financial information to help them make a sound decision. Your management group also requires detailed financial data and the labor unions (if applicable) will want to know your employees are getting a fair share of your business earnings.

II. Common Classifications On the balance sheet you list your assets and equities under classifications according to their general characteristics. It is a relatively simple matter to make a comparison of one classification with another or to make comparisons within a classification because similar assets or similar equities are listed together. Some of the most commonly used classifications are:

Current Assets

Current assets include cash and other assets that in the normal course of events are converted into cash within the operating cycle. For example, a manufacturing enterprise will use cash to acquire inventories of materials. These inventories of materials are converted into finished products and then sold to customers. Cash is collected from the customers. This circle from cash back to cash is called an operating cycle. In a merchandising business one part of the cycle is eliminated. Materials are not purchased for conversion into finished products. Instead, the finished products are purchased and are sold directly to the customers. Several operating cycles may be completed in a year, or it may take more than a year to complete one operating cycle. The time required to complete an operating cycle depends upon the nature of the business. It is conceivable that almost all of the assets that are used to conduct your business, such as buildings, machinery, and equipment, can be converted into cash within the time required to complete an operating cycle. However, your current assets are only those that will be converted into cash within the normal course of your business. The other assets are only held because they provide useful services and are excluded from the current asset classification. If you happen to hold these assets in the regular course of business, you can include them in the inventory under the classification of current assets. Current assets are usually listed in the order of their liquidity and frequently consist of cash, temporary investments, accounts receivable, inventories and prepaid expenses.

Cash

Cash is simply the money on hand and/or on deposit that is available for general business purposes. It is always listed first on a balance sheet. Cash held for some designated purpose, such as the cash held in a fund for eventual retirement of a bond issue, is excluded from current assets.

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Marketable Securities

These investments are temporary and are made from excess funds that you do not immediately need to conduct operations. Until you need these funds, they are invested to earn a return. You should make these investments in securities that can be converted into cash easily; usually short-term government obligations.

Accounts Receivable

Simply stated, accounts receivables are the amounts owed to you and are evidenced

on your balance sheet by promissory notes. Accounts receivable are the amounts billed to your customers and owed to you on the balance sheet's date. You should label all other accounts receivable appropriately and show them apart from the accounts receivable arising in the course of trade. If these other amounts are currently collectible, they may be classified as current assets.

Inventories

Your inventories are your goods that are available for sale, products that you have in a partial stage of completion, and the materials that you will use to create your products. The costs of purchasing merchandise and materials and the costs of manufacturing your various product lines are accumulated in the accounting records and are identified with either the cost of the goods sold during the fiscal period or as the cost of the inventories remaining at the end of the period.

Prepaid expenses

These expenses are payments made for services that will be received in the near future. Strictly speaking, your prepaid expenses will not be converted to current assets in order to avoid penalizing companies that choose to pay current operating costs in advance rather than to hold cash. Often your insurance premiums or rentals are paid in advance.

Investments

Investments are cash funds or securities that you hold for a designated purpose for an indefinite period of time. Investments include stocks or the bonds you may hold for another company, real estate or mortgages that you are holding for income-producing purposes.

Your investments also include money that you may be holding for a pension fund.

Plant Assets

Often classified as fixed assets, or as plant and equipment, your plant assets include land, buildings, machinery, and equipment that are to be used in business operations over a relatively long period of time. It is not expected that you will sell these assets and convert them into cash. Plant assets simply produce income indirectly through their use in operations.

Intangible Assets

Your other fixed assets that lack physical substance are referred to as intangible assets and consist of valuable rights, privileges or advantages. Although your intangibles lack physical substance, they still hold value for your company. Sometimes the rights, privileges and advantages of your business are worth more than all other assets combined. These valuable assets include items such as patents, franchises, organization expenses and goodwill expenses. For example, in order to become incorporated you must incur legal costs. You can designate these legal costs as organizing expenses.

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Other Assets

During the course of preparing your balance sheet you will notice other assets that cannot be classified as current assets, investments, plant assets, or intangible assets. These assets are listed on your balance sheet as other assets. Frequently, your other assets consist of advances made to company officers, the cash surrender value of life insurance on officers, the cost of buildings in the process of construction, and the miscellaneous funds held for special purposes.

Current Liabilities

On the equity side of the balance sheet, as on the asset side, you need to make a distinction between current and long-term items. Your current liabilities are obligations that you will discharge within the normal operating cycle of your business. In most circumstances your current liabilities will be paid within the next year by using the assets you classified as current. The amount you owe under current liabilities often arises as a result of acquiring current assets such as inventory or services that will be used in current operations. You show the amounts owed to trade creditors that arise from the purchase of materials or merchandise as accounts payable. If you are obligated under promissory notes that support bank loans or other amounts owed, your liability is shown as notes payable. Other current liabilities may include the estimated amount payable for income taxes and the various amounts owed for wages and salaries of employees, utility bills, payroll taxes, local property taxes and other services.

Long-Term Liabilities

Your debts that are not due until more than a year from the balance sheet date are generally classified as long-term liabilities. Notes, bonds and mortgages are often listed under this heading. If a portion of your long-term debt is due within the next year, it should be removed from the long-term debt classification and shown under current liabilities.

Deferred Revenues

Your customers may make advance payments for merchandise or services. The obligation to the customer will, as a general rule, be settled by delivery of the products or services and not by cash payment. Advance collections received from customers are classified as deferred revenues, pending delivery of the products or services.

Owner's Equity

Your owner's equity must be subdivided on your balance sheet: One portion represents the amount invested directly by you, plus any portion of retained earnings converted into paid-in capital. The other portion represents your net earnings that are retained. This rigid distinction is necessary because of the nature of any corporation. Ordinarily, stockholders, or owners, are not personally liable for the debts contracted by a company. A stockholder may lose his investment, but creditors usually cannot look to his personal assets for satisfaction of their claims. Under normal circumstances, the stockholders may withdraw as cash dividends an amount measured by the corporate earnings. The distinction in this rule gives the creditors some assurance that a certain portion of the assets equivalent to the owner's investment cannot be arbitrarily withdrawn. Of course, this portion could be depleted from your balance sheet because of operating losses. The owner's equity in an unincorporated business is shown more simply. The interest of each owner is given in total, usually with no distinction being made between the portion invested and the accumulated net earnings. The

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creditors are not concerned about the amount invested. If necessary, creditors can attach the personal assets of the owners.

Cost

Cost is conventionally used as the basis for accountability. Assets, when acquired under normal circumstances, are recorded at the price negotiated between two independent parties dealing at arm's length. Simply stated, the cost of an asset to the purchaser is the price that he or she must pay now or later in order to obtain it. The fair value of the asset is not relevant in recording the transaction on your balance sheet. A purchaser may acquire an asset at a cost that is greater or less than the fair value determined in the marketplace. If the asset is acquired, the purchaser accounts for the assets at his cost, value notwithstanding. A simple formula to remember in determining cost is: Assets = Liability + Equity or Equity = Assets - Liability

15.3 FORMAT OF BALANCE SHEET

(As per IRDA Regulations, Schedule VI)

ABC Life Insurance Company Ltd.

Balance Sheet as at 31st March, 20XX

Particulars	Schedule	Current Year (₹)	Previous Year (₹)
Sources of Funds			
1. Share Capital	5		
2. Reserves and Surplus	6		
3. Fair Value Change Account			
4. Borrowings	7		

Particulars	Schedule	Current Year (₹)	Previous Year (₹)
Application of Funds			
5. Investments	8		
6. Loans	9		
7. Fixed Assets	10		
8. Current Assets			
a. Cash and Bank Balances	11		
b. Advances and Other Assets	12		
9. Current Liabilities			
a. Current Liabilities	13		
b. Provisions	14		
10. Net Current Assets (8 - 9)			
11. Miscellaneous Expenditure (to the extent not written off)	15		
12. Debit Balance in P&L Account (Shareholders' A/c)			

IV. Sample Trial Balance Sheet

Trial Balance

Cash	10000
Accounts Receivable	28000
Inventory	55000
Prepaid Expenses	2000
Equipment	25000
Computers	15000

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Accumulated Depreciation Equipment		8000
Accumulated Depreciation Computers		6000
Goodwill	10000	
Accounts Payable		25000
Expenses Payable		5000
Payroll Taxes Withheld		2500
Loans Payable - Short Term		10000
Loans Payable - Long Term		30000
Capital Stock		10000
Paid In Capital		5000
Retained Earnings		22000
	145000	**123500**
Net Profit		21500
	145000	145000

Balance Sheet	
Assets	
Current Assets:	**Rs.**
Cash	xxx
Accounts Receivable	xxx
Inventory	xxx

Prepaid Expenses	xxx
Fixed Assets:	
Equipment	xxx
Equipment Depreciation	xxx
Computers	xxx
Computer Depreciation	xxx
Other Assets:	
Goodwill	xxx
Liabilities	
Current Liabilities:	
Accounts Payable	xxx
Expenses Payable	xxx
Payroll Taxes Withheld	xxx
Loans Payable (short term) **Long-**	xxx
term Liabilities:	
Loans Payable (long term)	xxx

Shareholders' Equity

Beginning Retained Earnings		xxx
Net Income	xxx	
Capital Stock	xxx	
Paid in Capital	xxx	
	Currents Assets	

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Accumulated Depreciation

Net Fixed Assets

Other Assets

Total Current Liabilities

Total Long Term Liabilities

Total Liabilities

Ending Retained Earnings

Total Shareholders' Equity

Total Liabilities and
Shareholders' Equity

15.4 SCHEDULES RELATED TO BALANCE SHEET

Schedule No.	Particulars
Schedule 5	Share Capital
Schedule 6	Reserves and Surplus
Schedule 7	Borrowings
Schedule 8	Investments
Schedule 9	Loans
Schedule 10	Fixed Assets
Schedule 11	Cash and Bank Balances
Schedule 12	Advances and Other Assets
Schedule 13	Current Liabilities
Schedule 14	Provisions
Schedule 15	Miscellaneous Expenditure (if any)

15.5 RELATED RATIOS

Now that the balance sheet is complete, here are some simple ratios you can calculate using the information provided on the balance sheet.

Current Ratio

Computation: Total current assets divided by total current liabilities.

Total Current Assets / Total Current Liabilities

The current ratio is a rough indication of a firm's ability to service its current obligations. Generally, the higher the current ratio, the greater the cushion between current obligations and a firm's ability to pay them. The stronger ratio reflects a numerical superiority of current assets over current liabilities. However, the composition and quality of current assets is a critical factor in the analysis of an individual firm's liquidity.

Quick Ratio

Computation: Cash and equivalents plus trade receivables divided by total current liabilities. Cash & Equivalents + Trade Receivables / (net) Total Current Liabilities

Also known as the "acid test" ratio, this is a refinement of the current ratio and is a more conservative measure of liquidity. The quick ratio expresses the degree to which a company's current liabilities are covered by the most liquid current assets. Generally, any value of less than 1 to 1 implies a reciprocal dependency on inventory or other current assets to liquidate short-term debt.

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Fixed/Worth Ratio

Computation: Fixed assets (net of accumulated depreciation) divided by tangible net worth.

Net Fixed Assets / Tangible Net Worth

This ratio measures the extent to which owner's equity (capital) has been invested in plant and equipment (fixed assets). A lower ratio indicates a proportionately smaller investment in fixed assets in relation to net worth and a better cushion for creditors in case of liquidation. Similarly, a higher ratio would indicate the opposite situation. The presence of substantial leased fixed assets (not shown on the balance sheet) may deceptively lower this ratio.

Debt/Worth Ratio

Computation: Total liabilities divided by tangible net worth.

Total Liabilities / Tangible Net Worth

This ratio expresses the relationship between capital contributed by creditors and that contributed by owners. It expresses the degree of protection provided by the owners for the creditors. The higher the ratio, the greater the risk being assumed by creditors. The lower the ratio, the greater the long-term financial safety. A firm with a low debt/worth ratio usually has greater flexibility to borrow in the future. A more highly leveraged company has a more limited debt capacity.

Illustration 1

The Life Assurance Fund of an insurance company on 31.03.2009 showed a balance of Rs. 87, 76,500. It was later found that the following were not taken into consideration:

1 Dividend from investment - 4, 80,000

2 Income tax on the above - 48,000

3 Bonus in reduction of premium - 8, 77,500

4 Claims covered under reinsurance - 4, 23,000

5 Claims intimated but not accepted by the company - 7, 62,000

Solution

	Rs.	Rs.
Balance of Life Assurance fund		87, 76,500
Add- Dividend	4, 80,000	
Recovered under Reinsurance	4, 23,000	
	………..	9, 03,000
		………….
		96, 79,500
Less- Claims intimated	7, 62,000	
Income-Tax	48,000	
Bonus in reduction of premium	8, 77,500	
	…………..	(16, 87,500)

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Correct balance of Life Assurance Fund

79, 92,000

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Illustration 2:

Following balances are extracted from the books of Bharat Assurance Company as on 31st March, 2012.

Life fund on 1st April, 2011 Rs. 15,70,562; Claims by death Rs. 1,16,980. Claims by maturity Rs. 96,420; Premium Rs. 2,70,572; Management expenses Rs.29,890; Commission Rs.36,541; Consideration for annuities granted Rs.10,620; Interest, dividend and rent Rs.52,461; Income tax on profit Rs.3,060; Surrenders Rs.21,768; Annuities Rs.
29,420; Bonus paid in cash Rs.9,450; Bonus paid in reduction of premium Rs.3,500; Preliminary expenses Rs.600; Claims admitted but not paid at the end of the year Rs. 80,034; Annuities due but not paid Rs.22,380; Capital paid up Rs.6,00,000; Govt. Securities Rs.16,90,890; Sundry Assets Rs.5,68,110. Additional relevant date; claims covered under reinsurance Rs.10,000. Further claims intimated Rs.8,000. Further bonus utilised in reduction of premiums Rs.1,500. Interest accrued Rs.15,400. Premiums outstanding Rs.7,400. Prepare a Revenue Account and the Balance Sheet taking all figures in thousands Rs.

Solution

Bharat Assurance Company

REVENUE ACCOUNT

for the year ending 31st March, 2012

Particulars	Schedule	Current Year	Previous Year
Premiums Earned (Net) Income from Investments:	1	2,79,472	
Interest, Dividend and Rent (52,461 +15,400) Other Income:		67,861	
Consideration for Annuities Created		10,620	
		....	
Total (a)		3,57,953	
Commission	2	35,541	
Operating Expenses Related to Insurance Business	3	29,890	
Total		**2,79,472**	

SCHEDULE 2 – COMMISSION

Commission Paid	36,541
Net Commission	36,541

SCHEDULE 3 – OPERATING EXPENSES RELATED TO INSURANCE BUSINESS

Management Expenses	29,890

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Total		29,890
SCHEDULE 4 – BENEFITS PAID (NET)		
Insurance Claims:		
(a) Claims by Death : Paid	1,16,980	
Less : Covered under Reinsurance	10,000 1,06,980	
Add : Further Claims Intimated	8000	1,14,980
(b) Claims by Maturity		96,420
(c) Annuities		29,420
(d) Surrenders		21,768
Total		**2,62,588**
SCHEDULE 5 – SHARE CAPITAL		
Paid up Share Capital		6,00,000
Less : Preliminary Expenses		600
Total		**5,99,400**

SCHEDULE 6 – RESERVES AND SURPLUS

Life Assurance Fund on 1/4/2011 15,70,562

Add : Surplus as per Revenue A/c 14,484 Less : Income

Tax on Profit 8,060

11,424 15,81,986

Total	**15,81,986**

SCHEDULE 8 - INVESTMENTS

Government Securities	16,90,890
Total	**16,90,890**

SCHEDULE 12 – ADVANCES AND OTHER ASSETS

Other Assets	
Interest Accrued on Investments	15,400
Outstanding Premiums	7,400
Amount Due from Other Insurance Companies	10,000
Sundry Assets	5,68,110
Total	**6,00,910**

SCHEDULE 13 – CURRENT LIABILITIES

Claims Outstanding (80,034 + 8,000)	88,034
Annuities Due	22,380
Total	**1,10,414**

DETERMINATION OF PROFIT IN LIFE INSURANCE BUSINESS

A life policy is generally taken for a number of years. The premium received for such long term contract cannot be treated as income for ascertaining the profits for that year. The future premium may or may not be received depends on the existence of the insured. Thus, on a particular date a liability of the corporation is to be calculated as the premium to be received in future will generally be less than the amount payable as claims. There is a gap between claims which are expected to arise and premium which are expected to be received. The gap is known as Net liability. It becomes desirable to create a reserve equal to its net liability in order to

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ascertain the profit. The Life insurance business made the valuation of net liability every year in order to ascertain the profit. This is done by a person called Actuary. The process by which net liability is ascertained by this person is known as actuarial valuation. The net liability is compared with life assurance fund on a particular date in order to ascertain the surplus or deficiency. This comparison is made by preparing a Valuation Balance sheet, which is given as follows: -

Valuation Balance Sheet

Liabilities	Amount	Assets	
Amount Net Liability as per Actuary's valuation			Life Assurance Fund
		Deficit (Bal. Fig)	
Surplus (Bal. Fig)	**...........**		
....			

Only surplus and not deficiency will be shown in the Balance sheet. With profit policy holders have a right to participate in the profits of life insurance business to the extent of 95% of true profit. The balance 5% may be utilized for such purpose as determined by the central government. For calculation of true profit, surplus as disclosed by the valuation Balance sheet must be adjusted.

Surplus as per Valuation Balance Sheet	
……… Less: Actuarial expenses	
…….	
Dividends payable to shareholders	……..
……..	

Add: Interim bonus paid ……..
Surplus ………

95% of net profit is payable as bonus to policyholders. While paying the above bonus, interim bonus paid already has to be deducted.

1. CHECK YOUR PROGRESS

TRUE OR FALSE

1. The Balance Sheet of a life insurance company must follow the format given by the Companies Act, 2013.
False (It follows IRDA regulations.)

2. Policyholders' funds appear on the asset side of the balance sheet.
False (They appear on the liability side.)

3. Loans are shown in Schedule 9 of the Balance Sheet.
True

4. Shareholders' Funds include share capital and reserves.
True

5. Fair Value Change Account is shown on the assets side of the balance sheet.
False

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15.6 LET US SUM UP

- The Balance Sheet of a Life Insurance Company is prepared as per the IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002.
- It includes Shareholders' Funds, Policyholders' Funds, Assets, Liabilities, and various schedules ranging from Schedule 1 to Schedule 15.
- All figures must be presented separately for linked and non-linked business where applicable important schedules.

15.7 KEYWORDS

- **IRDA** – Insurance Regulatory and Development Authority of India, which regulates insurance companies.
- **Balance Sheet** – A financial statement that shows the financial position of a life insurance company at a particular point in time.
- **Schedule** – A detailed annexure or format attached to the balance sheet, providing break-up of specific items such as capital, investments, liabilities, etc.
- **Shareholders' Funds** – The funds contributed by shareholders, including share capital and reserves.
- **Policyholders' Funds** – Funds representing policy liabilities and obligations towards life insurance policyholders.

2. CHECK YOUR PROGRESS

FILL IN THE BLANKS

1. The balance sheet of a life insurance company is prepared as per the __________ regulations.

Ans: IRDA

2. Investments in government securities are shown under __________ schedule.

Ans: Schedule 8

3.__________ funds are those accumulated from policyholders' premiums.

Ans: Policyholders'

4. Share Capital is disclosed in __________ of the balance sheet.

Ans: Schedule 1

5. __________ account shows unrealised gains or losses on investments.

Ans: Fair Value Change

15.8 SELF ASSESSMENT QUESTIONS

1. From the following data, prepare the **Balance Sheet of Life Insurance Company** as per IRDA format:

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Particulars	₹ (in '000)
Share Capital	10,000
Reserves and Surplus	4,000
Policy Liabilities	35,000
Linked Liabilities	20,000
Investments (Non-linked)	38,000
Investments (Linked)	18,000
Loans	1,000
Fixed Assets	2,000
Cash and Bank Balances	3,000
Advances and Other Assets	3,500
Current Liabilities and Provisions	5,000

(Format it as per IRDA Life Insurance Company Balance Sheet with relevant schedules.)

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2. Identify the schedules in which the following items would be reported in a Life Insurance Company's Balance Sheet:

- Reinsurance Payable
- Investments in Government Securities
- Furniture and Fixtures
- Outstanding Premium
- Advance Income Tax

…………………………………………………………………………………
…………………………………………………………………………………
…………………………………………………………………………………
………………

3. "Insurance contracts are based on utmost good faith" Comment.

…………………………………………………………………………………
…………………………………………………………………………………
…………………………………………………………………………………
………………

15.9 LESSON END EXERCISE

1. Prepare balance sheet and revenue account of life insurance companies as per prescribed form.

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2. A Life Assurance Corporation get its valuation made once in every two years. The life assurance fund on 31st March, 2012 amounted to Rs.41,92,000 before providing for Rs.32,000 for the shareholders' dividend for the year 2011-12. Its actuarial valuation on 31st march, 2012, disclosed net liability of Rs.40,40,000 under the assurance and annuity contracts. An interim bonus of Rs.40,000 was paid to the policy holders during the period ending 31st March, 2012. Prepare a statement showing the amount now available as bonus to policy holders.

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3. CHECK YOUR PROGRESS

MATCH THE FOLLOWING

A	B
1. Schedule 1	d. Share Capital
2. Schedule 6	a. Reserves and Surplus
3. Schedule 8	c. Investments
4. Schedule 13	e. Current Liabilities
5. Schedule 4	b. Borrowings

Answers:

1 – d
2 – a
3 – c
4 – e
5 – b

15.10 SUGGESTED READING

- John Clay and Stephen Holton, "Guide to Preparing Financial Statements" (Practitioners Publishing, 1997)
- Peter Atrill and Eddie McLaney, "Accounting and Finance for Non-Specialists" (Prentice Hall, 1997)
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- Gerald I. White, “The Analysis and Use of Financial Statements” (John Wiley & Sons, 1997)
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- SS Gulshan, Mercantile Law, excel Books
- Rustam S. Davar, Khorshed D.P. (Davar) Madon, General Principles of Indian Law, Progressive Corp.

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UNIT- 4 LESSON NO: 16

COURSE CODE : BCG 301

ACCOUNTS OF HOLDING COMPANIES,

STRUCTURE:

16.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

After going through this lesson, you should be able to know:

- Concept and meaning of holding and subsidiary companies.
- Presentation of accounts by holding company
- Concept of consolidated Balance sheet

Learning outcomes

- Understand the concept of holding and subsidiary company
- Knowledge about presentation of accounts by holding company
- Understand the concept of consolidated Balance sheet

16.1 INTRODUCTION

A holding company is a company that owns other companies' outstanding stock. The term usually refers to a company that does not produce goods or services itself; rather, its purpose is to own shares of other companies to form a corporate group. Holding companies allow the reduction of risk for the owners and can allow the ownership and control of a number of different companies.

In the United States, 80% or more of stock, in voting and value, must be owned before tax consolidation benefits such as tax-free dividends can be claimed. That is, if Company A owns 80% or more of the stock of Company B, Company A will not pay taxes on dividends paid by Company B to its stockholders, as the payment of dividends from B to A is essentially Company A transferring cash from one company to the other. Any other shareholders of Company B will pay the usual taxes on dividends, as they are legitimate and ordinary dividends to these shareholders.

Sometimes a company intended to be a pure holding company identifies itself as such by adding "Holding" or "Holdings" to its name. Holding companies are formed to organize and manage a group of smaller companies. If you are a business owner of investor, you may consider forming a holding company to protect your business assets or get a more favorable tax rate. A holding company ias an entity formed to buy and hold the majority of stock of other companies; a subsidiary is a business whose majority of stock is owned by a holding company. A holding company buys, absorbs or otherwise obtains a majority percentage of stock in another company, which becomes known as its subsidiary. Typically, a holding company must control 50 percent or more of a company's stock before it's considered a subsidiary. Holding companies may also own other holding companies — in this case,

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they're known as top holding companies. The holding company has all rights and responsibilities of ownership for its subsidiaries. The subsidiaries, while not independently owned, often continue to operate as individual entities, though major corporate decisions are made by the holding company. A holding company directs the management and operations of the subsidiaries it owns and maintains the authority to add or remove board members, directors and other key management and personnel. A holding company may have strict managerial control or may allow subsidiaries to act with some level of autonomy for day-to-day business operations, including lower- and midlevel hiring and certain budgeting decisions. A subsidiary has little to no financial control over its operations. Even independently acting subsidiaries are ultimately financially controlled by their holding company. This includes financial activities such as investment decisions, sales projections and budgeting. If a subsidiary was itself a holding company prior to becoming a subsidiary of another holding company, all of its subsidiaries also become subsidiaries of the top holding company.

A company has to either control the Board of directors or hold more than half of the equity capital of the other company. A holding company is any regular corporation, LLC, or LP that owns investments in other companies but doesn't engage in any operations itself. That is, Berkshire Hathaway is a holding company because it doesn't do anything. Instead, it owns 100% of the stock of GEICO, which is an insurance company. It owns 80% or 90% of the stock of Nebraska Furniture Mart, which is a huge furniture retailer.

It owns more than 8% of the stock of Coca-Cola through its insurance holdings. But Berkshire itself just has a handful of employees and a bank vault full of stock certificates. Any money it has comes from dividends paid by the subsidiaries on June 30th and December 31st of each year. It can be used to silo investment assets and protect them, such as Dunkin' Donuts putting its intellectual property into its own LLC. It can be used to transfer wealth to friends and family. If you own a collection of businesses, rental properties, or other valuables, it is far more convenient to transfer shares in a parent company than it is in each individual asset. It can permit you to structure deals so you control far more money than you otherwise could afford. If you had $10 million and used it to buy control of a $20 million insurance group that had $70 million in float, you would be controlling $70 million from your holding company. In essence, a holding company is in the business of providing capital and people. Berkshire Hathaway refuses to provide management to the subsidiaries it purchases; they don't run businesses. General Electric, on the other hand, is one of the greatest machines of all time and can have someone else running a company within 12 hours.

16.2 ACCOUNTS OF HOLDING COMPANY (TWO CONCERN ONLY)

When a company, called the **holding company**, controls another company, called the **subsidiary company**, the financial statements of both need to be **combined** for external reporting. This process is called **consolidation**, and it ensures a true and fair view of the financial position and performance of the corporate group.

Example:

If Company A owns 100% shares of Company B, A is the holding company and B is its subsidiary. Their balance sheets must be consolidated to avoid duplication and misrepresentation.

16.3 CONCEPT OF HOLDING AND SUBSIDAY COMPANY

The term holding company refers to that concept where it owns outstanding stock of other companies (Subsidiary Company). The parent company (Holding Company) does not produce any kind of goods or services or conduct any other business operation. Rather, holding company holds the controlling stock in other company. The prime objective of holding company is to own shares of other companies in order to influence the control the management of the other company

16.3.1 Holding Company

A **Holding Company** is a company that controls another company by either:

- Holding **more than 50% of the equity share capital** of that company, or
- **Controlling the composition of the board of directors** of the other company.

According to Section 2(46) of the Companies Act, 2013:

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

Features of subsidiary company

1. **Control Over Subsidiary**: A holding company controls **more than 50%** of the share capital or **the board of directors** of the subsidiary.
2. **Separate Legal Entity**: It is a legally registered company, distinct from its subsidiaries.
3. **Financial Supervision**: The holding company oversees the **financial policies** and important business decisions of its subsidiaries.

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4. **Consolidation Responsibility**: It must **prepare consolidated financial statements** that combine its own and its subsidiaries' accounts.
5. **Capital Investment**: The main asset of a holding company is its **investment in subsidiary companies**.

16.3.2 Subsidiary Company

A **Subsidiary Company** is a company that is controlled by another company (the holding company), either:

- Through ownership of **more than 50% of its total share capital**, or
- By having control over the composition of its **Board of Directors**.

According to Section 2(87) of the Companies Act, 2013:

"Subsidiary company" means a company in which the holding company —

1. Controls the composition of the Board of Directors; or
2. Exercises or controls more than one-half of the total share capital.

There are **two types** of subsidiary company

1. Wholly-Owned Subsidiary

- A **wholly-owned subsidiary** is one in which **100% of the shares** are held by the holding (parent) company.
- It gives **complete control** over operations, decisions, and profits.

***Example**:*
TCS Japan Ltd. is a wholly-owned subsidiary of Tata Consultancy Services Ltd. (TCS India).

Partially-Owned Subsidiary

- A subsidiary where the holding company holds **more than 50% but less than 100%** of the shares.
- The remaining shares are owned by **outside investors** or **minority shareholders**

***Example**:*
If Reliance Ltd. owns 75% of XYZ Ltd., it is a partially-owned subsidiary of Reliance.

Features of subsidiary company

1. **Majority Ownership by Holding:** More than 50% of its shares are held by another company (holding company).
2. **Separate Legal Existence:** It has its own legal identity, separate from the holding company.
3. **Limited Autonomy:** Although it runs day-to-day operations independently, strategic decisions are influenced or controlled by the holding company.
4. **Financial Reporting:** Prepares its own financial statements, but also provides data for the holding company's consolidation.
5. **Minority Shareholders:** In partially owned subsidiaries, there may be minority shareholders (others than the holding company).

16.3.3 Advantages of holding companies

1. Control with Limited Investment

A holding company can control subsidiary companies by owning **just over 50% of shares**, without having to invest the full capital required to run the subsidiary. This ensures **effective control with minimum investment**.

2. **Separate Legal Entities**

Each subsidiary is a **separate legal entity**, which helps in:

- Limiting liability to the concerned entity
- Managing business risks
- Protecting the assets of the holding company

3. **Diversification of Business Risk**

Holding companies often own multiple subsidiaries operating in **different industries or geographies**. This diversifies the business risk — if one subsidiary suffers losses, it doesn't necessarily affect the others.

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4. **Tax Advantages**

Subsidiaries may be located in different tax jurisdictions. With **careful tax planning**, the group may benefit from:

- Lower overall tax liabilities
- Losses in one subsidiary can sometimes be offset against profits in another

5. **Efficient Management and Specialization**

Subsidiaries can be given autonomy to operate independently, encouraging **specialized management** for different business verticals, while strategic decisions remain centralized at the holding level.

6. **Facilitates Growth and Expansion**

Holding companies can easily **expand** by acquiring or creating new subsidiaries without affecting the operations of existing ones.

7. **Easy Transfer and Restructuring**

Ownership of subsidiaries can be easily transferred or reorganized without affecting the holding company. It allows **flexible business restructuring** like mergers, spin-offs, and joint ventures.

8. **Better Capital Raising**

A holding company can raise funds at the group level and distribute them strategically among subsidiaries. Also, individual subsidiaries can raise capital based on their own performance.

9. Internal Financing

The holding company can **allocate funds internally** among subsidiaries, reducing dependency on external borrowings and improving capital efficiency.

10. **Continuity of Business**

Even if one subsidiary wind up or faces legal trouble, the other entities in the group can **continue to operate unaffected**, ensuring business continuity.

16.4.3 Disadvantages of holding company

1. **Limited Autonomy**

Even though a subsidiary is a separate legal entity, its **strategic decisions are often controlled by the holding company**. This reduces its independence in key areas such as:

- Expansion plans
- Pricing policies
- Product strategy

2. **Conflicts of Interest**

Sometimes, the interests of the subsidiary may **conflict with the goals of the holding company**. For example, the subsidiary may want to retain profits for growth, while the holding company may want dividends.

3. **Complex Compliance and Reporting**

Subsidiaries must prepare their **own financial statements** and submit information to the holding company for **consolidated reporting**, which increases:

- **Administrative burden**
- **Audit complexities**
- **Regulatory filings**

4. **Double Taxation and Legal Overheads**

In some cases, profits distributed as dividends from subsidiary to holding company can be **taxed again**, depending on jurisdiction. Also, maintaining separate entities increases:

- Legal compliance costs
- Filing of multiple tax returns and reports

5. **Vulnerability to Group-Wide Risks**

Although subsidiaries are legally separate, **reputation or financial problems** in one part of the group can affect the image or credit rating of the entire group.

6. Restricted Decision-Making

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Major decisions like mergers, acquisitions, or large capital expenditures in a subsidiary often require **approval from the holding company**, which can delay action.

7. Transfer Pricing & Regulatory Scrutiny

Inter-company transactions (sales, services, or loans between holding and subsidiary) may attract **government scrutiny** for:

- **Tax evasion**
- **Transfer pricing violations**

8. Dependence on Holding Company

Many subsidiaries depend on the holding company for:

- Funding
- Key management personnel
- Technology and branding

If the holding company faces financial trouble, the **subsidiary may also suffer** operationally.

16.4 COMPARISON BETWEEN HOLDING AND SUBSIDIARY COMPANY

Difference between holding and subsidiary company

Basis	Holding company	Subsidiary company
1. Control	Controls the subsidiary	Is controlled by the holding company
2. Ownership	Owns >50% of shares in subsidiary	>50% of shares held by holding company
3. Management	Strategic decision-making body	Operates under the holding's supervision
4. Autonomy	High autonomy	Limited autonomy in strategic matters
5. Management	Strategic decision-making body	Operates under the holding's supervision

16.5 PRESENTATION OF ACCOUNTS BY HOLDING COMPANIES

PRESENTATION OF ACCOUNTS BY HOLDING COMPANIES

As laid down in section (212) of the companies Act, 1956. A holding company requires to attach its balance sheet. The following documents and present the same to its shareholders.

a) A copy of the Balance Sheet of the subsidiary.

b) A copy of the Profit and Loss Account of the subsidiary.

c) A copy of the Report of the Board of Directors of the subsidiary.

d) A copy of the Auditors Report of subsidiary.

e) A statement indicating the extent of holding company's interest in the subsidiary at the end of the accounting year of the subsidiary.

16.6 CONSOLIDATED BALANCE SHEET

A company may purchase either the whole or the majority of 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 company so controlled is known as subsidiary company. Holding company has the power to nominate the majority of the directors of subsidiary company. Consolidated balance sheet is a single balance sheet of holding and subsidiary companies. In India, it is not compulsory on the part of the holding company to prepare the consolidated balance sheet. But in England, it is a must on the part of the holding company to prepare the consolidated balance sheet in addition to its normal balance sheet. A consolidated balance sheet presents the assets and liabilities of a parent company and all its subsidiaries on a single document, with no distinctions on which items belong to which companies. If your company has $1 million in assets and it purchases subsidiaries with assets of $400,000 and $300,000, respectively, then your consolidated balance sheet will show $1.7 million in assets, and the sheet will commingle those assets. For example, in the asset section, accounts receivable will list the total amount of receivables held by all three companies. 1.6 AS. 21 – Consolidation of Financial statement AS. 21 come into effect in respect of accounting periods commencing on or after 1st April i.e. for year ending 31st March 2002. The A.S. 21 is applicable to all the enterprises that prepare consolidated financial statement. It is mandatory for Listed companies and Banking companies. 4 As per AS 21, The Consolidated financial statements would include:

i) Profit & Loss A/c

ii) Balance sheet

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iii) Cash flow statement

iv) Notes of Accounts except typical notes.

v) Segment reporting AS 21 also desire various import terms, as well as treatment and same while preparing consolidated financial statement. Consolidated financial statements should be prepared for both domestic as well as foreign subsidiaries.

When to Consolidate

A company must issue consolidated financial statements whenever it owns a controlling stake in another business — that is, whenever it owns more than 50 percent of that business. If the parent company owns 100 percent of the subsidiary, this is pretty straightforward. Complications arise, however, if the parent company owns a controlling stake with less than 100 percent ownership. Part of the subsidiary belongs to someone else, and that must be reflected on the balance sheet. The parent company handles this by consolidating the balance sheet as usual, then creating a separate account in the owners' equity section of the sheet. This account, called "minority interest" or "non-controlling interest," is equal to the value of the portion of the subsidiary that the parent company doesn't own. In essence, the parent company claims all of the subsidiary's assets and liabilities on the balance sheet and then "gives some of the value back" in the equity section.

Alternatives to Consolidation

When one company owns a less-than-controlling stake in another — that is, less than 50 percent — then it does not consolidate the balance sheet. Say your business owns 45 percent of another company. Your balance sheet would list only your company's assets, liabilities and equity. Your investment in the other company would exist as a single asset on your balance sheet, equal to the value of your 45 percent stake.

Other Statements

Parent companies don't just consolidate the balance sheet; they consolidate all of their financial statements. So, the parent company's consolidated income statement combines the revenue, expenses, gains, losses and taxes of the parent and all its subsidiaries. Likewise, the consolidated cash flow statement combines all the companies' operational, investment and financing cash flows. The combined owners' equity statement looks like the equity section of the balance sheet: It will show the combined equity in all the companies and "give back"

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) Intercompany owing.

5) Revaluation of fixed assets as on date of acquisition, depreciation, adjustment on revaluation amount etc. which are discussed here in after.

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 acquire majority OR shares in existing company. Such company also considered as subsidiary company in which holding company acquired majority shares.

1. CHECK YOUR PROGREE
Fill in the blanks

1. A company that controls one or more companies by holding majority of shares is called a **__________ company**.

   Answer: *Holding*

2. A company whose more than 50% shares are held by another company is called a **__________ company**

   Answer: *Subsidiary*

3. In a consolidated balance sheet, the share capital of the **__________ company only only** is shown.

   Answer: *Holding*

4. The portion of a subsidiary's net assets that belongs to outsiders is termed as **__________ interest**.

   Answer: *Minority*

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5. Consolidated financial statements are prepared to present the financial position of the group as an__________**economic entity**.

   Answer: *Single*

16.7 LET US SUM UP

- A Consolidated Balance Sheet shows the combined financial position of a holding company and its subsidiary (or subsidiaries) as one economic entity.
- It includes all assets, liabilities, and reserves of both companies after eliminating intra-group transactions.
- Only the share capital of the holding company is included in the consolidated balance sheet.
- Minority Interest is the portion of net assets of the subsidiary that is not owned by the holding company and is shown separately.
- Goodwill or Capital Reserve is calculated based on the difference between the investment in the subsidiary and the holding company's share of the net assets of the subsidiary.
- Intra-group transactions (like inter-company debts, unrealized profits, etc.) are eliminated to avoid duplication or inflation of assets/liabilities.
- The consolidated financial statements are mandatory under Companies Act, 2013, Section 129(3).

16.8 KEYWORDS

- **Holding company:** A company that controls another company by holding majority of its shares.
- **Subsidiary company:** A company whose more than 50% of shares are held by another (holding) company.
- **Consolidated balance sheet:** A financial statement combining the assets, liabilities, and equity of holding and subsidiary.

16.9 SELF-ASSESSMENT QUESTIONS

Question: Difference between holding and subsidiary company.

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Question: Explain the need and importance of preparing a consolidated balance sheet.

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Question: What are the key principles to be followed while preparing consolidated financial statements

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16.10 LESSON END EXERCISE

Question: What is a consolidated balance sheet

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Question: What are the types of subsidiary company

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Question: What are the advantages and disadvantages of holding company

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16.11 SUGGESTED READING

M.C. Shulka, T.S. Grewal and S.C.Gupta, Advance Accounts, S. Chand & Company Ltd,Vol.II.

• S.P. Jain and K.L. Narang, Advanced Accountancy, Kalayani Publishing House.

• M.A. Arulanandam and K.S. Raman, Advanced Accountancy, Himalaya Publishing House, (Part-II)

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UNIT: 4 LESSON:17

COURSE NO: BCG 301

○ LEGAL REQUIREMENTS FOR HOLDING COMPANIES

17.0 LEARNING OBJECTIVES AND OUTCOMES

Learning objectives

- State the legal provisions and mandatory disclosures required for holding companies under applicable accounting standards and laws.

- Prepare a consolidated balance sheet of a holding company with one subsidiary using the vertical format.

Learning outcomes

- State the legal provisions and mandatory disclosures required for holding companies under applicable accounting standards and laws.
- Prepare a consolidated balance sheet of a holding company with one subsidiary using the vertical format.

17.1 INTRODUCTION

- A holding company is a company that owns other companies' outstanding stock. The term usually refers to a company that does not produce goods or services itself; rather, its purpose is to own shares of other companies to form a corporate group. Holding companies allow the reduction of risk for the owners and can allow the ownership and control of a number of different companies.
- In the United States, 80% or more of stock, in voting and value, must be owned before tax consolidation benefits such as tax-free dividends can be claimed. That is, if Company A owns 80% or more of the stock of Company B, Company A will not pay taxes on dividends paid by Company B to its stockholders, as the payment of dividends from B to A is essentially Company A transferring cash from one company to the other. Any other shareholders of Company B will pay the usual taxes on dividends, as they are legitimate and ordinary dividends to these shareholders.
- Sometimes a company intended to be a pure holding company identifies itself as such by adding "Holding" or "Holdings" to its name. Holding companies are formed to organize and manage a group of smaller companies. If you are a business owner of investor, you may consider forming a holding company to protect your business assets or get a more favorable tax rate. A holding company ias an entity formed to buy and hold the majority of stock of other companies; a subsidiary is a business whose majority of stock is owned by a holding company. A holding company buys, absorbs or otherwise obtains a majority percentage of stock in another company, which becomes known as its subsidiary. Typically, a holding company must control 50 percent or more of a company's stock before it's considered a subsidiary. Holding companies may also own other holding companies in this case, they're known as top holding companies. The holding

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  company has all rights and responsibilities of ownership for its subsidiaries. The subsidiaries, while not independently owned, often continue to operate as individual entities, though major corporate decisions are made by the holding company. A holding company directs the management and operations of the subsidiaries it owns and maintains the authority to add or remove board members, directors and other key management and personnel. A holding company may have strict managerial control or may allow subsidiaries to act with some level of autonomy for day-to-day business operations, including lower- and midlevel hiring and certain budgeting decisions. A subsidiary has little to no financial control over its operations. Even independently acting subsidiaries are ultimately financially controlled by their holding company. This includes financial activities such as investment decisions, sales projections and budgeting. If a subsidiary was itself a holding company prior to becoming a subsidiary of another holding company, all of its subsidiaries also become subsidiaries of the top holding company.
- A company has to either control the Board of directors or hold more than half of the equity capital of the other company. A holding company is any regular corporation, LLC, or LP that owns investments in other companies but doesn't engage in any operations itself. That is, Berkshire Hathaway is a holding company because it doesn't do anything. Instead, it owns 100% of the stock of GEICO, which is an insurance company. It owns 80% or 90% of the stock of Nebraska Furniture Mart, which is a huge furniture retailer.
- It owns more than 8% of the stock of Coca-Cola through its insurance holdings. But Berkshire itself just has a handful of employees and a bank vault full of stock certificates. Any money it has comes from dividends paid by the subsidiaries on June 30th and December 31st of each year. It can be used to silo investment assets and protect them, such as Dunkin' Donuts putting its intellectual property into its own LLC. It can be used to transfer wealth to friends and family. If you own a collection of businesses, rental properties, or other valuables, it is far more convenient to transfer shares in a parent company than it is in each individual asset. It can permit you to structure deals so you control far more money than you otherwise could afford. If you had $10 million and used it to buy control of a $20 million insurance group that had $70 million in float, you would be controlling $70 million from your holding company. In essence, a holding company is in the business of providing capital and people. Berkshire Hathaway refuses to provide management to the subsidiaries it purchases; they don't run businesses. General Electric, on the other hand, is one of the greatest machines of all time and can have someone else running a company within 12 hours.

17.2 LEGAL REQUIREMENTS OF HOLDING COMPANIES

LEGAL REQUIREMENTS OF HOLDING COMPANIES

A holding company may invest in subsidiaries in a variety of industries to diversify its investment, lower its risk potential and, in some instances, take advantage of shared loss and tax consolidation. Although a holding company may enjoy the profits of its subsidiaries, it also has a fiduciary responsibility to the subsidiaries it controls. A subsidiary that regains a majority of its shares also regains its autonomy from its holding company.

17.2.1 How to Prepare the Reports

A. Applicability of GAAP, Consolidation Rules and SEC Consistency Holding companies are required to prepare and file the Consolidated Financial Statements for Holding Companies in accordance with generally accepted accounting principles (GAAP) and these instructions. All reports shall be prepared in a consistent manner. The holding company's financial records shall be maintained in such a manner and scope so as to ensure that the Consolidated Financial Statements for Holding Companies can be prepared and filed in accordance with these instructions and reflect a fair presentation of the holding company's financial condition and results of operations. Holding companies should retain workpapers and other records used in the preparation of these reports. Scope of the ''consolidated holding company'' to be reported in the submitted reports For purposes of this report, the holding company should consolidate its subsidiaries on the same basis as it does for its annual reports to the SEC or, for those holding companies that do not file reports with the SEC, on the same basis as described in generally accepted accounting principles (GAAP). Generally, under the rules for consolidation established by the SEC and by GAAP, holding companies should consolidate any company in which it owns more than 50 percent of the outstanding voting stock. Each holding company shall account for any investments in unconsolidated subsidiaries, associated companies, and those corporate joint ventures over which the holding company exercises significant influence according to the equity method of accounting, as prescribed by GAAP. The equity method of accounting is described in Schedule HC, item 8. (Refer to the Glossary entry for ''subsidiaries'' for the definitions of the terms subsidiary, associated company, and corporate joint venture.) Rules of Consolidation For purposes of these reports, all offices (i.e., branches, subsidiaries, VIEs, and IBFs) that are within the scope of the consolidated holding company as defined above are to be reported on a consolidated basis. Unless the instructions specifically state otherwise, this consolidation shall be on a line-by-line basis, according to the caption shown. As part of the consolidation process, the results of all transactions and all intercompany balances (e.g., outstanding asset/debt relationships) between offices, subsidiaries, and other entities included in the scope of the consolidated holding company are to be eliminated in the consolidation and must be

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excluded from the Consolidated Financial Statements for Holding Companies. (For example, eliminate in the consolidation

(1) loans made by the holding company to a consolidated subsidiary and the corresponding liability of the subsidiary to the holding company,

(2) a consolidated subsidiary's deposits in another holding company consolidated subsidiary and the corresponding cash or interest-bearing asset balance of the subsidiary, and

(3) the intercompany interest income and expense related to such loans and deposits of the holding company and its consolidated subsidiary.) Exception: For purposes of reporting the total assets of captive insurance and reinsurance subsidiaries in Schedule HC-M, Memoranda, items 7(a) and 7(b), only, holding companies should measure the subsidiaries' total assets before eliminating intercompany transactions between the consolidated subsidiary and other offices or General Instructions FR Y9C GEN-3 General Instructions March 2013

Under section 4

(1) For the purpose of this Act, **a company shall**, subject to the provisions of sub-section (3), be **deemed** to be a subsidiary of another if, but only if:

(a) that other controls the composition of its Board of Directors: or

(b) where the first-mentioned company is any other company, holds more than half in nominal value of its equity share capital; or

(c) the first-mentioned company is a subsidiary of any company which is that other's subsidiary.

(2). For the purposes of this Act, a company **shall be deemed** to be the holding company of another if, but only if, that other is its subsidiary.

(3). In this section, the expression 'company' includes anybody corporate and the expression 'equity share capital' has the same meaning as in sub section (2) of section 85.

(4). In the case of a body corporate which is incorporated in a country outside India, a subsidiary or holding company of the body corporate under the law of such country **shall be deemed** to be a subsidiary or holding company of the body corporate within the meaning and for the purposes of this Act also, whether the requirements of this section are fulfilled or not.

(5) A private company, being a subsidiary of a body corporate incorporated outside India, which, if incorporated in India, would be a public company within the meaning of this Act, **shall be deemed** for the purposes of this Act to be a subsidiary of a public company if the entire share capital in that private

company is not held by that body corporate whether alone or together with one or more other bodies corporate incorporated outside India". [Emphasis supplied]"

Company is a juristic person with different identity from that of its members. Each and every company is a distinct and separate legal entity. The relationship of holding and subsidiary, is therefore, essentially a legal fiction. Legal fiction denotes a fact which is, but for the legal fiction, not existing. In other words, the purpose of legal fiction is to assume a thing as existing whereas in reality no such thing exists. Thus, both holding and subsidiary companies are separate legal entities and they are related to each other by virtue of a legal fiction creating a subsidiary –holding company relationship. The law has to assume such relationship so as to bring both the holding and subsidiary companies under one roof to regulate them.

Section 4 of the Act which defines the terms "holding company" and "subsidiary company" is a legal fiction created by the Act. Further this legal fiction contains sub fictions within it. The interpretation of a legal fiction has been beautifully explained by the Supreme Court. Justice S.R. Das J observed that "when legal fiction is created, for what purpose, one is led to ask at once, is it so created".[2] Once the purpose is ascertained full effect must be given to the statutory fiction and it should be carried to its logical conclusion[3]. The overall impact is that the fiction created by this section is applicable to the entire Act.

In other words, wherever the term subsidiary is used in the Act the effect of section 4 has to be given.

17.2.2 Mode of creation of a subsidiary company.

A subsidiary company is a business entity that is controlled by another organization through ownership of a majority of its voting stock. This separate legal structure may be used to gain certain tax benefits, track the results of a separate business unit, segregate risk from the rest of the organization, or prepare certain assets for sale. A larger business may own dozens or even hundreds of subsidiary companies.

Section 4 of the Act prescribes three conditions under which a company becomes a subsidiary of another company. A company shall be deemed to be a subsidiary of another if, but only if, (1) the other controls the composition of its Board of Directors, (2) the other company holds more than half of its equity capital and (3) the controlling company, as above said, is a subsidiary of another company.

In other words, to be a holding company, a company has to either control the Board of directors or hold more than half of the equity capital of the other company. The above two methods of control need not be exercised by the holding company by itself and the control can be exercised through a subsidiary company also. It is pertinent to point out here that the Indian Law does not require the holding company

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to be a member of the subsidiary company. All that the Indian law requires is the actual control of the subsidiary company by a holding company in any one or both methods i.e., Board control or Share control.

As far as foreign companies are concerned, the law states that, in the case of a body corporate which is incorporated in a country outside India, a subsidiary or holding company of the body corporate under the law of such country shall be deemed to be a subsidiary or holding company of the body corporate within the meaning and for the purposes of this Act also, whether the requirements of this section are fulfilled or not.

Thus, if a foreign company is a holding company of another company as per the laws of the country of that company, for the purposes of the Act, it will be treated in the same manner in India also even though the holding company may not be satisfying the two methods of controlling the subsidiary company. It is to be noted here that the holding and subsidiary relationship is inter se the two foreign companies only. In other words, if A is the holding company of B in a foreign country, in India also A will be treated as the holding company of B.

17.2.3 Meaning of the term "body corporate" used in Section 4.

The term body corporate includes companies incorporated outside India. Sub-section (5) of section 4 includes, for the purpose of the section, any body corporate in the definition of company. The moot question is whether the term "any body corporate" include other non-corporate entities also, say partnership firms, association of persons etc., The answer to this question can be found if we ask another pertinent question i.e., what for section 4 is enacted?

Section 4 of the Act seeks to create a holding-subsidiary relationship between two companies. A company cannot be a holding or subsidiary company of another noncorporate entity. Thus, essentially there has to be incorporated companies to create the holding-subsidiary relationship between them. Therefore, it can be concluded that, the term anybody corporate essentially refers to a company incorporated outside India. Any meaning other than this will not be in conformity with the provisions of section 4.

17.2.4 Subsidiary of foreign company.

A company incorporated in India can become a subsidiary of a company incorporated outside India in any one of the three ways provided for in sub-section (1) of section 4. In other words, Indian company shall be a subsidiary of a foreign company if

a. Indian company's Board of Directors are controlled by the foreign company; or

b. More than half of the equity share capital of the Indian company is held by the foreign company.

c. The foreign company is a subsidiary of another foreign company.

For example (1) A (Fco) appoints majority or all of the Board of directors of B (Ico). (2) A hold more than 50% of the equity share capital of B. (3) A is the subsidiary of another Fco C. Then B is a subsidiary of C also.

17.2.5 Effect of sub-section (7) of section 4.

Under Indian law a private company subsidiary of a public company is treated as a public company and made subject to all stringent legal compliance applicable to a public company. However, by virtue of sub- section (7) of section 4 of the Act, in the case of a private company which is a subsidiary of a foreign public company a different treatment is given whereby under certain conditions such subsidiary is treated as a private company.

Indian private company, which is a subsidiary of a foreign company, shall be treated as a private company under two circumstances. When the foreign holding company if incorporated in India would not have been a public company under the Act i.e such a foreign company could have been incorporated only as a private company. This situation involves two private companies as both holding and subsidiary companies are private companies.

The other circumstance is when the foreign holding company, if incorporated in India would have been a public company under the Act and the entire equity share capital of the subsidiary is held by such foreign company either **alone or together with** one or more bodies corporate incorporated outside India. Otherwise such Indian subsidiary shall be treated as a private company subsidiary of a public company. Under this situation the holding company is a public company and the subsidiary is a private company.

Let us critically analyze the provisions of sub-section (7) by breaking it into various limbs.

i. A private company ii. Being a subsidiary of a body corporate incorporated outside
India iii. Which iv. If incorporated in India
v. Would be a public company within the meaning of this Act, vi. **Shall be deemed** for the purposes of this Act to be a subsidiary of a public company vii. If the **entire share capital** in that private company is not held

viii. By that body corporate

ix. Whether **alone or together with** one or more other bodies corporate incorporated outside India.

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The first two limbs are connected with fourth and fifth limbs by the third limb. These five limbs explain the factual relationship between the Indian private company which is the subsidiary of a foreign public company. It considers the Indian private company as a subsidiary of the foreign company in the first place and further stipulates that such foreign company if incorporated in India would have been a public company i.e., within the meaning of section 3(1)(iv) of the Act. This is the first condition relating to the status of the foreign holding company. Sixth limb states what the treatment will be accorded to the private company if the conditions of seventh, eighth and ninth limbs are not met with by such foreign company. These limbs provide the second condition that such foreign company should hold the **entire equity share capital** of the private company either alone or together with one or more foreign bodies corporate. If all these conditions are met by the foreign holding company the Indian private company will be treated as a private company.

17.2.6 Holding entire share capital of a Wholly Owned Subsidiary

A pertinent question, in relation to holding the entire share capital of the subsidiary (in the case of a wholly owned subsidiary), that arises is whether all the shares to be registered in the name of the foreign holding company. In other words, in a wholly owned subsidiary of a foreign public company can Indian individuals hold shares in trust?

Answer to this question lies in section 49 of the Act which governs the manner in which investment to be made by a company in the shares of another company. In a wholly owned subsidiary, there is only one shareholder i.e., the holding company. However, to transact business and to convene Board and company meetings at least two individuals are required. The general practice, in pursuant to section 49(3), is that the holding company makes at least one Individual to hold a share in trust on behalf of it and such a share is registered in the name of the individual. The individual and the holding company file appropriate declarations with the ROC in compliance with section 187-D (1) and (2) of the Act.

Section 3 (i) of the Act defines “a company” to be incorporated in India. Again, the definition of “body corporate” in section 2 (7) of the Act includes a foreign company. A body corporate, for the limited purposes of section 4 (5), is included in the definition of “a company”. For the purposes of section 4 (5) and (7) a body corporate could only be a company incorporated outside India. Though a body corporate is not a company for the purposes of Section 49, the foreign holding company being a body corporate, by virtue of legal fiction created by section 4(5), becomes a company for the purposes of section 49 of the Act also. In view of this the shares held by the individual in trust for the holding company in the subsidiary shall be treated as the share holding of the holding company.

Section 49 of the Act has to be read in conjunction with section 4 of the Act. Though the term “a company”, in section 49 of the Act, does not include a body corporate expressly, section 4 of the act includes the same expressly. The effect of section 49 is obvious on section 4 as a holding company holds the entire shares of the subsidiary (WOS) company. Further Section 4(7) deals with the manner of shareholding of a holding company in its subsidiary company and section 49 deals with different situations in which a company is deemed to hold shares of another company in its own name. Thus, the provisions of these two sections cannot be read in isolation.

17.2.7 Crucial test that decides the issue is share holding

Sub-section (7) is thus, primarily, concerned with subsidiary within the meaning of sub-section (1)(b)(ii) of section 4 of the Act. The criteria are the direct shareholding by the foreign company either full or in part in the subsidiary. If the Act intended to cover the foreign public company holding shares through one of its subsidiaries the word **"through"** would have been employed instead of the words **"together with".** There is no ambiguity in the language employed by the legislature. The intention to cover only such foreign public companies which have direct investment in Indian private companies is very clear. If the foreign company, to which the relationship of subsidiary has to be determined, is not holding any shares in the Indian Company such foreign company is out of the purview of sub-section (7).

The share holding pattern is the test applied by the Act, in case the holding company is a public company, to determine the status of subsidiary. The provisions of section 4 (7) of the Act are applicable only to such foreign holding company which actually holds shares in the subsidiary either alone or together with other foreign bodies corporate. The crucial point is that unless the holding company holds any share in the subsidiary no reference to such a holding company to be made while applying the provisions of subsection 7 of section 4 of the Act.

17.2.8 Single-holding.

In a case of single holding i.e., one holding company and one subsidiary company the impact of subsection (7) is quite simple. If the holding company is a private company subsection (7) will have no application. If the holding company is a public company, if the entire equity share capital is not held by the holding company either alone or together with other bodies corporate the subsidiary will be treated as a private company subsidiary of a public company.

To illustrate this with the earlier example, if A is a private foreign company holding more than 50% or the entire equity share capital of the Indian private company B, B becomes a subsidiary of A. As A is a private company Sub-section (7) is not applicable and B remains a private company.

Suppose A is a public company. If A holds the entire share capital of B either alone or together with other bodies corporate, B will be treated as a private company. If even a single share is held by an Indian (individual or company) in company B, it will be treated as a private company subsidiary of a public company.

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In other words, sub-section (7) will have its impact only when the holding company is a public company.

17.2.9 Chain-holding.

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It is only in the event of chain holding where there are subsidiaries and sub-subsidiaries involving public and private companies the real impact of sub-section (7) is felt. It becomes a daunting task to interpret and apply the law enunciated in sub-section (7) of section 4 of the Act as chain-holding involves lot of combinations.

Now let us suppose, in the earlier example, that A is a private company and subsidiary of C which is a public company and C is not holding any share in B. There can be two situations. Situation I. A holds the entire share capital of B.

Situation II.A holds 60% of the equity share capital of B and rest of the shares is held by Indian public company D.

If C also holds share in B there can be two situations.

Situation III. A hold 90% and C holds 10% of the equity share capital of B.

Situation IV: A holds 40%, C holds 20% of the equity share capital of B and rest of the share capital is held by D.

What is the position of B in all these situations?

In situation I and II since C is not at all holding any shares in B, provisions of subsection (7) are not applicable and B will be treated as a private company. In situation III C holds 10% and A holds 90% of the equity share capital of B. Here C is holding the entire equity share capital of B together with A. Provisions of sub-section (7) are applicable and B will be treated as a private company. In situation IV C together with A holds only 60% of the equity share capital of B. Here also provisions of sub-section (7) are applicable and B will be treated as a private company subsidiary of a public company.

What is the implication when a private company becomes a subsidiary of a public company under section 4(7) of the Act?

The expression private company subsidiary of a public company used in various places in the Companies Act, 1956 (the Act) has wider application so as to bring a private company which is a subsidiary of a foreign public company into its scope. As has been discussed, a private company incorporated in India though becomes a subsidiary of a foreign public company in any one of the ways mentioned under section 4(1) of the Act, it is only such private company which becomes a subsidiary of a foreign public company under section 4(1)(b)(ii) is considered for the expression "private company subsidiary of a public company", for the purposes of the Act, by sub-section (7) of section 4 of the Act. When a private company becomes a subsidiary of a public company within the meaning of section 4(7) it shall remain as a subsidiary of a public company for all purposes of the Act.

Investment planning through a subsidiary is a global phenomenon. The legislature also recognizes this and it has aptly enacted sub-section (7) of section 4 of the Act by bringing subsidiary having Indian investment (whatsoever is the extent) into the fold of public company. However, investors are free to adopt the chain-holding method to come out of this by channelizing the investment through a wholly owned off shore subsidiary.

1. CHECK YOUR PROGRESS

Fill in the blanks

1. A company that controls one or more companies by holding majority of shares is called a **__________ company**.

   Answer: *Holding*
2. A company whose more than 50% shares are held by another company is called a **__________ company**

   Answer: *Subsidiary*
3. In a consolidated balance sheet, the share capital of the **__________ company only only** is shown.

   Answer: *Holding*
4. The portion of a subsidiary's net assets that belongs to outsiders is termed as **__________ interest**.

Answer: Minority

17.3 LET US SUM UP

- A **Holding Company** is one that holds more than 50% of the equity share capital of another company or controls the composition of its board of directors.
- A **Subsidiary Company** is one whose management or majority shareholding is controlled by another company (the holding company).
- As per the Companies Act, 2013, a holding company is legally required to prepare **Consolidated Financial Statements (CFS)** along with its standalone financials.
- **Consolidated Balance Sheet** is prepared to present the financial position of the group (holding + subsidiary) as a single economic entity.
- While preparing the consolidated balance sheet:

- Investment in subsidiary shown in holding company's books is replaced by the subsidiary's assets and liabilities.
  - **Minority Interest** is shown separately in the consolidated balance sheet.
  - **Capital Reserve** or **Goodwill** is calculated based on the difference between cost of investment and the proportionate share in net assets.
  - **Inter-company balances and transactions** are eliminated.

2. CHECK YOUR PROGRESS

True or False

Indicate whether each statement is True (T) or False (F).

#	Statement	T / F
1	All intercompany interest income and expense are eliminated on consolidation.	T
2	GAAP requires consolidation only when a parent owns at least 75% of voting shares.	F
3	Investments in joint ventures where the parent exerts significant influence are accounted for under the equity method.	T
4	A holding company's workpapers used to prepare consolidated statements need not be retained after filing.	F
5	If a subsidiary has a different year-end date, the parent must align the subsidiary's results to the parent's reporting date before consolidating.	T

3. CHECK YOUR PROGRESS

Column 1 (Options)	Item	Column 2 (Options)	Description
A	Line-by-line consolidation	1	Combining each line-item of parent & subsidiary financials
B	Equity method	2	Recording an investment at parent's share of investee's profits
C	Variable Interest Entity (VIE)	3	Consolidating entities in which the parent has contractual control despite < 50% voting
D	Scope of consolidation	4	All subsidiaries > 50% owned or controlled

E	Intercompany eliminations	5	Eliminating loans, payables and receivables between group companies

Answers:

- A → 1
- B → 2
- C → 3
- D → 4
- E → 5

17.4 KEYWORDS

1. **Holding Company:** The terms "holding company" is used to describe the financial, managerial, legal and governing relationships between different types of business organizations, including corporations and financial institutions. A holding company is an entity formed to buy and hold the majority of stock of other companies; a subsidiary is a business whose majority of stock is owned by a holding company. A company has to either control the Board of directors or hold more than half of the equity capital of the other company.

2. **Subsidiary company:** is a business entity that is controlled by another organization through ownership of a majority of its voting stock. This separate legal structure may be used to gain certain tax benefits, track the results of a separate business unit, segregate risk from the rest of the organization, or prepare certain assets for sale. A larger business may own dozens or even hundreds of subsidiary companies.

3. **Minority Interest:** The claim of outside shareholders in the subsidiary company has to be assessed and shown as liability in the consolidated balance sheet. Minority interest in the net assets of the

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company is nothing but the proportionate share of aggregation of share capital, reserve surpluses funds etc. proportionate share of all assets should be deducted from the minority interest.

17.5 SELF-ASSESSMENT QUESTIONS

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Question: Write two key legal requirements related to the presentation of accounts by holding companies as per the Companies Act, 2013.

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Question: How holding company differ from subsidiary company.

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Question: Highlight the features of holding company

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17.6 LESSON END EXERCISE

Question: Define a holding company. Under what conditions is a company considered a holding company

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Question: What is a consolidated balance sheet? Why is it prepared.

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17.7 SUGGESTED READINGS

- M.C. Shulka, T.S. Grewal and S.C. Gupta, Advance Accounts, S. Chand & Company Ltd, Vol.II.
- S.P. Jain and K.L. Narang, Advanced Accountancy, Kalayani Publishing House.
- M.A. Arulanandam and K.S. Raman, Advanced Accountancy, Himalaya Publishing House, (Part-II).

UNIT: 4 **LESSON 18**

COURSE NO: BCG 301

MEANING OF MINORITY INTEREST, COST OF CONTROL/ CAPITAL RESERVE, REVENUE PROFIT AND CAPITAL PROFITS

STRUCTURE:

18.0 LEARNING OBJECTIVES AND OUTCOMES

Learning objectives

- To define the concepts of Cost of Control (Goodwill) and Capital Reserve in the context of holding company accounts.
- To understand the meaning and accounting treatment of Minority Interest in a consolidated balance sheet.
- To classify and differentiate between capital profits/losses and revenue profits/losses for consolidation purposes.
- To apply appropriate accounting formulas for the computation of Goodwill, Capital Reserve, and Minority Interest.

Learning outcomes

After completing this topic, learners will be able:

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- To compute cost of control and identify whether it results in goodwill or capital reserve.
- To calculate the correct amount of minority interest, including all relevant components.
- To apportion capital and revenue profits/losses between holding and minority shareholders appropriately.
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18.1 INTRODUCTION

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- A holding company is a company that owns other companies' outstanding stock. The term usually refers to a company that does not produce goods or services itself; rather, its purpose is to own shares of other companies to form a corporate group. Holding companies allow the reduction of risk for the owners and can allow the ownership and control of a number of different companies.
- In the United States, 80% or more of stock, in voting and value, must be owned before tax consolidation benefits such as tax-free dividends can be claimed. That is, if Company A owns 80% or more of the stock of Company B, Company A will not pay taxes on dividends paid by Company B to its stockholders, as the payment of dividends from B to A is essentially Company A transferring cash from one company to the other. Any other shareholders of Company B will pay the usual taxes on dividends, as they are legitimate and ordinary dividends to these shareholders.
- Sometimes a company intended to be a pure holding company identifies itself as such by adding "Holding" or "Holdings" to its name. Holding companies are formed to organize and manage a group of smaller companies. If you are a business owner of investor, you may consider forming a holding company to protect your business assets or get a more favorable tax rate. A holding company ias an entity formed to buy and hold the majority of stock of other companies; a subsidiary is a business whose majority of stock is owned by a holding company. A holding company buys, absorbs or otherwise obtains a majority percentage of stock in another company, which becomes known as its subsidiary. Typically, a holding company must control 50 percent or more of a company's stock before it's considered a subsidiary. Holding companies may also own other holding companies in this case, they're known as top holding companies. The holding company has all rights and responsibilities of ownership for its subsidiaries. The subsidiaries, while not independently owned, often continue to operate as individual entities, though major corporate decisions are made by the holding company. A holding company directs the management and operations of the subsidiaries it owns and maintains the authority to add or remove board members, directors and other key management and personnel. A holding company may have strict managerial control or may allow subsidiaries to act with some level of autonomy for day-to-day

business operations, including lower- and midlevel hiring and certain budgeting decisions. A subsidiary has little to no financial control over its operations. Even independently acting subsidiaries are ultimately financially controlled by their holding company. This includes financial activities such as investment decisions, sales projections and budgeting. If a subsidiary was itself a holding company prior to becoming a subsidiary of another holding company, all of its subsidiaries also become subsidiaries of the top holding company.

- A company has to either control the Board of directors or hold more than half of the equity capital of the other company. A holding company is any regular corporation, LLC, or LP that owns investments in other companies but doesn't engage in any operations itself. That is, Berkshire Hathaway is a holding company because it doesn't do anything. Instead, it owns 100% of the stock of GEICO, which is an insurance company. It owns 80% or 90% of the stock of Nebraska Furniture Mart, which is a huge furniture retailer.
- It owns more than 8% of the stock of Coca-Cola through its insurance holdings. But Berkshire itself just has a handful of employees and a bank vault full of stock certificates. Any money it has comes from dividends paid by the subsidiaries on June 30th and December 31st of each year. It can be used to silo investment assets and protect them, such as Dunkin' Donuts putting its intellectual property into its own LLC. It can be used to transfer wealth to friends and family. If you own a collection of businesses, rental properties, or other valuables, it is far more convenient to transfer shares in a parent company than it is in each individual asset. It can permit you to structure deals so you control far more money than you otherwise could afford. If you had $10 million and used it to buy control of a $20 million insurance group that had $70 million in float, you would be controlling $70 million from your holding company. In essence, a holding company is in the business of providing capital and people. Berkshire Hathaway refuses to provide management to the subsidiaries it purchases; they don't run businesses. General Electric, on the other hand, is one of the greatest machines of all time and can have someone else running a company within 12 hours.

18.2 CONCEPT OF MINORITY INTEREST

MINORITY INTEREST

The claim of outside shareholders in the subsidiary company has to be assessed and shown as liability in the consolidated balance sheet. Minority interest in the net assets of the company is nothing but the proportionate share of aggregation of share capital, reserve surpluses funds etc. proportionate share of all assets should be deducted from the minority interest. Thus, minority interest is the share of outsider in the following:

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1) Share in share capital in subsidiary.

2) Share in reserves (Both pre- and post-acquisition of subsidiary).

3) Share in accumulated losses should be deducted.

4) Proportionate share of profit or loss on revaluation of assets.

5) Preference share capital of subsidiary company held by outsiders and dividend due on such share capital, if there are profits.

Minority interest means outsiders interest. It is treated as liability and shown in consolidated. Balance sheet as current liability. This amount is basically intrinsic value of shares held by minority. Minority interest means outsider's interest. It is treated as liability and shown in consolidated balance sheet as current liability. This amount is basically intrinsic value of shares held by minority. When the outsiders hold some of the shares of S Ltd, their proportionate share in the assets and liabilities of S Ltd is known as minority interest. The majority interest is calculated by using the following equation:

Paid up value of shares held by outsiders Add: Outsiders' share of capital profits Outsiders' share of revenue profits	xxx xxx xxx
Less: Outsiders' share of capital loss Outsiders' share of revenue loss Minority interest	(xxx) (xxx)
	Xxx

If preference shares of S Ltd are held by outsiders, the face value of such shares with dividend due there on will be included in the minority interest. Minority interest is shown as a liability in the consolidated balance sheet.

Illustration 1: Minority interest

The following is the Balance sheet of S Ltd. as on 31st March, 2024.

Liabilities	Rs.	Assets	Rs.
Share capital		Fixed Assets	2,90,000
Equity shares of Rs. 10 each	2,70,000	Investment	2,75,000
General Reserve Profit & Loss a/c	3,60,000	Current Assets	1,30,000
Current liabilities		Preliminary Expenses	20,000
	85,000		

	7,15,000		7,15,000

H Ltd. acquired 25,000 shares in S Ltd. on 31st March, 2010 at a cost of Rs. 2,75,000. fixed assets were revalued at Rs. 3,28,000. find minority interest

Solution: Minority Interest = 2,000/27,000 =2 /27

Minority Interest	**Rs.**
1) Share in share capital (2,70,000 × 2/27)	= 20,000
2) Share in Reserves and Surpluses (3,60,0008 × 2/27)	= 20,000
3) Share in capital profits	= 28,000
(Profit on appreciation on fixed Assets	
(3,60,000 – 20,000 + 38,000) = 3,78,000 × 2/27	
Minority Interest	=**68,000**

18.3 CONCEPT OF COST OF CONTROL/ CAPITAL RESERVE

Cost of Control (Good Will)/Capital Reserve

The holding company acquires more than 50% of the shares of the subsidiary company. Such shares may be acquired at a market price. Which may be at a premium or at discount. This amount is reflected in the balance sheet of holding company of the assets side as investment in the shares of subsidiary company. This is the price paid for shares in net assets of subsidiary company as on date of its acquisition. Net assets of the subsidiary company consist of share capital, accumulated profits and reserve after adjustment, accumulated losses as on the date of acquisition. If the amount paid by the holding company for the shares of subsidiary company is more than its proportionate share in the net asset of the subsidiary company as on the date of acquisition, the difference is considered as goodwill. If there is excess of proportionate share in net assets of subsidiary company intrinsic of shares acquired and cost of shares acquired by holding company there will be capital reserve in favour of holding company. Its goodwill already exists in the balance sheet of holding company or both the goodwill thus calculated, will be added up to the existing goodwill. Capital Reserve will be deducted from Goodwill. In short, net amount resulting from goodwill and capital Reserve will be shown in the consolidated Balance sheet. If H Ltd purchases the shares of S Ltd at a higher price than their actual value, the excess payment is known as cost of control or good will (Loss on purchase of shares of S Ltd). On the other hand, if the shares are purchased at a lower price than their actual value, the extent of lower payment is known as capital reserve (profit on purchase of shares of S Ltd). The cost of control/capital reserve is calculated as follows:

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Amount paid for 'N' shares of S Ltd. Paid up value of shares held by H Ltd	xxx xxx
Add: H Ltd' share of capital profits	xxx
Less: H Ltd' share of capital losses	(xxx)
Cost of control/capital reserve	--------------- xxx ----------------

*If it is positive, the amount will be treated as cost of control and if it is negative, the amount will be treated as capital reserve. The amount of cost of control is shown in the asset side of the consolidated balance sheet and the capital reserve is shown in the liability of the consolidated balance sheet.

Illustration 2: Cost of control/ Goodwill

Balance sheet of S Ltd. as on 31st March 2010 (Liabilities only)

Liabilities	**Rs.**
Share capital 40,000	
Equity shares of Rs. 10/- each	**4,00,000**
Reserves and surpluses	**2,50,000**
Secured loan	**2,50,000**
Other Liabilities	**1,00,000**
	10,00,000

On the above date H Ltd. acquired 30,000 Equity shares in S Ltd. on the above date for Rs. 7,50,000 fixed assets of S Ltd. were appreciated by Rs. 1,50,000 find out cost of control / Goodwill.

Solution

: Particulars		Rs.
Cost of investment in S Ltd.		7,50,000 Less: 1) Share in share
capital (4,00,000×3/ 4	3,00,000	
2) Share in Reserves and surpluses		
Capital profit 2,50,000 ×3/ 4 = 1,87,500		
Share in capital profit		
(Appreciation in fixed assets) 1,50,000×3/4= 1,12,500		
		6,00,000
Goodwill		1,50,000

1 CHECK YOUR PROGRESS

True or false

1) A subsidiary is a company whose majority of stock is owned by a holding company. (T/F)
Answer: True

2) Cost of control arises when the holding company pays more than its share in the subsidiary's net assets. (T/F)
Answer: True

3) A capital reserve is recorded when the holding company pays less than the intrinsic value of its share in the subsidiary. (T/F)
Answer: True

4) Preference shares held by outsiders are not included in minority interest. (T/F)
Answer: False

5) The claim of outside shareholders in a subsidiary is considered minority interest. (T/F)
Answer: True

18.4 CONCEPT OF REVENUE PROFIT/ LOSSES

REVENUE PROFITS / LOSSES

These are otherwise known as post-acquisition profits/losses. These profits/losses are earned By S Ltd after the acquisition shares by H Ltd. These profits/losses are to divided among h Ltd and outsiders on the basis of their shareholding proportions. H Ltd' share of revenue profits/losses is added/deducted from its P&L account in the consolidated balance sheet. The outsiders' share of revenue profits/losses is adjusted on minority interest.

18.5 CONCEPT OF CAPITAL PROFIT/ LOSSES

CAPITAL PROFITS / LOSSES

These are otherwise known as pre-acquisition profits or losses. These are reverses/ P&L (Cr) or (Dr) balance on the date of purchase of shares of S ltd by H ltd. These profits/losses are to be divided among H Ltd and outsiders on the basis of their shareholding proportions. H Ltd' share of capital profits/losses is adjusted on the calculation of cost of control (good will)/capital reserve. The outsiders' share of capital profits/losses is adjusted on minority interest. The holding company may acquire the shares in the subsidiary company either on the balance sheet date or any date earlier than balance sheet date. All the profit earned by the subsidiary company till the date of acquisition of shares by holding company have to be taken as capital profits for the holding company. Such reserves lose their individual identity and considered as capital profits. In case, the holding company acquired shares on a date other than balance sheet date of subsidiary, the profits of subsidiary company will have to be apportioned between capital profits and Revenue profits from the point of view of the holding company. Thus, any profit earned by subsidiary company before the date of acquisition is the capital profit, while any profit earned by subsidiary company after the date of acquisition is Revenue profits. While preparing the consolidated

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balance sheet share in capital profits should be adjusted with the cost of control and Revenue profits / Reserves should be merged with the balances in the Reserve and surpluses of the holding company.

2 CHECK YOUR PROGRESS

Fill in the blanks

1)Revenue profits or losses are also known as _____________ profits or losses.

Answer: post-acquisition

2) Capital profits or losses are also referred to as _____________ profits or losses.

Answer: pre-acquisition

3) Revenue profits/losses are earned by the subsidiary company _____________ the acquisition of shares by the holding company.

Answer: after

4) Capital profits/losses are related to profits/losses existing in the subsidiary company _____________ the acquisition of shares by the holding company.

Answer: before

5) The holding company's share of revenue profits is added to the _____________ account in the consolidated balance sheet.

Answer: Profit and Loss

18.6 LET US SUM UP

- A holding company is one that holds a majority share in another company, termed a subsidiary, primarily for control and investment purposes.
- Minority interest is the portion of net assets and profits/losses belonging to shareholders other than the holding company and is shown as a liability in the consolidated balance sheet.
- When the price paid for shares exceeds the proportionate net assets acquired, the excess is called goodwill (cost of control); when less, it is treated as capital reserve.
- Capital profits/losses relate to the period before acquisition, while revenue profits/losses occur after acquisition.
- The correct calculation and treatment of these elements are essential for preparing consolidated financial statements.

18.7 KEYWORDS

1) **Holding Company**

   A company that owns more than 50% of the equity shares or controls the composition of the Board of Directors of another company. It does not necessarily engage in production or services but exists to manage and control subsidiary companies.

2) **Subsidiary Company**

A company in which more than 50% of the equity shares are held by another company (the holding company), or whose Board of Directors is controlled by the holding company.

3) **Minority Interest**

The portion of a subsidiary's net assets and profits that belongs to shareholders other than the holding company. It is shown as a liability in the consolidated balance sheet.

4) **Cost of Control / Goodwill**

The excess amount paid by the holding company over its share in the net assets of the subsidiary at the time of acquisition. This amount is treated as goodwill and shown on the asset side of the consolidated balance sheet.

5) **Capital Reserve**

The surplus arising when the holding company pays less than its share of net assets of the subsidiary. It is considered a gain and shown on the liability side of the consolidated balance sheet.

6) **Capital Profits / Losses**

Profits or losses earned by the subsidiary before the date of acquisition by the holding company. These are used to calculate goodwill or capital reserve.

7) **Revenue Profits / Losses**

Profits or losses earned by the subsidiary after the acquisition date. The holding company's share is added to consolidated profits, and the outsiders' share is included in the minority interest.

18.8 SELF ASSESSMENT QUESTIONS

1. S Ltd.'s Balance Sheet (just before consolidation):

Equity Share Capital: ₹6,00,000, General Reserve: ₹3,00,000, Profit & Loss A/c (Credit): ₹1,00,000, Fixed Assets appreciated by ₹60,000

H Ltd. owns 80% shares. Calculate Minority Interest.

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2. H Ltd. acquired 80% shares in S Ltd. for ₹7,20,000.

S Ltd.'s balance sheet at acquisition shows:

Equity Share Capital: ₹6,00,000

- General Reserve: ₹2,00,000

  Profit & Loss A/c: ₹1,00,000

  Fixed assets were revalued upward by ₹50,000.

  Find the cost of control or capital reserve

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3. What is the difference between cost of control and capital reserve

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18.9 LESSON END EXERCISE

1. Classify the following as **capital profit** or **revenue profit**:

a) Reserve in subsidiary before acquisition

b) Profit for the year after acquisition

c) Profit on sale of asset before acquisition

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2. Balance Sheet of S Ltd. (extracted):

   Equity Capital: ₹5,00,000

   Reserves and Surplus: ₹3,00,000

   Preference Share Capital: ₹2,00,000 (held entirely by outsiders)

   H Ltd. holds 70% of equity shares.

   Find the **minority interest**.

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3. S Ltd. had a General Reserve of ₹1,50,000 and P&L (Dr) balance of ₹50,000 on the date of acquisition. It earned ₹3,00,000 profit after acquisition.
Determine:

Capital Profit

Revenue Profit

Also, calculate how these are apportioned between H Ltd. (who owns 60%) and minority interest.

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3. CHECK YOUR PROGRESS

Match the following:

Column A	**Column B**
A. Revenue Profits	1. Pre-acquisition profits
B. Capital Profits	2. Adjusted with Profit & Loss account
C. Post-acquisition profits	3. Share included in cost of control calculation
D. Holding company's share of capital profits	4. Adjusted with Reserves & Surplus of H Ltd
E. Minority interest	5. Outside shareholders' share
F. Capital Reserve	6. Shown on liability side of consolidated B/S
G. Goodwill	7. Paid more than net assets of subsidiary
H. Acquisition Date	8. Divides capital and revenue profits

Answers A 2, B 1, C 4, D 3, E 5, F 6, G 7, H 8

18.10 SUGGESTED READINGS

- M.C. Shulka, T.S. Grewal and S.C. Gupta, Advance Accounts, S. Chand & Company Ltd, Vol. II.
- S.P. Jain and K.L. Narang, Advanced Accountancy, Kalayani Publishing House.
- M.A. Arulanandam and K.S. Raman, Advanced Accountancy, Himalaya Publishing House, (Part-II).

UNIT: 4 **LESSON 19**

COURSE NO: BCG-301

TREATMENT OF UNREALISED DIVIDEND

STRUCTURE:

18.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objective

- To understand the need for eliminating investment in subsidiary shares during consolidation.

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- To identify and eliminate mutual owing and inter-company transactions in consolidated financial statements.
- To calculate and adjust unrealized profit arising from intra-group transactions.
- To explain the accounting treatment for contingent liabilities in consolidation.
- To determine the effect of revaluation of subsidiary's assets and liabilities on capital profits and cost of control.
- To assess the impact of bonus shares issued from capital or revenue profits on shareholding and cost of control.
- To account for dividends received or receivable from the subsidiary company by the holding company.
- To evaluate the treatment of provision for taxation in consolidated balance sheets.
- To differentiate between pre- and post-acquisition profits when shares are purchased in installments.
- To compute the effect of sale of shares by the holding company on goodwill, capital reserve, and minority interest.

Learning Outcomes

- **To prepare** a consolidated balance sheet by eliminating investment in subsidiary against net assets.
- **To apply** the concept of cancelling mutual owing (e.g., intercompany bills, loans) during consolidation.
- **To identify and remove** unrealised profit from stock and profit figures in intra-group trading.
- **To distinguish** between internal and external contingent liabilities and their treatment in group accounts.
- **To allocate** capital profit arising from asset revaluation between holding and minority shareholders.
- **To analyze** the effect of bonus share issuance from both pre- and post-acquisition profits on consolidation.
- **To correctly account** for dividends received by the holding company as capital or revenue income.
- **To present** provision for taxation made by the subsidiary as a liability in the consolidated balance sheet.
- **To divide** profits into capital and revenue based on acquisition timelines in case of share purchase in parts.

- **To adjust** capital reserve or goodwill in case of partial disposal of shares by the holding company.
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19.1 INTRODUCTION

- A holding company is a company that owns other companies' outstanding stock. The term usually refers to a company that does not produce goods or services itself; rather, its purpose is to own shares of other companies to form a corporate group. Holding companies allow the reduction of risk for the owners and can allow the ownership and control of a number of different companies.
- In the United States, 80% or more of stock, in voting and value, must be owned before tax consolidation benefits such as tax-free dividends can be claimed. That is, if Company A owns 80% or more of the stock of Company B, Company A will not pay taxes on dividends paid by Company B to its stockholders, as the payment of dividends from B to A is essentially Company A transferring cash from one company to the other. Any other shareholders of Company B will pay the usual taxes on dividends, as they are legitimate and ordinary dividends to these shareholders.
- Sometimes a company intended to be a pure holding company identifies itself as such by adding "Holding" or "Holdings" to its name. Holding companies are formed to organize and manage a group of smaller companies. If you are a business owner of investor, you may consider forming a holding company to protect your business assets or get a more favorable tax rate. A holding company ias an entity formed to buy and hold the majority of stock of other companies; a subsidiary is a business whose majority of stock is owned by a holding company. A holding company buys, absorbs or otherwise obtains a majority percentage of stock in another company, which becomes known as its subsidiary. Typically, a holding company must control 50 percent or more of a company's stock before it's considered a subsidiary. Holding companies may also own other holding companies in this case, they're known as top holding companies. The holding company has all rights and responsibilities of ownership for its subsidiaries. The subsidiaries, while not independently owned, often continue to operate as individual entities, though major corporate decisions are made by the holding company. A holding company directs the management and operations of the subsidiaries it owns and maintains the authority to add or remove board members, directors and other key management and personnel. A holding company may have strict managerial control or may allow subsidiaries to act with some level of autonomy for day-to-day business operations, including lower- and midlevel hiring and certain budgeting decisions. A subsidiary has little to no financial control over its operations. Even independently acting subsidiaries are ultimately financially controlled by their holding company. This includes financial

activities such as investment decisions, sales projections and budgeting. If a subsidiary was itself a holding company prior to becoming a subsidiary of another holding company, all of its subsidiaries also become subsidiaries of the top holding company.

- A company has to either control the Board of directors or hold more than half of the equity capital of the other company. A holding company is any regular corporation, LLC, or LP that owns investments in other companies but doesn't engage in any operations itself. That is, Berkshire Hathaway is a holding company because it doesn't do anything. Instead, it owns 100% of the stock of GEICO, which is an insurance company. It owns 80% or 90% of the stock of Nebraska Furniture Mart, which is a huge furniture retailer.
- It owns more than 8% of the stock of Coca-Cola through its insurance holdings. But Berkshire itself just has a handful of employees and a bank vault full of stock certificates. Any money it has comes from dividends paid by the subsidiaries on June 30th and December 31st of each year. It can be used to silo investment assets and protect them, such as Dunkin' Donuts putting its intellectual property into its own LLC. It can be used to transfer wealth to friends and family. If you own a collection of businesses, rental properties, or other valuables, it is far more convenient to transfer shares in a parent company than it is in each individual asset. It can permit you to structure deals so you control far more money than you otherwise could afford. If you had $10 million and used it to buy control of a $20 million insurance group that had $70 million in float, you would be controlling $70 million from your holding company. In essence, a holding company is in the business of providing capital and people. Berkshire Hathaway refuses to provide management to the subsidiaries it purchases; they don't run businesses. General Electric, on the other hand, is one of the greatest machines of all time and can have someone else running a company within 12 hours.

19.2 ELIMINATION OF INVESTMENTS IN SHARES OF SUBSIDIARY COMPANY

Investment in shares in subsidiary company represents the cost paid by the holding company to acquire the shares of the subsidiary company. The investment in shares of the subsidiary company entitles the holding company to share the net assets of the subsidiary company. While preparing consolidated balance sheet all the assets and liabilities of subsidiary company have to be merged with those of the holding company and therefore it is logical to eliminate investments of the holding company in the shares of the subsidiary company. Share in net assets of the outside shareholders should treat as the minority interest it is shown in the balance sheet on the liability side of holding company.

19.3 MUTUAL OWING / INTER COMPANY TRANSACTIONS

The holding company and the subsidiary company may have number of intercompany transactions in any one or more of the following matters. 1. Loan advanced by the holding company to the subsidiary company or vice versa. 2. Bill of Exchange drawn by holding company on subsidiary company or vice versa. 3. Sale or purchase of goods on credit by holding company form subsidiary company or vice versa. 4. Debentures issued by one company may be held by the other. As a result of these intercompany transactions, certain accounts appear in the balance sheet of the holding company as well as the subsidiary company. In the consolidated balance sheet, all these common accounts should be eliminated.

For e.g.,

1. S Ltd. has taken loan of Rs. 20,000 from H Ltd. then S ltd. balance sheet shows a liability of Rs. 20,000 while H Ltd. balance sheet shows on assets of Rs. 20,000. **2.** H Ltd. draws a bill of Rs. 50,000 on S Ltd., then H Ltd. books it will show bills receivable Rs. 50,000 while S Ltd. books will show bills payable Rs. 50,000.

3. S Ltd. issued debentures of Rs. 1,00,000 which are held by H Ltd. then S Ltd. balance sheet will show a liability of Rs. 50,000 while H Ltd. books will show an asset of Rs. 50,000.

All the above intercompany transactions have to be eliminated while preparing the consolidated balance sheet. These can be done by deducting intercompany transactions from the respective items on both sides of balance sheet.

19.4 UNREALISED PROFIT

The problem of unrealized profit arises in those cases where the companies of the same group have sold goods to each other at the profits and goods still remain unsold at the end of the year company to whom the goods are sold. While preparing the consolidated balance sheet, unrealized profit has to be eliminated from the consolidated balance sheet in the following manner.

1. Unrealized profits should be deducted from the current revenue profits of the holding company.

2. The same should be deducted from the stock of the company consolidated balance sheet. Minority shareholders will not be affected in any way due to unrealized profits.

For e.g. The stock in trade of S Ltd. includes Rs. 60,000 in respect of goods purchased from H Ltd.

These goods have been sold by H Ltd. at a profit of 20% on invoice price.

Therefore, unrealized profit = 60,000 × 20/100 =12,000

Unrealized profit Rs. 12,000 should be deducted from closing stock in the consolidated balance sheet and from Revenue profits i.e., from profit and loss account.

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1. CHECK YOUR PROGRESS

TRUE OR FALSE

1. Bonus shares issued out of post-acquisition profit reduce revenue profit.

ANSWER ☑ **True**

2. Dividend from pre-acquisition profit is treated as revenue income.

ANSWER ✗ **False**

3. Minorities are affected by bonus shares issued from capital profits.

ANSWER ✗ **False**

4. Proposed dividends on minority shares can be shown as a separate liability.

ANSWER ☑ **True**

5. Profit on sale of shares by holding company is excluded from cost of control.

ANSWER ✗ **False**

19.5 CONTINGENT LIABILITIES

As 29 defines a contingent liability as:

A possible obligation that arises from past events and whose existence will be confirmed only by occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity or a present obligation that arises from the past events but not recognized / provided.

Such contingent liability may be of two types.

a) External contingent liability.

b) Internal contingent liability.

Internal contingent liability relates in respect of transactions between holding and subsidiary company and it will not be shown as foot note in the consolidated balance sheet, as they appear as actual liability in the consolidated balance sheet.

19.6 REVALUATION OF ASSETS AND LIABILITIES

The holding company may decide to revalue the assets and liabilities of the subsidiary company on the date of acquisition of share in the subsidiary company. Any profit or loss on such revaluation is a capital profit or loss. Profit on revaluation of assets of the subsidiary company whether before or after date of acquisition of shares by the holding company, the same must be shared by the holding company, and the minority shareholders in proportion to their respective holding. The minority shareholders share should be added to the minority interest. But the holding company share should be treated as capital profits and considered in cost of control. Further readjustment for depreciation on increase in the value of assets should be made in the profit and loss account in the subsidiary company. And same should be deducted from the Revenue profits of the subsidiary company.

Illustration: 1 (Revaluation of Fixed Assets)

From the following balance sheet of H. Ltd. and its subsidiary S Ltd. drawn up at 31.12.2010. ii) Reserve and profit and loss account (cr.) of S. Ltd. stood at Rs. 50,000 and 30,000 respectively, on the date of acquisition of its 80% shares. Held by H Ltd. as on 1/01/2010 and Machinery (Book value Rs. 2,00,000) and furniture (Book value Rs. 40,000) of S Ltd. were revalued at Rs.3,00,000 and Rs. 30,000 respectively for the purpose of fixing the price of its shares there was no purchase or sale of these assets since the date of acquisition.

Balance sheets of H Ltd. S Ltd. as at 31st December, 2010.

Liabilities	H Ltd.	S Ltd.	Assets	H Ltd.	S Ltd.
Share Capital					
Shares of Rs. 100 each	10,00,000	2,00,000	Machinery	6,00,000	1,80,000
Reserves	4,00,000	1,50,000	Furniture	1,00,000	34,000
Profit & loss A/c	2,00,000	50,000	Other Assets (current)	8,80,000	2,86,000
Creditors	3,00,000 19,00,000	1,00,000 5,00,000	Shares in S Ltd. 1600 at Rs. 200 each	3,20,000 19,00,000	- 5,00,000

Solution: Workings 1) Preparation of holding Co. share

H Ltd. shares in S Ltd. 1600/ 2000= 4/5

Minority’s share 400/2000= 1/5

2)

Capital Profit	**Rs.**
Reserve Balance as on date of Acquisition	50,000

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Profit and loss	30,000
	80,000
Add: Undervaluation of machinery (3,00,000 - 2,00,000)	1,00,000
○	1,80,000
Less: Overvaluation of Furniture (40,000-30,000)	(10,000)
	1,70,000
H. Ltd. Rs. 1,70,000 4/5	1,36,000
S Ltd. 1,70,000 × 1/ 5	34,000

3)

	Rs.
Current profit (Reserve 1,50,000 – 50,000)	1.00.000
Profit and loss A/c (50,000 – 30,000)	20.000
	1.20.000
Less: Depreciation on machinery undercharged @ 10% on 1,00,000	(10000)
	1.10.000
Add: Depreciation over charged on furniture @ 15% on Rs. 10,000	1.500
	1.11.500
H Ltd. Rs.1,11,500 × 4/5 1,11,500 × 1/5 22.300	89.200 Minority share Rs.
	96,300

4) Minority Interest

Share capital (200 x Rs. 100) 40,000

Add: share in capital profit 34,000

Add: share in Revenue Profit 22,300 96,300

5) Cost of control / Goodwill

Cost of shares 3,20,000

Less: Nominal value of shares held (1,60,000)

H’s Co. share in capital profit (1,36,000)

Goodwill 24,000

19.7 PREFERENCE SHARE IN SUBSIDAY COMPANY

In case the subsidiary company has also Preference share capital, its treatment on consolidation will be as follows:

a) Nominal value of non-participating Preference share capital of the subsidiary company is held by the holding company should be adjusted in cost of control against the cost of Preference shares.

b) Preference shares held by outsiders. Paid up value of such Preference shares should be included in Minority interest.

CHECK YOUR PROGRESS

FILL IN THE BLANKS

1. Investment in shares of a subsidiary is eliminated against the ___________ of the subsidiary company.

   Answer: net assets

2. The share of outside shareholders in the subsidiary is shown as ___________ in the consolidated balance sheet.

   Answer: minority interest

3. Mutual owing refers to ___________ between holding and subsidiary companies.

   Answer: inter-company transactions

4. Unrealized profits arise when goods remain ___________ at the end of the year.

   Answer: unsold

5. Contingent liabilities arising out of internal transactions are ___________ in the consolidated balance sheet.

   Answer: not shown separately

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19.8 BONUS SHARE

The issue of bonus shares by the subsidiary company will increase the number of shares held by the holding company as well as by the minority shareholders without any additional cost. However, ratio of holding will not change. Issue of bonus shares may or may not affect the cost of control depending upon whether such shares are issued out of capital profits or revenue profits.

i) Issue of bonus shares out of pre-acquisition profits (capital profits): In case the subsidiary company issues bonus shares out of capital profits the cost of control remains unaffected in the consolidated balance sheet on account of issue of bonus shares. As share capital increases by the amount of bonus and capital profits decreases by the same amount. Hence, there is no effect on cost of control when bonus shares are issued from pre-acquisition profits.

ii) Issue of bonus share of post-acquisition profits (Revenue profits): In this case, a part of revenue profits will get capitalized resulting decrease in cost of control or increase in capital reserve. Issue of bonus shares whether out of capital profits or revenue profits will not affect on minority interest. Minority interest will remain unaffected.

Illustration: 2 (Issue of bonus shares out of capital profit (pre acquisition profit)

H Ltd. acquired 12,000 Equity shares of Rs. 10 each in S Ltd. on December 31, 2010. The summarized Balance sheets of H Ltd. and S Ltd. as on that date were.

Balance sheet as on 31st December, 2010

Liabilities	H Ltd. Rs.	S Ltd. Rs.		H Ltd. Rs.	S Ltd. Rs.
Capital A/c Authorized			Fixed Assets	5,06,000	1,56,000
Issue and paid up	8,00,000	2,40,000	Investment in S Ltd. at cost 12000 shares of Rs. 10 each	2,00,000	--
12,000 shares of Rs. 5 each	6,00,000		Stock in hand	60,000	20,000
16,000 shares of Rs. 10 each		1,60,000	Bills receivable (including Rs. 2000 from S Ltd.)	4,000	
Capital Reserve		68,000	Debtors and balance at bank	4,000	34,000
General Reserve	40,000	20,000			

Profit and loss A/c	1,00,000	20,000			
Bills payable (including Rs. 2000 to H Ltd.)		7,000			
Creditors	70,000	35,000			
	8,10,000	3,10,000		8,10,000	3,10,000

Note: (Re Balance sheet of H Ltd.) contingent liability for bills discounted Rs. 2400)

On 31.12.10 subsidiary Ltd. utilized part of its capital Reserve to make a bonus issue of every Four shares held, effect of bonus not given in above balance sheet.

You are required to prepare the consolidated balance sheet as on 31.12.10 and show there in how your figures are made up.

Solution:

1)*Proportion of holding shares:*

H Ltd. share in S Ltd. = 12000/16000= 3/4

Minority S Ltd. = 4000/10000 = ¼

2*)*

Capital profit		Rs.	
Capital Reserve	68000		
Less: Bonus Issue	<u>40000</u>	28,000	
Revenue Reserves		20,000	
Profit and Loss Account		20,000	
		<u>68,000</u>	
H Ltd. 68,000*3/4=	–	51,000	
S Ltd. 68000*1/4=	–	<u>17,000</u>	**68,000**

3) There will be no revenue profit since the shares are acquired on 31.12.10 at the time of preparing final accounts.

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4)

Minority interest Rs.

Share capital (Rs. 2,00,000 □ 1/4) 50,000
Circluder Bonus capital profit 17,000

67000

5)

1) Capital Reserve Rs.

Cost of shares in S Ltd. 2,00,000

Less: i) Share in share capital 1,50,000

ii) Share in capital profit

Including Bonus 51,000 2,01,000

Capital Reserve 1,000

H Ltd. and its subsidiary S Ltd.

Consolidated Balance sheet as at 31.12.2010

Liabilities	Rs.	. Rs.	Assets	Rs.	Rs.
Share capital			Fixed Assets		
Authorized		8,00,000	H Ltd.	5,06,000	
Issue and paid up 1,20,000 shares of Rs. 5 each fully paid		6,00,000	S Ltd.	2,56,000	7,62,000
Reserves and surplus			Investments		
General Reserve		40,000	Current Assets loans and Advances		
Capital Reserve		1,000	Stock		
Profit and Loss Account		1,00,000	H Ltd.	60,000	
Minority Interest		67,000	S Ltd.	20,000	80,000
Creditors			Debtors and Bank Balances		
H Ltd.	70,000		H Ltd.	40,000	
S Ltd.	35,000	1,05,000	S Ltd.	34,000	74,000
Bills payable S Ltd.	7,000		Bills Receivable H Ltd.	4,000	
Less: Bills held by H Ltd. per contra	(2,000)	5,000	Less: accepted by S ltd. per contra	(2,000)	2,000

		9,18,000			**9,18,000**

Issue of bonus share out of current / Revenue profit.

Illustration: 6 Issue of bonus shares (Out of current profit (Revenue / post-acquisition)

The balance sheets of H Ltd. and S Ltd. as at December, 31st 2010 given below.

Liabilities	H Ltd.	S Ltd.	Assets	H Ltd.	S Ltd.
Share capital (Rs.10 each)	8,00,000	2,00,000	Fixed Assets	7,00,000	2,00,000
General Reserve	2,00,000	80,000	Investment 16,000 shares in S Ltd.	2,00,000	
Profit and Loss A/c	1,00,000	60,000	Current Assets	3,00,000	1,60,000
Creditors	1,00,000	20,000			
	12,00,000	**3,60,000**		**12,00,000**	**3,60,000**

S Ltd. had a credit balance of Rs. 80,000 in the General Reserve when H Ltd. acquired share in S Ltd. S Ltd. decided to capitalize Rs. 40,000 out of post-acquisition profits earned by making a bonus issue of one share for every five shares held.

Prepare a consolidated Balance sheet as on December, 31st 2010.

Solution :

	Rs.
1) Proportion of holding shares	$\frac{16,000}{20,000} = \frac{4}{5}$
Minority	$\frac{4,000}{20,000} = \frac{1}{5}$

2) Capital Profit

General Reserve	80,000
	80,000
H Ltd. $80,000 \times \frac{4}{5}$	64,000
S Ltd. $80,000 \times \frac{1}{5}$	16,000

3) Current Profits

Profit and Loss A/c	60,000	
Less : Bonus issue	40,000	20,000
		20,000
H Ltd.	$20,000 \times \frac{4}{5}$	16,000
Minority	$20,000 \times \frac{1}{5}$	4,000

H Ltd. and its Subsidiary S Ltd.
Consolidated Balance sheet as at December, 31st 2010.

Liabilities	Rs.	. Rs.	Assets	Rs.	Rs.
Share capital			Fixed Assets		
Authorized, Issue and paid up 80,000 Equity shares of Rs. 10 each		8,00,000	H Ltd.	7,00,000	
Reserves and surplus			S Ltd.	2,00,000	9,00,000
General Reserve		2,00,000	Investments		
Capital Reserve		56,000	Current Assets loans and Advances		
Profit and Loss Account			Stock		
Balance	1,00,000		H Ltd.	3,00,000	
Add : Revenue from S Ltd.	16,000	1,16,000	S Ltd.	1,60,000	4,60,000
Minority Interest		68,000			
Secured loan					
Unsecured loan					

Current Liabilities and Provisions					
Creditors					
H Ltd.	1,00,000				
S Ltd.	20,000	1,20,000			
		13,60,000			**13,60,000**

(Includes 8,000 Equity shares issued as fully paid by capitalizing Revenue profit)

19.8.1 TREATMENT OF BONUS SHARE

i) Dividend paid

When subsidiary company pays dividend, the holding company will naturally receive its due share. On receipt the holding company will debit bank account. However, account to be credited depends upon whether dividend received out of pre-acquisition profit or out of post-acquisition profit. Dividend received by the holding company out of Pre-acquisition profit should be credited to investment account. Only the dividend out of post-acquisition profit should be treated as Revenue income and credited to profit and loss account.

ii) Proposed dividend:

In case the subsidiary company has proposed dividend on its shares which is not accounted by the holding company for such dividend due on their investment in subsidiary company profits.

Profit may be then analyzed between capital Revenue in the usual manner.

iii) Dividend payable:

In case subsidiary company has declared dividend and the holding company taken credits for such dividend in its account, following treatments should be given

- No adjustment in respect of such dividend should be done in the subsidiary company book.
- In the holding company books dividend out of pre-acquisition profit should be credited investment account. Dividend out of post-acquisition profit should be credited to profit and loss account.
- In the consolidated Balance-sheet the amount of dividend payable by the subsidiary company will be cancelled against the amount of dividend receivable by the holding company. dividend payable to minorities may be either included in the minority interest or be shown separately as liability in the consolidated balance sheet.

iv) Intension to propose dividend:

In case subsidiary company as intension to propose dividend, such proposed dividend given in adjustment may be completely ignored while preparing the consolidated balance sheet.

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Alternatively proposed dividend on share capital held by minority may be deducted from minorities interest and shown separately liability in the consolidated balance sheet.

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19.9 PROVISION FOR TAXATION

Any provision for taxation provided by the subsidiary company should be taken to the consolidated balance sheet and be shown on the liability side.

19.10 PURCHASE OF SHARES IN INSTALLMENT

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.

19.11 SALE OF SHARES

When a holding company disposed off a part of its holding in the subsidiary company and 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.

- 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.
- 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.

19.12 LET US SUM UP

1. Investment in Subsidiary Shares is eliminated against the holding company's share in net assets of the subsidiary. Remaining share is shown as minority interest.
2. Mutual Owing / Inter-company Transactions (e.g., loans, bills, intra-group sales) are cancelled to avoid duplication.
3. Unrealized Profit on intercompany unsold goods is deducted from stock and revenue profits. Minority shareholders remain unaffected.
4. Contingent Liabilities arising from internal group transactions are not shown as footnotes in the consolidated balance sheet.

5. Revaluation of Assets/Liabilities at acquisition affects capital profit and therefore cost of control and minority interest.
6. Bonus Shares:
   - If issued from pre-acquisition (capital) profits: No change in cost of control.
   - If issued from post-acquisition (revenue) profits: Reduces cost of control or increases capital reserve. Minority interest remains unaffected.
7. Dividend Treatment:

   - Pre-acquisition dividend → Credited to Investment Account
   - Post-acquisition dividend → Credited to Profit & Loss Account
   - Inter-company dividend adjustments are eliminated during consolidation.

8. Provision for Taxation by the subsidiary is shown on the liability side in the consolidated balance sheet.
9. Purchase of Shares in Installments: The cut-off date for acquisition of control is used to divide profits between capital and revenue.
10. Sale of Shares by Holding Company: Profit/loss is adjusted in cost of control. Minority interest and goodwill are re-calculated.

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3. CHECK YOUR PROGRESS
FILL IN THE BLANKS

1. Sale of shares by holding company affects the **cost of control** calculation.

ANSWER capital**,** minority

2. **Minority interest** remains unaffected by issue of bonus shares.

ANSWER closing stock**,** revenue profits

3. Dividend payable to holding company is **cancelled** against dividend receivable during consolidation.

ANSWER capital profit

4. Profit or loss on sale of shares is adjusted while calculating **goodwill or capital reserve**.

ANSWER Depreciation

5. If shares are purchased in installments, profits are split between capital and revenue using the **control acquisition date**.

ANSWER Goodwill

19.13 KEYWORDS

- **Bonus Shares**: Shares issued by the subsidiary company to existing shareholders out of accumulated profits or reserves, without charging any amount. These increase share capital but do not change ownership ratio.
- **Mutual Owing / Inter-company Transactions**: Transactions between the holding and subsidiary companies such as loans, sales, bills, etc., which are eliminated in consolidation to avoid duplication
- **Unrealized Profit**: Profit that arises from inter-company transactions but is not realized from the group's perspective (e.g., stock unsold within the group). It is eliminated from consolidated profits and inventory.
- **Revaluation of Assets**: Adjustment of the book value of subsidiary's assets to fair market value at the time of acquisition. The profit/loss arising is treated as capital profit or loss.
- **Minority Interest**: The share of equity and reserves in the subsidiary that belongs to shareholders other than the holding company. It is shown on the liability side of the consolidated balance sheet.
- **Provision for Taxation**: A liability recognized in the books of the subsidiary company for tax payable. It is carried to the consolidated balance sheet as a liability

19.14 SELF ASSESSMENT QUESTION

1. H Ltd. holds 80% in S Ltd. S Ltd. issues ₹50,000 in bonus shares out of post-acquisition profits. Show how it affects:

- Revenue profits
- Cost of control
- Capital reserve

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………………………………………

2. H Ltd. buys 40% of S Ltd. shares in Jan and another 30% in June (total 70%). If profits of S Ltd. from Jan to June = ₹60,000 and July to Dec = ₹1,20,000, split profits into capital and revenue.

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3. H Ltd. acquired 3,000 shares (Rs. 10 each) in S Ltd. for ₹40,000. The net assets of S Ltd. on date of acquisition amounted to ₹36,000. Compute Goodwill/Capital Reserve.

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19.15 LESSON END EXERCISE

1. S Ltd.'s stock includes goods worth ₹80,000 bought from H Ltd., who made 25% profit on cost.

a) Calculate unrealized profit

b) How is it treated in the consolidated balance sheet?

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2. H Ltd. holds 9,000 shares out of 12,000 in S Ltd. S Ltd. issues bonus shares in 1:3 ratio from capital reserve. Show the effect on:

- Share capital
- Capital reserve
- Cost of control

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3. How is the sale of shares by holding company treated in consolidated financials.

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19.16 SUGGESTED READING

- M.C. Shulka, T.S. Grewal and S.C. Gupta, Advance Accounts, S. Chand & Company Ltd, Vol. II.
- S.P. Jain and K.L. Narang, Advanced Accountancy, Kalayani Publishing House.
- M.A. Arulanandam and K.S. Raman, Advanced Accountancy, Himalaya Publishing House, (Part-II

UNIT: 4 **LESSON: 20**

COURSE CODE

PREPARATION OF CONSOLIDATED BALANCE SHEET

STRUCTURE:

20.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

- To understand the consolidated profit and loss statement.
- To acquire skills in solving practical problems.
- To learn about foreign subsidiaries.

Learning Outcomes

- consolidated profit and loss statement.
- To acquire skills in solving practical problems.
- To learn about foreign subsidiary.

20.1 INTRODUCTION

A holding company is a company that owns other companies' outstanding stock. The term usually refers to a company that does not produce goods or services itself; rather, its purpose is to own shares of other companies to form a corporate group. Holding companies allow the reduction of risk for the owners and can allow the ownership and control of a number of different companies.

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In the United States, 80% or more of stock, in voting and value, must be owned before tax consolidation benefits such as tax-free dividends can be claimed. That is, if Company A owns 80% or more of the stock of Company B, Company A will not pay taxes on dividends paid by Company B to its stockholders, as the payment of dividends from B to A is essentially Company A transferring cash from one company to the other. Any other shareholders of Company B will pay the usual taxes on dividends, as they are legitimate and ordinary dividends to these shareholders.

Sometimes a company intended to be a pure holding company identifies itself as such by adding "Holding" or "Holdings" to its name. Holding companies are formed to organize and manage a group of smaller companies. If you are a business owner of investor, you may consider forming a holding company to protect your business assets or get a more favorable tax rate. A holding company ias an entity formed to buy and hold the majority of stock of other companies; a subsidiary is a business whose majority of stock is owned by a holding company. A holding company buys, absorbs or otherwise obtains a majority percentage of stock in another company, which becomes known as its subsidiary. Typically, a holding company must control 50 percent or more of a company's stock before it's considered a subsidiary. Holding companies may also own other holding companies in this case, they're known as top holding companies. The holding company has all rights and responsibilities of ownership for its subsidiaries. The subsidiaries, while not independently owned, often continue to operate as individual entities, though major corporate decisions are made by the holding company. A holding company directs the management and operations of the subsidiaries it owns and maintains the authority to add or remove board members, directors and other key management and personnel. A holding company may have strict managerial control or may allow subsidiaries to act with some level of autonomy for day-to-day business operations, including lower- and midlevel hiring and certain budgeting decisions. A subsidiary has little to no financial control over its operations. Even independently acting subsidiaries are ultimately financially controlled by their holding company. This includes financial activities such as investment decisions, sales projections and budgeting. If a subsidiary was itself a holding company prior to becoming a subsidiary of another holding company, all of its subsidiaries also become subsidiaries of the top holding company.

A company has to either control the Board of directors or hold more than half of the equity capital of the other company. A holding company is any regular corporation, LLC, or LP that owns investments in other companies but doesn't engage in any operations itself. That is, Berkshire Hathaway is a holding company because it doesn't do anything. Instead, it owns 100% of the stock of GEICO, which is an insurance company. It owns 80% or 90% of the stock of Nebraska Furniture Mart, which is a huge furniture retailer.

It owns more than 8% of the stock of Coca-Cola through its insurance holdings. But Berkshire itself just has a handful of employees and a bank vault full of stock certificates. Any money it has comes from dividends paid by the subsidiaries on June 30th and December 31st of each year. It can be used to silo investment assets and protect them, such as Dunkin' Donuts putting its intellectual property into its own LLC. It can be used to transfer wealth to friends and family. If you own a collection of businesses, rental properties, or other valuables, it is far more convenient to transfer shares in a parent company than it is in each individual asset. It can permit you to structure deals so you control far more money than you otherwise could afford. If you had $10 million and used it to buy control of a $20 million insurance group that had $70 million in float, you would be controlling $70 million from your holding company. In essence, a holding company is in the business of providing capital and people. Berkshire Hathaway refuses to provide management to the subsidiaries it purchases; they don't run businesses. General Electric, on the other hand, is one of the greatest machines of all time and can have someone else running a company within 12 hours.

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20.2 CONSOLIDATED PROFIT AND LOSS ACCOUNT

The consolidated profit and loss account of the holding company and its subsidiaries are prepared to show the operating activities of the companies comprising the groups. While preparing the consolidated profit and loss account of the holding company and its subsidiary, the items appearing in the profit and loss account of the holding company and the subsidiary companies have to be aggregated.

But while doing so, the following adjustment have to be made.

- Prepare profit and loss account in columnar form Amounts relating to inter-company transactions are entered in the adjustment column against the respective items and are subtracted while entering amounts in the total columns.
- All inter company operating transactions are eliminated such as purchase and sale of goods, interest on loans among the group companies.
- All inter company profits are adjusted.
- Dividends received from the subsidiary company by the holding company should be eliminated from both the sides of consolidated profit and loss account.
- Interest accrued and outstanding on Debenture of the subsidiary company held by the holding company should be accounted by holding and subsidiary company both and then its should be eliminated.
- Readjustment of Depreciation on Revaluation on fixed Assets at the time of acquisition of shares by the holding company should be adjusted in consolidated balance sheet and respective fixed assets and in the consolidated profit and loss account.
- The minority interest in the profit of subsidiary company should be transferred minority interest account, in the proportion of total profit after adjustment of revaluation of fixed Assets, but before adjusting unrealized profit on stock.
- The share of holding company in pre-acquisition profit should be transferred to cost of control, in case shares are acquired during the year.
- Share of holding company in the past acquisition profits shall be considered as revenue profits.
- The balance in holding company columns will represents the total profit or loss made or suffered by the group as a whole.

o Group Consisting more than one subsidiary: There are three situations

a) A holding company may have a number of subsidiaries without any mutual holding between the subsidies. The following chart will clearly show the position.

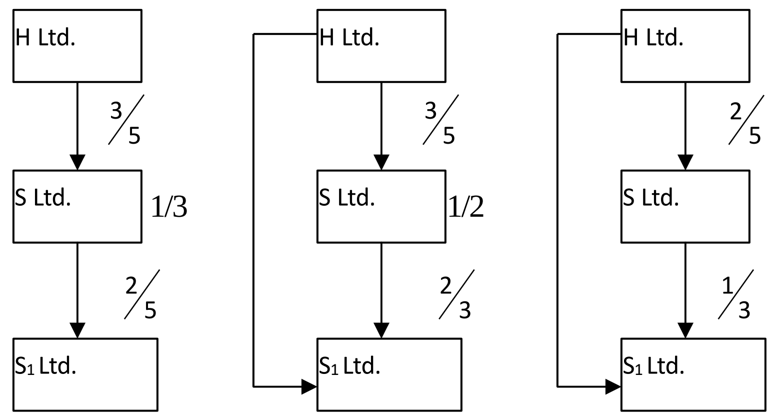
H Ltd.

$\frac{3}{7}$	$\frac{4}{5}$	$\frac{4}{7}$
S_1 Ltd.	S_2 Ltd.	S_3 Ltd.

In this case, the holding company H Ltd. acquired shares of of the $\frac{3}{7}, \frac{4}{5}, \frac{4}{7}$ S_1 ltd. S_2 ltd, S_3 ltd. respectively. And as such the investment account of holding company will show investment in S_1 ltd. S_2 ltd, and S_3 ltd. The calculation of cost of control, minority interest etc. of each company should be done following the usual principles.

b) There may be change holding i.e. the holding company may hold shares in a subsidiary company which is also holding company of its subsidiary company, there may be different combinations which are shown by the following chart.

1 2 3



There may be cross holding i.e., subsidiary company may have shares in the holding company as well. However, according to company's Act, subsidiary company cannot acquire shares in its holding company after becoming subsidiary company, but it can continue to hold those shares in the holding company, which were acquired before it became subsidiary company.

Note: possibilities discuss, 2 and 3 above are at advanced level and therefore not discussed in study material assuming such type of problem should not to be asked in M.com level.

20.3 FOREIGN SUBSIDIARY

Foreign subsidiaries companies final A/c should be consolidated along with other subsidiary companies in the usual manner. The trial balance of the subsidiary or balance sheet and profit and loss A/c of the foreign subsidiary is the first converted into home currency.

The rules of conversion are the same as for foreign branches which can be summarized as under.

a) Fixed Assets and fixed liabilities should be converted at the rate of exchange prevailing as on date when such assets were purchased or such liabilities are incurred or the payment was made if they are acquired or raised after acquisitions of shares.

b) Floating assets and liabilities should be converted at the rate of exchange prevailing on the last day of the accounting year.

c) Revenue items or net profit for the year should converted at the average rate of exchange ruling during the period under review.

d) Opening stock should be converted at the rate of exchange at the beginning of the year.

e) Share capital and Reserves of subsidiary company as on date of acquisition, should be converted at the rate of exchange prevailing on date of acquisition.

f) Any remittances for purchases of goods by subsidiary company from holding company or vice-versa should be converted at the actual rates prevailing on the date of purchase or date of receipt of remittances.

g) Fixed assets / Fixed liabilities as on date of acquisition which are carried forward should be converted at the rate of exchange prevailing on date of acquisition of shares; if rate on date of acquisition on fixed assets not given.

After converting the various items of trial balance, a new trial balance can be prepared, difference if any in the new trial balance should be transferred to exchange fluctuation account. Such difference may be carried and shown in the Balance sheet either as an asset or as a liability depending on whether balance debit or credit, alternatively difference in exchange can be transferred to profits & loss account.

3. CHECK YOUR PROGRESS

Match the following:

Column A	Column B
A. Revenue Profits	1. Pre-acquisition profits
B. Capital Profits	2. Adjusted with Profit & Loss account
C. Post-acquisition profits	3. Share included in cost of control calculation
D. Holding company's share of capital profits	4. Adjusted with Reserves & Surplus of H Ltd
E. Minority interest	5. Outside shareholders' share
F. Capital Reserve	6. Shown on liability side of consolidated B/S
G. Goodwill	7. Paid more than net assets of subsidiary
H. Acquisition Date	8. Divides capital and revenue profits

Answers A 2, B 1, C 4, D 3, E 5, F 6, G 7, H 8

20.4 SOLVED PROBLEMS

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Illustration: 1

The following are summarized Balance Sheets as on March 31, 2010

	H Ltd. Rs.	S Ltd. $
Share capital (Fully 100/ 100$ paid shares of Rs. each)	40,00,000	1,00,000
Reserves & Surplus	15,00,000	50,000
Bank overdraft	4,00,000	20,000
Sundry Creditors	3,50,000	40,000
	62,50,000	2,10,000
Fixed Assets	33,30,000	1,50,000
Investments		
In S. Ltd.	22,80,000	
Other	1,20,000	15,000
Cash at Bank	40,000	5,000
Other Current Assets	4,80,000	40,000
	62,50,000	2,10,000

Other Information

1. H. Ltd. acquired 600 shares in S Ltd. on October 1, 2009.
2. The Reserves of S Ltd. on April 1, 2009 was $ 20,000.
3. Stock of S Ltd. includes goods costing Rs. 10,000 sold by H Ltd. at the invoice price of Rs. 12,500 which were included in the books of S. Ltd. at $300
4. S Ltd. paid in November 2009 an interim dividend at 10% p.a. for 6 months ended 30th September 2009.
5. S Ltd. Remitted the amount due to H Ltd. when rate of exchange was $ 1 = 43. Amount of dividend received was credited to profit & loss account by H Ltd.
6. The Exchange rate were as under on 1st April 2009 $ 1 = Rs. 41.00.

On 30th September 2009 $ 1 = Rs. 42.00

On 31st March 2010 $ 1 = Rs. 44.00

Average rate $ 1 = Rs. 42.50

Prepare consolidated Balance sheet.

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Solution:

Consolidated Balance Sheet of H Ltd. & its subsidiary S Ltd. as on 31st March 2010

Liabilities			Rs.	Assets		Rs.
Share capital				Fixed Assets		
40000 Equity shares of Rs. 100 each			40,00,000	H Ltd.	33,30,000	
Reserves & Surplus				S Ltd.	63,00,000	96,30,000
H Ltd.	15,00,000			Investments		
Less: Stock Res.	2,500			H Ltd.	12,00,000	
	14,98,500			S Ltd.	6,30,000	7,50,000
Less: Pre-acquisition dividend	(1,29,000)	6,500		Current Assets		
Share of S Ltd. (Revenue)		4,22,580	17,91,080	Stock	12,500	
Capital Reserve (on consolidation)			11,88,000	(-) Stock Reserve	2,500	10,000
Current liabilities				Other current Assets		
Bank overdraft				H Ltd.	4,80,000	
H Ltd.		4,00,000		S Ltd.	17,46,800	22,26,800
S Ltd.		8,80,000	12,80,000	Bank Balance		
Sundry Creditors				H. Ltd.	40,000	
H. Ltd.		3,50,000		S. Ltd.	2,20,00	26,00,000
S Ltd.		17,60,000	21,10,000			
Minority interest			25,07,720			
			1,28,76,800			**1,28,76,800**

Working Note:

1. Conversion of S Ltd. Balance Sheet as on 31st March 2010

Particulars	Dr. $	Cr. $	Rate	Dr (Rs.)	Cr. (Rs.)
Share capital		1,00,000	42.00		42,00,000
Reserves & surplus as on 1st April 2003 ($ 20000 – S 5000)		15,000	42.00		6,30,000
Profit for half year up to 30tn September 09		17,500	42.50		7,35,000
For next half year (after 1.10.09)		17,500	42.50		7,43,750
Bank overdraft		20,000	44.00		8,80,000
Sundry Creditors		40,000	44.00		17,60,000
Fixed Assets	1,50,000		42.00	63,00,000	
Investments	15,000		42.00	6,30,000	
Bank	5,000		42.00	2,20,000	
Stock (purchases from H Ltd.)	300		Actual	12,500	
Other current Assets	39,700		44.00	17,46,800	
Difference in Exchange				39,450	
	2,10,00	2,10,000		89,48,750	89,48,750

Working 2)

Analysis of Reserve & Surplus as on 31st March 2010

Reserve surplus balances.			50,000
Less: Balance as on 1st April 2009.	(20,000)		
Less: Interim Dividend paid	(5000)	(15,000)	
Profit for the year			**35,000**

□Profit up to date of acquisition up to 30th September is equal to 17,500 and Balance profit post-acquisition is equal to $ 17,500.

Working 3) Analysis of profit	Capital (Rs.)	Revenue (Rs.)
Balance as on 1st April 2009	6,30,000	
Profit up to date of Acquisition	7,35,000	
Profit after the Acquisition		7,43,750
Difference in exchange		(39,450)
	1,36,500	74,300
Less – Minority Interest (2/5th)	(5,46,000)	2,81,720
Balance to H Ltd.	8,19,000	4,22,580

Cost of control / capital Reserve	Rs.
Cost of investment in S Ltd.	22,80,000
Less: Pre-acquisition dividend received **(5000** □ 3/5) = 3,00 * 43	(1,29,000)
	21,51,000

Illustration 2:

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The following are summarized Balance Sheets of 'X' Ltd. and 'Y' Ltd. as on 31st December 2010

	X Ltd.	Y Ltd		X Ltd.	Y Ltd.
Paid up capital in			Freehold premises	4,50,000	1,20,000
Shares of Rs. 100 each	10,00,000	3,00,000	Plant & Machinery	3,50,000	1,60,000
General reserve	4,00,000	1,25,000	Furniture	80,000	30,000
Profit and Loss A/c	3,00,000	1,75,000	Debtors	3,00,000	1,70,000
Sundry Creditors	1,00,000	70,000	Stock investment in	3,20,000	1,60,000
			Shares in Y Ltd. at cost	2,60,000	-
			Cash balance	40,000	30,000
	18,00,000	6,70,000		18,00,000	6,70,000

You are required to prepare a consolidated Balance Sheet as on 31st December 2010. Showing in detail necessary adjustments and taking into consideration the following information

a) 'X' Ltd. acquired the shares of Y Ltd. on 1.1.2010 when the balance on their profit and Loss account and general reserve were Rs. 75000 and Rs. 80000 respectively.

b) Stock of Rs. 1,60,000 held by 'Y' Ltd. consists of Rs. 60,000 goods purchased from 'X' Ltd. Who has charges profit at 25% on cost.

c) Included in Debtors of X Ltd. Rs. 30000 due from Y Ltd.

Consolidated Balance Sheet of X Ltd. and Y. Ltd. as on 31.12.2010

Liabilities	Rs.	Assets	Rs.
Share capital in shares of Rs. 10 each	10,00,000	Fixed Assets	
Reserves & Surplus		Freehold premises (4,50,000 + 1,20,000)	5,70,000
Capital Reserve	43,333	Plant & Machinery (3,50,000 + 1,60,000)	5,10,000
General Reserve (4,00,000+30,000)	4,30,000	Furniture (80,000 + 30,000)	1,10,000
Profit & Loss A/c (2,92,000+66,667)	35,867	Investment	NIL
Secured Loans	NIL	Current Assets	
Current Liabilities Provisions	NIL	Loans & Advances Stock (320000 + 160000) 480000	
Creditors (1,00,000 + 70,000)	1,70,000	Less: Unrealized profit 12000	4,68,000
Minority Interest	2,00,000	Debtors (300000 +	4,70,000

		170000)	
		Cash (40000 + 30000)	70,000
	21,98,000		21,98,000

Notes:

1) Calculation of Capital Reserve

Investment cost		2,60,000
Less: i) Share in share capital	(2,00,000)	
Less: ii) Propionate Pre-acquisition profit (1,55,000 *2/3)	(1,03,333)	3,03,333
Capital Reserve		(43,333)

2) Minority Interest

Share in Share Capital	1,00,000
⅓ rd of General Reserve	41,667
⅓ rd of Profit & Loss A/c	58,333
	2,00,000

3) General Reserve

of X Ltd.				4,00,000
of Y Ltd. (125000- Pre-acquisition 8000)			45,000	
Less: due to minority shareholders (⅓)	15,000	30,000		
			4,30,000	

4)Unrealized profit

Unrealized profit = 20% of 60,000 — 12,000

5) Profit & Loss Account

X Ltd. (300000-unrealised profit)		2,88,000
Y Ltd. (175000-Pre-acquisition 75,000)	1,00,000	
Less: ⅓ rd. of minor	33,333	
		66,667
		3,54,667

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Illustration: 3

H Ltd. acquired 8,000 shares of Rs. 10 each in K Ltd. on 31st March 2011. The summarized Balance Sheets of the two companies as on that date were as follows:

Particulars		H Ltd. Rs.	K Ltd. Rs.
Liabilities:			
Share Capital:			
30,000 Shares of Rs. 10 each	... ...	3,00,000	
10,000 Shares of Rs. 10 each	... ...	-	1,00,000
Capital Reserve	... ...	-	52,000
General Reserve	... ...	25,000	5,000
Profit & Loss Account	... ...	38,200	18,000
Loan from I Ltd.	... ...	2,100	-
Bills payable (including Rs. 1,000 to H Ltd.)	... ...	-	1,700
Creditors	... ...	17,900	5,000
		3,83,200	1,81,700
Assets:			
Fixed Assets		1,50,000	1,44,700
Investments in K Ltd. at cost	... ...	1,70,000	-
Stock-in-hand	... ...	40,000	20,000
Loan to H Ltd.	... ...	-	2,000
Bills Receivable (including Rs. 700 from K Ltd.)	... ...	1,200	-
Debtors	... ...	20,000	10,000
Bank	... ...	2,000	5,000
		3,83,200	1,81,700

You are given the following information:

1) K Ltd. made a bonus issue on 31st March 2011 of one share for every two shares held, reducing the capital reserve equivalently, but the transaction is not shown in the above Balance Sheets.
2) Interest receivable (Rs. 100) in respect of the loan due by H Ltd. to K Ltd. has not been credited in the account of K Ltd.
3) The directors decided that the fixed assets of K Ltd. were overvalued and should be written down by Rs. 5,000.

Prepare the Consolidated Balance Sheet as at 31st March 2011, showing your workings.

Solution: Consolidated Balance Sheet of K Ltd. and its Subsidiary K Ltd. as at 31st March, 2011

LIABILITIES	Rs.	Rs.	ASSETS	Rs.	Rs.
Share Capital			Fixed Assets		
Equity Share Capital			Goodwill (on consolidation)		33,920
30,000 Equity shares of Rs. 10 each, fully paid		3,00,000	Other Fixed Assets	1,50,000 1,39,700	2.89.700
Reserves & Surplus			Current Assets, Loans & Advances		
General Reserves	25,000		Stock	40,000 20,000	60.000
P & L A/c H Ltd.	38,200	63,200			
Minority Interest		34,020	Debtors	20,000 10,000	30,000
Current Liabilities & Provisions			Bills Receivable	1,200	
Creditors					1,000
H Ltd.	17,900		Less: Mutual Dues	(200)	
K Ltd.	5,000	22,900			
Bills Payable	1,700		Cash & Bank	2,000 5,000	7.000
Less: Mutual Dues	(200)	1,500			
Total		4,21,620	Total		4,21,620

1) Holding Proportion

H Ltd.

12000/15000 = 4/5

Minority Interest $\square \dfrac{3,000}{15,000} \square 1/5$

1) Analysis of profits

			Capital Profit	Revenue Profit
P/L as on date of Acquisition	18,000			
Add: Interest due on balance	100		18,100	-
Reserve on date of Acquisition				
Capital			52,000	-
General			5,000	-
			75,100	-
Less: Bonus Issue		50,000		
Loss on Revaluation of		5,000	(55,000)	-

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Fixed Assets

	20,100	-
Holding Co. Minority Interest $\frac{4}{5}$	16,080	-
○ $\frac{1}{3}$	4,020	-

3) **Cost of control**		
Cost of Investment		1,70,000
Less: Equity Share Capital	1,20,000	
(Including Bonus)		
Capital Profit	16,080	(1,36,080)
Goodwill		**33,920**
4) **Minority Interest**		

Share Capital	30,000
Share in Capital Profit	4,020
	34,020

Illustration: 4

Balance Sheet as on 31st March, 2011

Liabilities	H Ltd. (Rs.)	S. Ltd. (Rs.)
Share capital:		
6% Preference shares of Rs. 10 each	-----	1,60,000
Equity shares of Rs. 10 each	6,00,000	2,00,000
General Reserve	1,00,000	80,000
Profit and loss account	2,00,000	90,000
6% debentures of Rs. 10 each	-----	40,000
Proposed dividend:		
On Equity shares	60,000	20,000
On Preference shares	-----	9,600
Debenture's interest accrued	-----	2,400
Sundry creditors	2,94,000	1,25,000
	12,54,000	7,27,000
Assets		
Fixed assets	5,00,000	4,40,000
15000 Equity shares in S Ltd.	3,30,000	-----
12000 Preference shares in S. Ltd.	1,20,000	-----
1000 6% debentures in S Ltd.	10,000	-----
Current assets	2,94,000	2,87,000
	12,54,000	7,27,000

Other information is as under:

1) The general reserve of S Ltd. as on 31.03.2010 was Rs. 80,000

2) H. Ltd. acquired the shares in S Ltd. on 31.03.2010

3) The balance of profit and loss account of S Ltd. is made up as follows:

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	Rs.	
Balance as on 31.03.2010	56,000	
Net profit for the year ended 31.03.2010		63,600
		1,19,600
Less: Provision for proposed dividend		29,600
		90,000

1) The balance of profit and loss account of S Ltd. as on 31.03.2010 is after providing for Preference dividend of Rs. 9,600 and proposed dividend of Rs. 10,000 both of which were subsequently paid and credited to profit and loss account of H. Ltd.

2) No entries have been made in the books of H. Ltd. for debentures interest due from or proposed dividend of S. Ltd. for the year ended on 31.03.2011.

3) S. Ltd. has issued fully paid bonus shares of Rs. 40,000 on 31.03.2011 among the existing shareholders by drawing upon the general reserves. The transaction has not been given effect to in the books of S. Ltd.

You are required to prepare the consolidated balance sheet of H. Ltd. with its subsidiary S. Ltd. as on 31st March, 2011.

Solution:

H Ltd. consolidated Balance Sheet with its Subsidiary S Ltd. as on 31st March, 2011

Liabilities		Rs.	Assets		Rs
Share capital:			**Fixed Assets :**		
Equity shares of Rs. 10 each		6,00,000	Goodwill		63,300
Minority Interest		1,39,900	Other Fixed Assets :		
Reserve and Surplus :			H. Ltd.	5,00,000	
General Reserve		1,00,000	S. Ltd.	4,40,000	9,40,000
Profit & Loss A/c	2,00,000		Investments		--
Add: Deb. Interest	600		Current Assets		
Profit from			**Loans & Advances:**		
S. Ltd.	47,700		H. Ltd.	2,94,000	
	2,48,300		S. Ltd.	2,87,000	5,81,000
Less :			**A. Current Assets:**		

Dividend from S. Ltd. for 2010	14,700	2,33,600	Deb. Interest due	600	
			Less : Mutual obligation	600	---
Secured Loans:					
6% Debentures	40,000		B. Loans and Advances		---
Less: Mutual obligation	10,000	30,000			

Debenture Interest outstanding		1,800			
Current Liabilities & Provisions					
A. Current Liabilities					
Creditors					
H. Ltd.	2,94,000				
S. Ltd.	1,25,000	4,19,000			
B. Provisions					
Proposed Dividend (H. Ltd.)		6,000			
		1584300			1584300

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Working Notes:

1.	**Capital Profit**	**Rs.**
	General Reserve	80,000
	Profit & Loss A/c	56,000
		1,36,000
	Less : Bonus Shares	40,000
		96,000
	Holding Company (¾)	72,000
	Minority Interest (¼)	24,000
2.	**Revenue Profit** Profit and Loss A/c	90,000
	Less: Balance on 1.04.2010	56,000
	Add: Proposed dividend for current year	34,000
Ad	Add: i.e., for the period after acquisition of shares	29,600
		63,600
	Holding Company (¾)	47,700
	Minority Interest (¼)	15,900
3.	Bonus Shares	40,000
	Holding Company (¾)	30,000
	Minority Interest (¼)	10,000
4.	Goodwill / Cost of Control Cost of shares acquired: Equity shares	3,30,000
	Preference shares	1,20,000
		4,50,000

Less: Dividend for 2009-10		
Equity (10000 ×¾)	7500	
Preference (9600 ×¾)	7200	14,700
4,35,300		
Less: Paid-up value of shares acquired		
Equity Shares	1,50,000	
Preference shares	1,20,000	
Capital profit	72,000	
Bonus shares (Equity)	30,000	3,72,000
goodwill		**63,300**

1) Minority Interest

Share capital (Equity)	50,000	
Bonus shares (Equity)	10,000	
Preference capital	40,000	
Capital profit	24,000	
Revenue profit	15,900	
		1,39,900

Illustration : 5

More than one subsidiary company H. Ltd. Owns 80% of issued capital of A Ltd. and 90% of issued capital of B Ltd. The following are the balances of all companies as on 31.03.2010.

Assets	H. Ltd.	A. Ltd.	B. Ltd.
Fixed Assets	3,40,000	20,000	54,000
Less : Provision for depreciation	1,40,000	12,000	18,000
	2,00,000	8,000	36,000
Current Assets	5,36,000	1,00,000	1,00,000
Investments			

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Shares in A. Ltd.	30,000		
Shares in B Ltd.	50,000		
Current Accounts			
A. Ltd.	40,000		
B. Ltd.	40,000		
Liabilities	8,96,000	1,08,000	1,36,000
Share capital	6,40,000	40,000	50,000
Current Liabilities	80,000	12,000	20,000
Current Accounts	-----	44,000	36,000
Proposed dividend	40,000	-----	5,000
Revenue Reserve	1,36,000	12,000	25,000
	8,96,000	**1,08,000**	**1,36,000**

Additional Information:

1) At the time of acquiring the shares the subsidiaries had the following Revenue Reserves.

A. Ltd. Rs. 12,000

B. Ltd. Rs. 6,000

2) Neither of the subsidiaries has paid any dividend since acquisition of shares.

Payment of creditors of A. Ltd. H. Ltd. to the extent of Rs. 4,000 has not been considered in the books of A. Ltd.

3) A remittances of Rs. 4,000 by B. Ltd. to H. Ltd. has not yet been adjusted in the books of H. Ltd.

4) The stock of H. Ltd. includes Rs. 6,000 purchased from H. Ltd. which made 25% profit on cost. H. Ltd. stock includes Rs. 5,000 purchased from B. Ltd. which made 20% profit on sales B. Ltd. stock includes Rs. 8,000 (Cost of Rs. 6,000) purchased from A. Ltd.

Prepare the consolidated Balance Sheet of H. Ltd. and its subsidiaries A. Ltd. and B. Ltd.

Solution :

Consolidated Balance Sheet of H. Ltd. & its subsidiaries A Ltd. & B. Ltd. as at 31st March 2010

Liabilities		**Rs.**	**Assets**		**Rs.**
Share Capital			Fixed Assets		
Authorized Capital		-	H. Ltd.	240000	
Issued, Subscribed & paid-up capital		640000	A. Ltd.	20000	
Minority Interest			B. Ltd.	54000	
A. Ltd.	10000	18400		414000	
B. Ltd.	8000		Less : Pro for Depre.	170000	244000
Reserve & Surplus			Investments		-----
Capital Reserves on consolidation			Current Assets		
A. Ltd.	11600		Loans & Advances		
B. Ltd.	400	12000	A) Current Assets		
Revenue Reserve	----	1,53,400	H. Ltd.	536000	
Secured Loans	-----		A. Ltd.	100000	
Unsecured loans	-----		B. Ltd.	100000	

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Current Liabilities & Provision	731800			736000	
A) Current Liabilities			Less : Profit included in stock	4200	
H. Ltd. 12000	40000			731800	
A. Ltd. 4000	8000		Add : Cash in transit	4000	735800
Less : Payment by H. Ltd.			B) Loans & Advances	-----	
B. Ltd.	(20000)	108000			
B) Provision					
Suspense Account		8000			
Proposed dividend		40000			
		979800			979800

Unexpected credit by H. to A

Note : Difference in current A/c has been treated as cash in transit.

Paid up value of shares held by outsiders 25000 × 1/10	5000
Add: 1 / 1 0 share of pre-acquisition Revenue Reserve	600
Add : 1/10th share of post-acquisition Revenue Reserve	2400
	8000
5. Cost of control in B. Ltd. intrinsic value of the shares in B. Ltd.	
Paid up value of the shares held 9/10 × Rs. 50000	45000
Add : 9/10th shares of pre-acquisition Revenue	5400
Reserve in B. Ltd.	
Intrinsic value of the shares held	50400
Less : Price paid for the shares held	50000

Capital Reserve	400
6. Unrealise profit included in stock of B. Ltd. Unrealised Profit = Rs. (8000-6000)	2000
H Ltd. share of unrealized profit Rs. 1000 × 9/10 × 8/10	1440
C. H. Ltd.	
1. Unrealized profit included in stock of H. Ltd. cost price is the selling price of B Ltd. Unrealized profit = Rs. 10000 × 20/100 × 9/10 = 1800	

2. Revenue Reserves of H. Ltd.	
Revenue Reserves as per Balance sheet	136000
Add : 9/10 share of post-acquisition Revenue Reserve in A Ltd.	21600
	157600
Less : Unrealised profit included in stock (960+1440+1800)	(4200)
Adjusted Balane	153400

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1. CHECK YOUR PROGRESS

TRUE OR FALSE

1. Bonus shares issued out of post-acquisition profit reduce revenue profit.

ANSWER ☑ **True**

2. Dividend from pre-acquisition profit is treated as revenue income.

ANSWER ✕ **False**

3. Minorities are affected by bonus shares issued from capital profits.

ANSWER ✕ **False**

4. Proposed dividends on minority shares can be shown as a separate liability.

ANSWER ☑ **True**

5. Profit on sale of shares by holding company is excluded from cost of control.

ANSWER ✕ **False**

2. CHECK YOUR PROGRESS

FILL IN THE BLANKS

1. Investment in shares of a subsidiary is eliminated against the __________ of the subsidiary company.

   Answer: net assets

2. The share of outside shareholders in the subsidiary is shown as __________ in the consolidated balance sheet.

   Answer: minority interest

3. Mutual owing refers to __________ between holding and subsidiary companies.

   Answer: inter-company transactions

4. Unrealized profits arise when goods remain __________ at the end of the year.

   Answer: unsold

5. Contingent liabilities arising out of internal transactions are __________ in the consolidated balance sheet.

   Answer: not shown separately

20.5 LET US SUM UP

A holding company is a company that owns other companies' outstanding stock. The term usually refers to a company that does not produce goods or services itself; rather, its purpose is to own shares of other companies to form a corporate group. Holding companies allow the reduction of risk for the owners and can allow the ownership and control of a number of different companies. In the United States, 80% or more of stock, in voting and value, must be owned before tax consolidation benefits such as tax-free dividends can be claimed. That is, if Company A owns 80% or more of the stock of Company B, Company A will not pay taxes on dividends paid by Company B to its stockholders, as the payment of dividends from B to A is essentially Company A transferring cash from one company to the other. Any

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other shareholders of Company B will pay the usual taxes on dividends, as they are legitimate and ordinary dividends to these shareholders. Sometimes a company intended to be a pure holding company identifies itself as such by adding “Holding” or “Holdings” to its name. After the financial crisis of 2007–08, many U.S. investment banks converted to holding companies. According to the Federal Financial Institutions Examination Council’s (FFIEC) website, JPMorgan Chase & Co., Bank of America Corp., Citigroup Inc., Wells Fargo & Co., and Goldman Sachs Groups, Inc. were the five largest bank holding companies in the finance sector, as of 31 December 2013, based on total assets. The Public Utility Holding Company Act of 1935 in the United States caused many energy companies to divest their subsidiary businesses. Between 1938 and 1958 the number of holding companies declined from 216 to 18. An energy law passed in 2005 removed the 1935 requirements, and has led to mergers and holding company formation among power marketing and power brokering companies. In US broadcasting, many major media conglomerates have purchased smaller broadcasters outright, but have not changed the broadcast licenses to reflect this, resulting in stations that are (for example) still licensed to Jacor and Citicasters, effectively making them such as subsidiary companies of their owner iHeartMedia. This is sometimes done on a per-market basis. For example, in Atlanta both WNNX and later WWWQ are licensed to “WNNX LiCo, Inc.” (LiCo meaning “license company”), both owned by Susquehanna Radio (which was later sold to Cumulus Media). In determining caps to prevent excessive concentration of media ownership, all of these are attributed to the parent company, as are leased stations, as a matter of broadcast regulation.

In the United States, a personal holding company is defined in section 542 of the Internal Revenue Code. A corporation is a personal holding company if both of the following requirements are met: Gross income test: At least 60% of the corporation’s adjusted ordinary gross income is from dividends, interest, rent, and royalties. Stock ownership test: More than 50% in value of the corporation’s outstanding stock is owned by five or fewer individuals. A parent company is a company that owns enough voting stock in another firm (subsidiary) to control management and operations by influencing or electing its board of directors. A parent company could simply be a company that wholly owns another company. This would be known as a “wholly owned subsidiary”. When an existing company establishes a new company and keeps majority shares with itself, and invites other companies to buy minority shares, it is called a parent company.

Consolidated financial statements present the financial position and results of operations for a parent (controlling entity) and one or more subsidiaries (controlled entities) as if the individual entities actually were a single company or entity. Consolidation is required when a corporation owns a majority of another corporation’s outstanding common stock. The accounting principles applied in the preparation of the consolidated financial statements are the same accounting principles applied in preparing separate-company financial statements. Two companies are considered to be related companies when one controls the other company. Consolidated financial statements are generally considered to be more useful than the separate financial statements of the individual companies when the companies are related. Whether the subsidiary is acquired or created, each individual company maintains its own accounting records, but consolidated financial statements are needed to present the companies together as a single economic entity for general-purpose financial reporting. Consolidated financial statements are presented primarily for the benefit of the shareholders, creditors, and other resource providers of the parent. Significantly, consolidated financial statements often represent the only means of obtaining a clear picture of the total resources of the combined entity that are under the control of the parent company. While consolidated financial statements are useful, their limitations also must be kept in mind. Some information is lost any time data sets are aggregated; this is particularly true when the information involves an aggregation across companies that have substantially different operating characteristics. Subsidiaries are legally separate from their parents, the creditors and stockholders of a subsidiary generally have no claim on the parent, nor do the stockholders of the subsidiary share in the profits of the parent. Therefore, consolidated financial statements usually are of little use to those interested in obtaining information about the assets, capital, or income of individual subsidiaries.

20.6 KEYWORDS

- **Holding Company:** The terms "holding company" is used to describe the financial, managerial, legal and governing relationships between different types of business organizations, including corporations and financial institutions. A holding company is an entity formed to buy and hold the majority of stock of other companies; a subsidiary is a business whose majority of stock is owned by a holding company. A company has to either control the Board of directors or hold more than half of the equity capital of the other company.
- **Subsidiary company:** is a business entity that is controlled by another organization through ownership of a majority of its voting stock. This separate legal structure may be used to gain certain tax benefits, track the results of a separate business unit, segregate risk from the rest of the organization, or prepare certain assets for sale. A larger business may own dozens or even hundreds of subsidiary companies.
- **Minority Interest:** The claim of outside shareholders in the subsidiary company has to be assessed and shown as liability in the consolidated balance sheet. Minority interest in the net assets of the

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company is nothing but the proportionate share of aggregation of share capital, reserve surpluses funds etc. proportionate share of all assets should be deducted from the minority interest.

- **Unrealised Profits:** The problem of unrealized profit arises in those cases where the companies of the same group have sold goods to each other at the profits and goods still remain unsold at the end of the year company to whom the goods are sold. While preparing the consolidated balance sheet, unrealized profit has to be eliminated from the consolidated balance sheet in the following manner. Unrealised profits should be deducted from the current revenue profits of the holding company. The same should be deducted from the stock of the company consolidated balance sheet. Minority shareholders will not be affected in any way due to unrealized profits.

- **Revenue Profits / Losses** These are otherwise known as post-acquisition profits/ losses. These profits/losses are earned By S Ltd after the acquisition shares by H Ltd. These profits/losses are to divided among h Ltd and outsiders on th ebasis of their shareholding proportions. H Ltd' share of revenue profits/losses is added/deducted from its P&l account in the consolidated balance sheet. The outsiders' share of revenue profits/losses is adjusted on minority interest.

- **Capital Reserve:** Capital Profit: The holding company may acquire the shares in the subsidiary company either on the balance sheet date or any date earlier than balance sheet date. All the profit earned by the subsidiary company till the date of acquisition of shares by holding company have to be taken as capital profits for the holding company. Such reserves loose their individual identity and considered as capital profits. In case, the holding company acquired shares on a date other than balance sheet date of subsidiary, the profits of subsidiary company will have to be apportioned between capital profits and Revenue profits from the point of view of the holding company.

- **Consolidated Balance sheet:** Consolidated balance sheet is a single balance sheet of holding and subsidiary companies. In India, it is not compulsory on the part of the holding company to prepare the consolidated balance sheet. But in England, it is a must on the part of the holding company to prepare the consolidated balance sheet in addition to its normal balance sheet. A consolidated balance sheet presents the assets and liabilities of a parent company and all its subsidiaries on a single document, with no distinctions on which items belong to which companies.

20.7 SELF-ASSESSMENT QUESTIONS

1. The following are the profit and Loss accounts of H. Ltd. and S. Ltd. for the year ended 31st March, 2010.

Particulars	H. Ltd.	S. Ltd.	Particulars	H. Ltd.	S. Ltd.

To Opening Stock	100000	-	By Sales	800000	650000
To Purchases	500000	400000	By Closing Stock	150000	100000
To Productive Wages	1,50,000	100000			
To Gross Profit c/d	200000	250000			
	950000	750000		950000	750000
To Sundry Expenses	75000	100000	By Gross Profit b/d	200000	250000
To Debentures Interest	-	6000	By Debenture interest	3000	--
To Provision for Taxation	60000	70000			
To Profit c/d	68000	74000			
	203000	250000		203000	250000
To Preference Dividend	-	3000	By Profit b/s	68000	74000
To Proposed Dividend	20000	20000			
To Corporate Dividend Tax	2000	2300			
To Balance c/d	46000	48700			
	68000	74000		68000	74000

You are also given the following additional information:

1) H. Ltd. holds 1500 Equity shares of Rs. 100 each in S. Ltd. whose capital consists of 2000 Equity shares of Rs. 100 each and 6% 500 cumulative Preference shares of Rs. 100 each. S. Ltd. has also issued 6% Debentures of Rs. 100000 out of which H. Ltd. holds Rs. 50000.

2) The shares in S. Ltd. were acquired by H. Ltd. on 1st July 2009 but the debentures were acquired on 1st April 2009 S. Ltd. was incorporated on 1st 2009.

3) During the year S. Ltd. sold H. Ltd. goods costing Rs. 50000 at the selling price of Rs. 75000. One fourth of the goods manufactured remained unsold on 31st March 2010. The goods were valued at cost to the holding company for closing stock purpose.

Prepare a consolidated profit and loss account.

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2. The following are the Profit & Loss A/c of H. Ltd. & S. Ltd. for the year ended March 31st, 2011

Particulars	H. Ltd. `	S. Ltd. `		H. Ltd. `	S. Ltd. `
To Opening Stock	2,00,000	1,00,000	By Sales	19,80,000	14,00,000
To Purchases	12,00,000	7,50,000	By Closing Stock	2,10,000	60,000
To Carriage	20,000	10,000			
To Wages	2,10,000	80,000			
To Gross Profit c/d	5,60,000	5,20,000			
	21,90,000			21,90,000	14,60,000
To Salaries	95,000	45,000	By Gross Profit b/d	5,60,00	5,20,000
To Rent	40,000	25,000	By Commission	1,00,000	
To Commission	-	50,000	By Debenture Interest S Ltd.	10,000	
To Sundry Expenses	65,000	25,000	By Rent	40,000	
To Debentures Interest	-	25,000			
To Provision for Taxation	1,90,000	1,10,000			
To Net Profit c/d	3,20,000	2,40,000			

	7,10,000	5,20,000		7,10,000	5,20,000
To Preference Dividend	-	40,000		1,00,000	40,000
To Proposed Dividend	90,000	60,000	By Balance B/d By Net Profit B/fd	3,20,000	2,40,000
To Corporate Dividend Tax	15,021	16,690			
To Balance carried to Balance sheet	3,14,979	1,63,310			
	4,20,000	2,80,000		4,20,000	2,80,000

You are given following additional information:

1. H. Ltd. acquired 3000 Equity shares in S. Ltd. on 1st October 2010, of 4000 Equity shares of S. Ltd. However, Debentures were acquired on 1st April 2009.

2. During the year H. Ltd. sold goods to S Ltd. Costing ` 60,000 for 80,000. One fourth of the goods remained unsold on March 31st 2011. It is included in closing stock at cost to S. Ltd.

3. Commission, rent credited to profit & Loss A/c of H. Ltd. include 40,000, ` 10,000 received from S. Ltd.

Prepare a consolidated profit and Loss A/c for the year ended March 31st 2011.

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3. State in brief procedure for consolidation of Foreign subsidiary company; Balance State in brief procedure for consolidation of Foreign subsidiary company; Balance Sheet with Indian Holding Company.

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20.8 LESSON END EXERCISE

1. The following are the profit and Loss accounts of H. Ltd. and S. Ltd. for the year ended 31st March, 2010.

Particulars	H. Ltd.	S. Ltd.	Particulars	H. Ltd.	S. Ltd.
To Opening Stock	100000	-	By Sales	800000	650000
To Purchases	500000	400000	By Closing Stock	150000	100000
To Productive Wages	1,50,000	100000			
To Gross Profit c/d	200000	250000			
	950000	750000		950000	750000
To Sundry Expenses	75000	100000	By Gross Profit b/d	200000	250000
To Debentures Interest	-	6000	By Debenture interest	3000	--
To Provision for Taxation	60000	70000			
To Profit c/d	68000	74000			
	203000	250000		203000	250000
To Preference Dividend	-	3000	By Profit b/s	68000	74000
To Proposed Dividend	20000	20000			
To Corporate Dividend Tax	2000	2300			
To Balance c/d	46000	48700			
	68000	74000		68000	74000

You are also given the following additional information:

1. H. Ltd. holds 1500 Equity shares of Rs. 100 each in S. Ltd. whose capital consists of 2000 Equity shares of Rs. 100 each and 6% 500 cumulative Preference shares of Rs. 100 each. S. Ltd. has also issued 6% Debentures of Rs. 100000 out of which H. Ltd. holds Rs. 50000.

2. The shares in S. Ltd. were acquired by H. Ltd. on 1st July 2009 but the debentures were acquired on 1st April 2009 S. Ltd. was incorporated on 1st 2009.

3. During the year S. Ltd. sold H. Ltd. goods costing Rs. 50000 at the selling price of Rs. 75000. One fourth of the goods manufactured remained unsold on 31st March 2010. The goods were valued at cost to the holding company for closing stock purpose.

Prepare a consolidated profit and loss account.

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2.H Ltd. acquired 12,000 Equity shares of Rs. 10 each in S Ltd. on December 31, 2010. The summarized Balance sheets of H Ltd. and S Ltd. as on that date were.

Balance sheet as on 31st December, 2010

Liabilities	H Lrd. Rs.	S Ltd. Rs.		H Ltd. Rs.	S Ltd. Rs.
Capital A/c Authorized			Fixed Assets	5,06,000	1,56,000
Issue and paid-up	8,00,000	2,40,000	Investment in S Ltd. at cost 12000 shares of Rs. 10 each	2,00,000	--
12,000 shares of Rs. 5 each	6,00,000		Stock in hand	60,000	20,000
16,000 shares of Rs. 10 each		1,60,000	Bills receivable (including Rs. 2000	4,000	

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			from S Ltd.)		
Capital Reserve ○		68,000	Debtors and balance at bank	4,000	34,000
General Reserve	40,000	20,000			
Profit and loss A/c	1,00,000	20,000			
Bills payable (Including Rs. 2000 to H Ltd.)		7,000			
Creditors	70,000	35,000			
	8,10,000	3,10,000		8,10,000	3,10,000

Note: (Re Balance sheet of H Ltd.) contingent liability for bills discounted Rs. 2400)

On 31.12.10 subsidiary Ltd. utilized part of its capital Reserve to make a bonus issue of every Four shares held, effect of bonus not given in above balance sheet.

You are required to prepare the consolidated balance sheet as on 31.12.10 and show there in how your figures are made up.

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3. Why profit of subsidiary company is divided into pre and post-acquisition.

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20.9 SUGGESTED READING

- M.C.Shulka, T.S.Grewal and S.C.Gupta, Advance Accounts, S.Chand & CompanyLtd,Vol.II.
- S.P. Jain and K.L. Narang, Advanced Accountancy, Kalayani Publishing House.
- M.A. Arulanandam and K.S. Raman, Advanced Accountancy, Himalaya Publishing House, (Part-II).