# *Directorate of Distance Education*

**UNIVERSITY OF JAMMU**
**JAMMU**

# SELF LEARNING MATERIAL

**OF**

**ADVANCED ACCOUNTING**

**M. COM. - II SEMESTER**

**For the Examination to be held in 2023 onwards**

**COURSE NO. : M. COM-C250** **UNIT : I-IV**

**LESSON NO. 1-20**

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# ADVANCED ACCOUNTING

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**DIRECTORATE OF DISTANCE EDUCATION**
**UNIVERSITY OF JAMMU**
**M. COM. SECOND SEMESTER (NON CBCS)**
**ADVANCED ACCOUNTING**
**(Core Course)**

| | |
|---|---|
| **Course: M. COM C250** | **Max Marks: 100 Marks** |
| **Credit: 4** | **External: 80 Marks** |
| **Time: 3.00 Hrs** | **Internal: 20 Marks** |

**(Syllabus for the examination to be held in May 2023, 2024, 2025)**

## COURSE OBJECTIVES

1. To sensitise the students about the need for corporate merger and acquisitions for achieving fast growth and maximize shareholders value in the context of ever increasing competition thrown up by liberalization and globalization of Indian economy.
2. To familiarise the students with the significance of rate of return on capital employed and financial evaluation of lease.
3. To make the students to develop knowledge of holding company accounts.
4. To make the students specialised in the preparation of cash flow and funds flow statements.

## COURSE OUTCOMES

After the completion of this course, the students will be able to:

1. develop competencies in Identifying opportunities/areas for mergers, demergers, amalgamations and takeovers etc. carrying out valuations involved therein, building up strategies for them and evaluating the post restructuring performance of the enterprise;

2. have deeper understanding of methods of valuation of profit for return on capital employed, financial evaluation of lease, methods of computing lease rentals and have greater confidence in their application;

3. prepare consolidated financial statements of Molding and subsidiaries companies with appropriate accounting standards;

4. demonstrate knowledge of preparation of funds flow cash flow statements in accordance with generally accepted accounting principles through analysis and synthesis of information as well;

5. prove proficiency with the ability to engage in competitive exams like CA, CS, ICWA and other courses.

**UNIT-I FINANCING FOR EXPANSION (MERGERS AND ACQUISITIONS) (9-109)**

Basics of mergers and acquisitions; Nature and forms of expansion; Forms of combination; Economics/ Reasons of merger; Types of mergers; Legal and procedural aspects of mergers; Valuation of firms; forms of-financing a merger; Capital structure after merger and consolidations; Financial problems of merger and consolidations; Mergers in India; Ind AS 103-Business Combinations; SEBI (Substantial acquisition of shares takeovers) Regulations. 2016; Computation of share exchange ratio, Pre-merger EPS and Post-merger EPS.

**UNIT II VALUATION OF RATE OF RETURN ON CAPITAL EMPLOYED AND LEASE EVALUATION (110-177)**

Basics of return on capital Employed; Significance of return on capital employed; Valuation of return on Capital employed by net assets approach and liabilities approach method; Computation of profit for return on capital employed; Precautions to be taken while using return on capital employed; Lease evaluation- basics of leasing and types of leasing arrangements;

Difference between financial lease and operating lease; Financial Evaluation of lease from the point of view of lease and lessor.

**UNIT-III CONSOLIDATED FINANCIAL STATEMENTS (178-266)**

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

**UNIT-IV FUNDS FLOW AND CASH FLOW STATEMENT (lnd AS 7) (267-365)**

Basics of funds flow statement; Difference between fund flow statement and cash flow statement, fund flow statement and Income statement; Advance treatment of investments, provision for taxation, proposed dividends, Interim dividends and provision against Current Assets; Preparation of fund flow statement on working capital basis.

Cash Flow Statement - Basics; Advance treatment of extra ordinary items, interest and dividends, taxes on incomes, acquisitions and disposals of subsidiaries and other business units, foreign currency cash flows and non cash transactions; Preparation of cash flow statement as per Ind AS 7.

**SUGGESTIVE READINGS**

1. Jain, S.P. & Narang K.L., Advanced Accounting, Kalyani Publishers, New Delhi.
2. Sehgal, A. & Sehgal, D., Advanced Accounting Taxmann, New Delhi
3. Gupta, R.L. Advanced Accounts. Sultan Chand & Sons, New Delhi.
4. Shukla, Grewal & Gupta. Advanced Accounts. S. Chand, New Delhi

## NOTE FOR PAPER SETTING

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

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

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

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## MODEL QUESTION PAPER

## ADVANCED ACCOUNTING

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

### SECTION - A

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

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

### SECTION - B

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

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

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

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

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

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

(i) All shares were acquired on 1.7.2011.

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

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

(iii) During 2011, Profits accured evenly.

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

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

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

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

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

Additional information :

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

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

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

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

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

4. Explain the SEBI Regulations, 1997 in detail.

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

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

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# FINANCING FOR EXPANSION (MERGERS & ACQUISITIONS)

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|---|---|---|
| **M.Com II Sem.** | **Advanced Accounting** | **Unit-I** |
| **M.Com – C 250** | | **Lesson No. 1** |

**STRUCTURE:**



## 1.1 INTRODUCTION

Merger and Acquisitions (MFA) is a general term that describes the consolidation of companies or assets through various types of financial transactions, including mergers, acquisitions, consolidations, tender offers, purchase of assets , and Management acquisitions.

When one company takes over another it establishes itself as a new owner, the purchase is called as the new owner, i.e. an acquisition. On the other hand, a Merger describes two firms, of approximately the same size, that join forces to move forward as a single new entity, rather than remain separetely owned and operated company. A purchase deal will also be called a merger when both CEOs agree that joining together is in best interest of both of their companies. Mergers, acquisitions, consolidations, Tender offers, acquisition of assets, management acquisitions etc. fall under the M & A Umbrella.

Mergers and acquisitions (M & A) commonly refer to transactions between two companies combining in some form. Although mergers and acquisitions (M & A) are used interchangeably, they come with different legal meanings. In a merger, two companies of similar size form a new single entity.

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

## 1.2 OBJECTIVES

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

## 1.3 BASICS OF MERGERS AND ACQUISITIONS

In the pure sense of the term, a merger happens when two firms agree to go forward as a single new company rather than remain separately owned and operated. This kind of action is more precisely referred to as a "merger of equals". A merger refers to the process whereby at least two companies combine to form one single company. Business firms make use of mergers and acquisitions for consolidation of markets as well as for gaining a competitive edge in the industry. The phrase mergers and acquisitions refers to the aspect of corporate strategy, corporate finance and management dealing with the buying, selling and combining of different companies that can aid, finance, or help a growing company in a given industry grow rapidly without having to create another business entity.

An acquisition, also known as a takeover or a buyout, is the buying of one company (the 'target') by another.

- Consolidation is when two companies combine together to form a new company
- An acquisition may be private or public, depending on whether the acquiree or merging company is or isn't listed in public markets.
- An acquisition may be friendly or hostile. Whether a purchase is perceived as a friendly or hostile depends on how it is communicated to and received by the target company's board of directors, employees and shareholders.
- It is quite normal though for M&A deal communications to take place in a so called 'confidentiality bubble' whereby information flows are restricted due to confidentiality agreements.
- In the case of a friendly transaction, the companies cooperate in negotiations; in the case of a hostile deal, the takeover target is unwilling to be bought or the target's board has no prior knowledge of the offer.
- Hostile acquisitions can, and often do, turn friendly at the end, as the acquirer secures the endorsement of the transaction from the board of the acquiree company. This usually requires an improvement in the terms of the offer.
- Acquisition usually refers to a purchase of a smaller firm by a larger one. Sometimes, however, a smaller firm will acquire management control of a larger or longer established company and keep its name for the combined entity. This is known as a reverse takeover.
- Another type of acquisition is reverse merger, a deal which enables a private company to get publicly listed in a short time period. A reverse merger occurs when a private company that has strong prospects and is eager to raise financing buys a publicly listed shell company, usually one with no business and limited assets.
- Achieving acquisition success has proven to be very difficult, while various studies have shown that 50% of acquisitions were unsuccessful. The

acquisition process is very complex, with many dimensions influencing its outcome. There is also a variety of structures used in securing control over the assets of a company, which have different tax and regulatory implications.

- The buyer buys the shares, and therefore control, of the target company being purchased.
- The buyer buys the assets of the target company. The cash the target receives from the sell-off is paid back to its shareholders by dividend or through liquidation. This type of transaction leaves the target company as an empty shell, if the buyer buys out the entire assets

## 1.4 NATURE AND FORMS OF EXPANSION

**Nature of Expansion**

1. Expansion is essential for raising profitability of the firm. Business expansion is a natural process of adaptation and development that occurs under favorable conditions.
2. Business expansion cannot be achieved over night. It takes place gradually. The business has to adapt to several circumstances to survive and grow.
3. Business expansion is an organic objective. Once the business is survived, it aims to grow. Growth gives the business continuous existence in the market.
4. Business expansion means increase in the number of business activities such as increase in production, increase in sales, profit, promotion etc. growth creates confidence in the minds of employees, shareholders, customers investors etc.
5. Business expansion does not happen by itself. To grow business requires a blueprint that provides clarity of further actions to be taken. The plan must also be dynamic and respond to a changing environment.
6. Business expansion can be achieved through acquisition and diversification, mergers, amalgamation and takeovers.
7. Business expansion is beneficial to the society as it provide employment to

the labors, better quality of products to the customers, dividend to the shareholders and prosperity and prestige in the market.

8. Expansion enables the business to create market opportunities, face competition and make optimum utilisation of available resources. Growth also enables to undertake innovation and develops corporate image.

9. Growth is pervasive. It is not applicable to any one particular type of organisation. It takes place in all types of business such as sole trading concern, partnership firm, joint stock companies, cooperative societies etc.

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

**(i) Internal Expansion**

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

**(ii) External Expansion**

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

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

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

**Following are the reasons for expansion:**

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

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

3. **Use for Higher Profits :** Every businessman aspires to earn more and more profits. The volume of profits can be increased by the expansion of business activities. Undoubtedly, profit is the main motive behind all types of expansions. The incurring of higher costs at the time of expansion may not be associated with higher profits. If a new concern is purchased at a higher price without considering

economic aspects, it will not be wise expansion plan. One should be very careful while planning expansion scheme and economic factors should be the motivating forces to enable a concern to increase its profits.

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

5. **Better Management :** A bigger business concern can afford to use the services of experts. Various managerial functions can be efficiently managed by those persons who are qualified for such jobs. On the other hand, a smaller concern is generally managed by the owners themselves and they may not be experts in all departments of the business.

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

## 1.5 FORMS OF COMBINATION

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

### (a) Merger or Amalgamation

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

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

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

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

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

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

(i) merger or amalgamation through absorption.

(ii) merger or amalgamation through consolidation.

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

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

Consolidation, generally, takes place between ' two equal-size concerns and the size of concerns considerably differs in case of a merger through absorption.

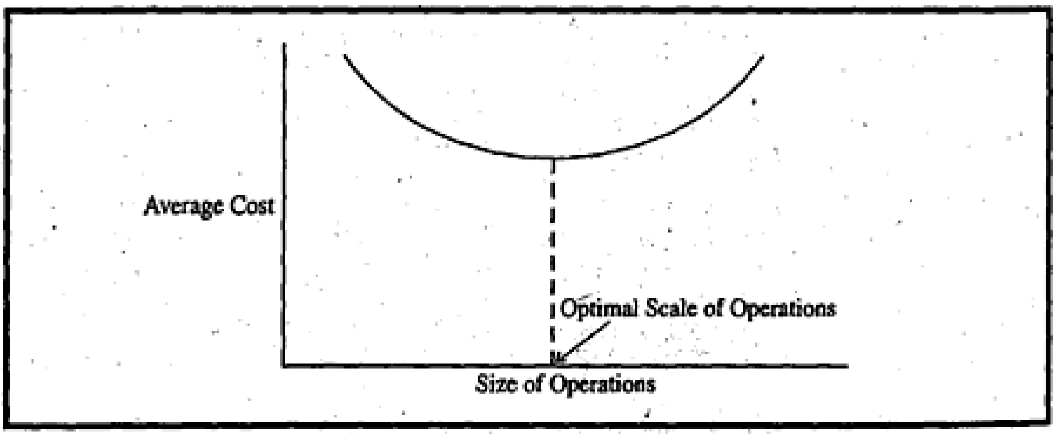
Generally a small concern is merged with a big concern. Though both the terms are used interchangeably. The methods and problems of financing mergers through absorption and consolidations are also similar.'

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

**(c) Holding Companies :** A holding company is a parent company, Limited liability company or Limited partnership that holds more than 50% of voting shares in subsidiary company. It is a form of business organisation which is created for the purpose of combining industrial unit is by owning a controlling amount of their share capital. Legally, a holding company is one which holds directly or through a nominee, a majority of the voting shares in the subsidiary Company or possesses the power to nominate the majority of the directors. A holding company may have a number of subsidiary companies or subsidiary company may be a holding company of another company or Companies. The subsidiary of a subsidiary company is also a subsidiary company of the holding company, although a subsidiary company has a separte legal entity but for all practical purposes subsidiaries are under the effective control of a holding company.

## 1.6 ECONOMICS/ REASONS OF MERGER

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



exit from others, and consolidate in some simultaneously. The following are the other important reasons for mergers or amalgamations:

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

   The economies will occur only up to a certain point of operations known as optimal point. It is a point where average costs are minimum. When production increases from this point, the cost per unit will go up. The optimal point of production is shown with the help of a (Fig. 1.1) also.

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

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

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

4. **Growth :** A company may not grow rapidly through internal expansion. Merger or amalgamation enables satisfactory and balanced growth of a company. It can

cross many stages of growth at one time through amalgamation. Growth through merger or amalgamation is also cheaper and less risky. A number of costs and risks of expansion and taking on new product lines are avoided by the acquisition of a going concern. By acquiring other companies a desired level of growth can be maintained by an enterprise.

5. **Diversification :** Two or more companies operating in different lines can diversify their activities through amalgamation. Since different companies are already dealing in their respective lines there will be less risk in diversification. When a company tries to enter new lines of activities then it may face a number of problems in production, marketing etc. When some concerns are already operating in different lines, they must have crossed many obstacles and difficulties. Amalgamation will bring together the experiences of different persons in varied activities. So amalgamation will be the best way of diversification.

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

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

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

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

10. **Economic Necessity :** Economic necessity may force the merger of some units. If there are two sick units, government may force their merger to improve their financial position and overall working. A sick unit may be required to merge with a healthy unit to ensure better utilisation of resources, improved returns and better management. Rehabilitation of sick units is a social necessity because their closure may result in unemployment etc.

## 1.7 SUMMARY

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

## 1.8 GLOSSARY

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

## 1.9 SELF ASSESSMENT QUESTIONS

Q.1 What do you mean by expansion?

Q.2 Explain the various forms of expansion.

Q.3 What are synergy benefits?

## 1.10 LESSON END EXERCISE

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

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

## 1.11 SUGGESTED READINGS


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

| M.Com II Sem. | Advanced Accounting | Unit-I |
|---|---|---|
| M.Com – C 250 | | Lesson No. 2 |

**STRUCTURE:**



## 2.1 INTRODUCTION

A business may grow over time as the utility of its products and services is required. It may also through an inorganic process, symbolised by an instantaneous expansion in work force, customers, infrastructure resources and thereby an overall increase in the revenues and profits of the company. Mergers and acquisitions are manifestations of an inorganic growth process. The process of mergers and acquisitions in India is a Court driven, long drawn and problematic.

## 2.2 OBJECTIVES

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

## 2.3 TYPES OF MERGERS

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

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

   Besides avoiding competition, there are factors like economies of scale, marketing economies, elimination of duplication of facilities, etc. to encourage companies to go for horizontal mergers.

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

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

## 2.4 LEGAL AND PROCEDURAL ASPECTS OF MERGER

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

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

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

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

4. **Approval of Shareholders :** After the approval of this scheme by the respective

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

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

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

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

## 2.5 VALUATION OF FIRMS

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

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

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

**I. Capitalised Earnings :** The capitalised earnings method is based on the philosophy that th price which a buyer would like to pay for the property of a concern will depend upon the present and expected earning capacity of the business. The present price is paid in the expectations of future returns from such investments. The capitalised earnings will depend upon the (1) Estimate of earnings, and (2) Rate of capitalisation. The estimation of earnings will involve the study of past earnings. The past earnings of a firm can be an estimated idea about the financial position of a business. If the earnings are showing a stability then the earnings will be easily calculated. On the other hand, the earnings are showing a trend then some allowance should be made for the conditions prevailing at that time. After estimating the average earnings, the earnings should be capitalised to arrive at an investment value. A decision about the rate of earnings at which the profits are to be capitalised is very difficult. It is a sort of arbitrary figure. One should be guided by economic factors only while calculating capitalisation rate. If the earnings per share are Rs.5 and the capitalisation rate is 10%, then the value of the share will be Rs.50.

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

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

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

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

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

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

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

**Solution :**

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

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

$$\text{Share Exchange Ratio} = \frac{\text{Net worth per share of target firm}}{\text{Net worth per share of acquiring firm}} = \frac{11.20}{13.80} = 0.81$$

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

**Solution :**

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

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

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

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

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

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

$$= \text{Earnings After the merger} \times \text{Exchange Ratio}$$

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

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

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

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

| | | |
|---|---|---|
| Number of shares after the merger | $= 4{,}00{,}000 + \left(1{,}00{,}000 \times \frac{4}{5}\right)$ | |
| | $= 4{,}80{,}000$ | |
| Earnings Per Share (EPS) after the merger | $= \frac{28{,}50{,}000}{4{,}80{,}000} = \text{Rs. } 5.937$ | |
| **Impact on EPS of company X's shareholders** | | ***Rs*** |
| EPS Before Merger | | 6.000 |
| EPS After merger | | 5.937 |
| Dilution in EPS | | 0.063 |
| **Impact on EPS for company Y's shareholders** | | ***Rs*** |
| Equivalent Earnings Per Share before the merger (4.50÷4/5) | | 5.625 |
| EPS after the merger | | 5.937 |
| Increase or Accretion in EPS | | 0.312 |

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

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

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

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

**Solution :**

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

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

## 2.6 SUMMARY

To conclude we can say that when two or more concerns dealing in same product or service join together, it is known as a horizontal merger. The idea behind this type of merger is to avoid competition between the units. for example, two manufacturers of same type of cloth, two book sellers, two transport companies operating on the same route—the merger in all these cases will be horizontal merger. Besides avoiding competition, there are, economies of scale, marketing economies, elimination of duplication of facilities, etc. A vertical merger represents a merger of firms engaged at different stages of production or distribution of the same product or service. In this case two or more companies dealing in the same product but at different stages may join to carry out the whole process itself. Conglomerate Merger. When two concerns dealing in totally different activities join hands it will be a case of conglomerate merger.

## 2.7 GLOSSARY

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

## 2.8 SELF ASSESSMENT QUESTIONS

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

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

## 2.9 LESSON END EXERCISE

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

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

## 2.10 SUGGESTED READINGS


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


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# FINANCING FOR EXPANSION (MERGERS & ACQUISITIONS)

| | | |
|---|---|---|
| **M.Com II Sem.** | **Advanced Accounting** | **Unit-I** |
| **M.Com – C 250** | | **Lesson No. 3** |

**STRUCTURE:**

3.1 Introduction

3.2 Objectives

3.3 Forms of Financing a Merger

3.4 Summary

3.5 Glossary

3.6 Self Assessment Questions

3.7 Lesson End Exercise

3.8 Suggested Readings

## 3.1 INTRODUCTION

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

## 3.2 OBJECTIVES

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

## 3.3 FORMS OF FINANCING MERGER

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

There are many resources to collect funds needed for business, but the ultimate selection of resources depends on the needs of the given business. Selecting the right type of expansion, financing is largely a matter of matching your needs to the restrictions of the source. Each type of financing has its own strengths and limitations. Following are the major forms of financing merger:

### 1. Personal Sources

Self-financing in the form of personal and family savings is the topmost form of financing used by most small business owners. It's low-cost source and has other advantages. For instance, when you approach other financing sources, such as bankers and venture capitalists, they'll want to know exactly how much of your own money you are putting into the venture. After all, if you don't have enough faith in your business to risk your own money, why should anyone else risk theirs?

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

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

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

**2. "Friends and Family" Financing**

Friends, relatives and business associates are popular sources for financing the growth of small businesses. There are two main advantages of friends and family financing.They alreadu know your character and circumstances and so are less likely to need a detailed business plan. Depending on who you're borrowing from, repayment terms may be extremely flexible, and you may not even have to pay interest.

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

**3. Internally Generated Funds**

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

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

4. **Bank Loans**

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

   - **Line-of-credit loans:** The most useful type of loan for the small business is the line-of-credit loan. This is a short-term loan that extends the cash available in your business's checking account to the upper limit of the loan contract. You pay interest on the actual amount advanced from the time it is advanced until it is paid back. Line-of-credit loans are intended for purchases of inventory and payment of operating costs for working capital and business cycle needs. They are not intended for purchases of equipment or real estate.

   - **Installment loans:** These bank loans are paid back with equal monthly payments covering both principal and interest. Installment loans may be written to meet all types of business needs. You receive the full amount when the contract is signed, and interest is calculated from that date to the final day of the loan. If you repay an installment loan before its final date, there will be no penalty and an appropriate adjustment of interest.

   - **Balloon loans:** These loans require only the interest to be paid off during the life of the loan, with a final "balloon" payment of the principal due on the last day. Balloon loans are often used in situations when a business has to wait until a specific date before receiving payment from a client for its product or services.

   - **Interim loans:** Interim financing is often used by contractors building new facilities. When the building is finished, a mortgage on the property will be used to pay off the interim loan.

- **Secured and unsecured loans:** Loans can be secured or unsecured. An unsecured loan has no collateral pledged as a secondary payment source in case of default on the payment of the loan. The lender provides you with an unsecured loan because it considers you a low risk. A secured loan requires some kind of collateral but generally has a lower interest rate than an unsecured loan. The collateral is usually related to the purpose of the loan; for instance, if you're borrowing to buy a printing press, the press itself will likely serve as collateral. Loans secured with receivables are often used to finance growth, with the banker lending up to 75 percent of the amount due. Inventory used to secure a loan is usually valued at up to 50 percent of its sale price.
- **Letter of credit:** International traders use these to guarantee payment to suppliers in other countries. The document substitutes the bank's credit for the entrepreneur's up to a set amount for a specified period of time.

**5. SBA Loans**

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

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

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

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

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

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

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

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

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

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

## 3.4 SUMMARY

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

## 3.5 GLOSSARY

- **Tender Offer-** It is a method that results into hostile or forced take-over.

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

## 3.6 SELF ASSESSMENT QUESTIONS

Q.1 What is a leveraged buy-out?

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Q.2 What do you mean by tender offer?

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## 3.7 LESSON END EXERCISE

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

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

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## 3.8 SUGGESTED READINGS

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

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# FINANCE FOR EXPANSION (MERGERS & ACQUISITIONS)

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|---|---|---|
| **M.Com II Sem.** | **Advanced Accounting** | **Unit-I** |
| **M.Com – C 250** | | **Lesson No. 4** |

**STRUCTURE:**



## 4.1 INTRODUCTION

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

## 4.2 OBJECTIVES

After going through this lesson, you will be able to

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

## 4.3 CAPITAL STRUCTURE AFTER MERGER AND CONSOLIDATION

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

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

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

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## 4.4 FINANCIAL PROBLEMS OF MERGER AND CONSOLIDATION

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

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

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

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

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

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

## 4.5 MERGERS IN INDIA

In developed economics, corporate mergers and amalgamations are a regular feature where hundreds of mergers take place every day. In India, too mergers have become a corporate game today. In 1988, there were only 15 mergers whereas in 1998 there were over 500 mergers. Corporate takeovers in India, were started by Swaraj Paul when he tried to take over Escorts. Since than many takeovers have taken place in our country such as Ashok Leyland by the Hindujas; Shaw Wallace, Dunlop, and Falcon Tyres by the Chabbria Group; Ceat Tyres by the Goenkas and Consolidated coffee by Tata Tea. The Institute of Chartered Accountants of India has issued Accounting Standard 14 on Accounting for Amalgamations. The government has also favoured mergers and amalgamations when these are in the interest of general public. The government has issued SEB1 (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 to provide greater transparency in the acquisition of shares and takeover of companies. In 2021, Aakash Educational Services was acquired by Byju's for £ 1 billion. In October 2021, Air India's ownership came full circle after Tata Sons for £ 2.39 billion.

Let's have a detailed analysis of the **famous** and the **Biggest Mergers & Acquisitions in India:**

1. **Future Group-Heritage Foods**

   In 2016, Future Group, the parent company of the famous 'Big Bazaar' retail group of stores merged operations with the Heritage Foods group. This deal had two fold effects, providing Heritage valuable supply chain of Future Group, while Future Group received yet another product to increase its product offering. Before this, Heritage Group's valuation was around 295 crores, which shot up to a whopping 600 crores post-merger.

   However, this wasn't a cash deal, as the compensation was in stock payments, where Heritage group received 3.95% of Future Value Retail Ltd.

2. **Mittal Steel-Arcelor Steel**

   This is one of many recession mergers and acquisitions. The financial crisis's cascading effect had echoed throughout the global economy, cementing the words 'Butterfly effect' forever. Europe was no exception to this. During this recession hit economy, a lot of companies were undervalued, which meant for cash-rich companies to go on a buying spree.

India based Mittal steel, in this spree, merged with Arcelor Steel in a deal valued at $33.1 Billion. The post-merger company, ArcelorMittal is one of the largest steel companies in the world right now.

3. **Vodafone-Idea**

A lot of things can be attributed to the probable reason of this one, while the industry by itself was facing am ton of challenges operating in India, the advent of Jio was like the final nail in the coffin for both the company's individual ventures.

Vodafone was still fighting the tax case with India back then, a while both companies were still reverberating from the 2G scam. The combined entity, Vodafone-Idea stood second only to Airtel now. In terms of compensation, the companies both hold an almost equal stake in the post-merger company, while Idea holds 54.9%, Vodafone holds 45.1%.

4. **Bank of Baroda-Vijaya Bank-Dena Bank**

In what could be termed as the first three-way amalgamation in India, Vijaya Bank and Dena Bank both merged with Bank of Baroda, effective from April 1, 2020, resultantly forming the third largest bank in India.

Since all three of the banks happen to be at least semi-government owned, compensation here is not applicable, but the government did infuse Rs 5042 Cr to enhance Bank of Baroda's capital base and help it meet the new expenses.

5. **Flipkart-Myntra**

Flipkart, the proud Indian e-commerce giant funded by Singapore based companies, acquired the fashion label 'Myntra' in 2014 whose product offering spanned across fashion and life-style products. This deal was made for a whopping Rs 2000 crores, however Myntra still continues to operate as a fashion apparel wing of Flipkart.

Flipkart, like its peer Amazon had started with selling books online and then proceeded to various other products. This could be termed as a product extension, however Flipkart continues to have its 'Flipkart fashion' wing, its products available both on the site itself and Myntra. Flipkart was later acquired by Walmart in 2018, beating Amazon to it and removing its chances of a potential monopoly in Indian E-commerce market.

6. **Zomato-Uber Eats**

   In January 2020, Zomato acquired Uber Eats beating the only competition Swiggy to it, for a deal of Rs 2492 crores. Uber Eats, along with being late to the market, also didn't have any exclusive point that made it stand out, resultantly had meagre success in the Indian market.

   At the same time, both Zomato and Swiggy's steep competitive drives resulted in huge profits for both of them, along with eating up market shares for any potential competitions. In the deal, however, Zomato received already established clientele and supply chains, and Uber Eats, well effectively cashed out.

7. **Tata Motors-Jaguar**

   There is a popular story attached to this one! It is said that a decade before this deal, Tata expressed interest in selling off Tata Motors to Ford. However, Ford not only declined but proceeded to humiliate the company as well. However, with subsequent losses in its luxury line of cars i.e. Jaguar, Ford was forced to sell the subsidiary to Tata Motors for $2.3 billion in 2008.

   Over and above that, Jaguar had been reporting losses before the said acquisition. But a decade after the acquisition, in 2019, it not only recovered these losses but also reported a profit of $3400.

8. **Aditya Birla Group-Jaypee Cements**

   In 2016, the company Jaypee Cements had a lot of debt accumulated with them, a reason why they also had to let go of their IPL team 'Deccan Chargers' in 2012. The obvious answer was to declare insolvency and go through the then newly crafted NCLT procedure of insolvency.

   However, a deal was struck with Aditya Birla group, which closed in early 2017, in which Jaypee cashed out by selling all of its assets to Ultra Tech, another cement company, in a deal of Rs 16189 Cr. While Jaypee avoided the cheap valuation in NCLT trials, Ultra Tech had an added 21 million ton capacity of production.

**9. UPL-Arysta LifeScience**

UPL was looking for diversification of its product line and increasing its market reach, when in 2018 Arysta LifeScience expressed an intention to sell. While before this deal, UPL was majorly an agro product manufacturing company.

However, post-acquisition, the product range was not only widened to farm pesticides from agrochemical products, it also provided UPL access to new markets of Africa, Latin America and China. The deal was valued at $4.2 billion, and has subsequently resulted in UPL becoming fifth largest agrochemical company in the world.

**10. HUL- GSK Consumer Healthcare**

In April 2020, Hindustan Unilever Limited merged GSK Consumer Healthcare of GlaxoSmithKline (GSK). This is one of the biggest examples of synergistic alliances we discussed earlier. While this deal provided HUL the products of Horlicks and Boost, another product line extension, GSK used these funds to establish its production in Bangladesh, following the western practice.

Since these two companies happen to be two of the biggest giants in FMCG sector, an approval was sought from National Company Law Tribunal as well, following which, the deal was closed in April 2020.

- **Regulations of Mergers and Takeovers in India**

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

Tax Act, 1961, and the Securities and Controls (Regulations) Act, 1956. The Securities and Exchange Board of India (SEBI) has issued guidelines to regulate mergers, acquisitions and takeovers.

- **Legal measures against takeovers**

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

- **Refusal to Register The Transfer of Shares**

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

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

- **Protection of minority shareholders' interests**

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

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

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

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

## 4.6 SUMMARY

Corporate restructuring refers to changes in ownership, business mix, assets mix and alliances with a motive to increase the value of shareholders. The economic considerations in terms of motives and effect of business combinations are similar but the legal procedures involved are different. A merger refers to a combination of two or more companies into one company. One or more companies may merge with an existing company or they may merge to form a new company. Mergers may be of three types (i) horizontal, (ii) vertical and (iii) conglomerate merger. The advantages of merger are economics of scale, synergy, strategic benefits, tax benefits and utilisation of surplus funds. The process of financial evaluation begins with determining the value of the target firm. The different approaches may be undertaken to assess the value of the target firm namely valuation based on assets, earnings,

dividend, cash flows etc. After the value of a firm has been determined the next step is the choice of the method of payment to the acquired firm. The payment take the form of either cash or securities i.e., ordinary shares, convertible securities, deferred payment plans and tender offers.

## 4.7 GLOSSARY

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

## 4.8 SELF ASSESSMENT QUESTIONS

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

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

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## 4.9 LESSON END EXERCISE

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

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

## 4.13 SUGGESTED READINGS


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


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# FINANCING FOR EXPANSION (MERGER & ACQUISITIONS)

| M.Com II Sem. | Advanced Accounting | Unit-IV |
|---|---|---|
| M.COMC250 | | Lesson No. 5 |

**STRUCTURE:**



## 5.1 INTRODUCTION

There is no uniform accounting standard that governs accounting procedures and disclosures in situations where one business gains control of another. The accounting treatment of such a transaction is determined by the form and type of the acquisition under the existing Indian GAAP. If the acquired company is kept as a separate legal entity, accounting must be done in accordance with Ind AS 110 or AS 21, depending on the situation. If the Acquired entity is legally merged with the Acquirer, then accounting must be carried out in accordance with Ind AS 103 or AS 14, as the case may be.

Apart from the foregoing, if the acquired firm is merged with the acquirer via a court-approved arrangement, then the accounting will be done in accordance with the scheme, which may diverge from the Indian accounting standards to some extent. The Indian GAAP also allows for the use of the pooling of interest technique, which accounts for the entire transaction on carrying values with no scope for goodwill.

## 5.2 OBJECTIVES

After reading this lesson, you will be able to learn about

- India Accounting Standard 103- Business Combinations.
- SEBI (Substantial Acquisitions of Shares and Takeover) Regulations, 2016.
- Pre-Merger and Post- Merger EPS.

## 5.3 INDIAN ACCOUNTING STANDARD 103- BUSINESS COMBINATIONS

With rapid globalisation and India playing a significant role in contributing to the fast-paced global economy, a dire need for more transparency and accountability on the part of Indian business houses towards their stakeholders worldwide has arisen. To ensure that these organisations meet international standards of accounting practices, the Ministry of Corporate Affairs, vide Notification dated 16 February 2015, notified new accounting standards, to be known as Indian Accounting Standards (Ind AS), the applicability of which has been carried out in a phased manner. Ind AS 103 "Business Combinations" deals with the accounting for business combinations in standalone as well as consolidated financial statements. A set of assets acquired and liabilities assumed are typically regarded as a business if they can together run independently as a going concern (i.e. it consists of inputs and processes applied to those inputs, which has the ability to create an output). If they do not constitute business, the same shall be accounted as an asset acquisition.

- **Ind AS 103 vis-à-vis AS 14**

  Ind AS 103 provides guidance for accounting in the books of the acquirer in relation to recognition and measurement of assets, liabilities, any non-controlling interest acquired, any goodwill, and disclosure requirements. Its scope is much wider than AS-14 "Accounting for Amalgamations". With the evolution of time, the types of restructuring undertaken by companies have also evolved. Since AS-14 does not address the accounting needs in case of such transactions, Ind AS 103 has been introduced to cover a wider range of transactions (including slump sale, demergers, etc.) to bring uniformity between the industry practices and accounting treatments. Ind AS 103 specifically provides for fair valuation of assets, liabilities and even non-controlling interest, which was earlier described as minority interest and valued at the amount of equity attributable to minority shareholders. One exception to such valuation is Common Control Business Combinations where the items are recorded at their carrying value (covered in detail below). A key difference between Ind AS 103 and AS 14 is that any Goodwill arising out of Business Combinations is tested for impairment annually instead of being amortised over five years. Ind AS 103 has also introduced new terms and concepts such as reverse acquisitions, bargain purchase and recording of contingent considerations, among others.

- **Ind AS - Common Control transactions**

  One of the most essential elements covered in this Standard is the manner of accounting in a common control transaction. Before we discuss the accounting procedure, it is crucial to understand the meaning of terms "control" and "common control". Ind AS 103 has defined common control business combination as a business combination in which all the combining entities or business are ultimately controlled by the same person/ persons both before and after the combination and such control is not transitory in nature. It further states that a company may be said to be under the control of another entity or an individual or a group of them where they exercise the right to govern its financial statements and operating policies arising out of contractual agreement(s) so as to obtain benefits from its activities. Interestingly, Ind AS 103 does not prescribe any threshold limit from a shareholding perspective to determine control in the entity. Instead, it has laid down few aspects such as decision making powers, board composition and contractual rights to determine control. Therefore, this brings in an element of subjectivity in determining where control lies. Ind AS 110 Consolidated Financial Statements states that where an entity (say, "A") has power over the other entity (say, "B"), has the rights to variable returns from its involvement with B and the ability to use its power to affect the returns of B, then it may be said that Entity A controls Entity B.

Given this, the extent of applicability of common control is wide and simultaneously demands more clarity in respect of definition of control.

- For example, we may consider a case where a lender, who does not hold any equity interest in the company, has entered into a contract as per which the company cannot enter into any major contracts or undertake any restructuring with any third party without the prior consent of the lender. In such a case, where the lender has agreed for a merger transaction with an entity in which it holds, say 80% equity interest, would such a transaction be referred to as a common control business combination?
- Another case can be mulled over where a company is merging with another company belonging to the same group, and both the entities have common lender or group of lenders having same rights and power as in the previous example. In such an instance, who would be said to have control in the merging entity, the lender(s) or the parent entity?

- **Accounting treatment under common control transactions under Ind AS 103**

Ind AS 103 prescribes application of pooling of interest method to account for common control business combinations. Under this method: All identified assets and liabilities will be accounted at their carrying amounts, i.e. no adjustment would be made to reflect their fair values unlike in case of non-common control business combinations. Balance of retained earnings in the books of acquiree entity shall be merged with that of the acquirer entity, and identity of the reserves shall be preserved. Any difference, whether positive or negative, shall be adjusted against the capital reserves (or "Amalgamation Adjustment Deficit Account" in some cases). Hence, no goodwill can be recorded in books under common control transactions under Ind AS 103.

To conclude, given that a substantial number of restructuring transactions occur, it becomes critical for entities involved to evaluate various aspects such as control, acquisition date, and common control to determine the accounting treatment. Further, given that under the Companies Act, an Auditor's Certificate is required for all the entities undertaking such restructuring, it is imperative to establish a clear and consistent understanding of the accounting implications. Undoubtedly, Ind AS 103 has brought about a radical change in the manner of accounting and presentation to reflect a truer picture of companies' financial statements. Nonetheless, many aspects continue to need clarity. One such welcome change in bridging the gap between Ind AS and other regulations has been the amendment to the Income tax Act, where the definition of demerger (which mandated book-value transfers), has been amended to allow companies to record assets/ liabilities at fair value under Ind AS 103 in case of non-common control demergers. Taking more such steps towards clearing the ambiguity between allied laws and regulations would make doing business in India easier and less cumbersome.

## 5.4 SEBI (SUBSTANTIAL ACQUISITIONS OF SHARES AND TAKEOVERS) REGULATIONS, 2016

To safeguard the interests of shareholders and investors, the government has brought a code to regulate the takeover/bids through SEBI (Substantial Acquisitions of Shares and Takeover). The main objectives of the regulations of SEBI is to provide greater transparency through a system of disclosures of information. The main provisions 3 to 27 of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2016, are given as follows:

**First two Provisions 1 and 2 are related to Preliminary and Title**

3. **Substantial acquisition of shares or voting rights -** (1) No acquirer shall acquire shares or voting rights in a target company which taken together with shares or voting rights, if any, held by him and by persons acting in concert with him in such

target company, entitle them to exercise twenty-five per cent or more of the voting rights in such target company unless the acquirer makes a public announcement of an open offer for acquiring shares of such target company in accordance with these regulations. (2) No acquirer, who together with persons acting in concert with him, has acquired and holds in accordance with these regulations shares or voting rights in a target company entitling them to exercise twenty-five per cent or more of the voting rights in the target company but less than the maximum permissible non-public shareholding, shall acquire within any financial year additional shares or voting rights in such target company entitling them to exercise more than five per cent of the voting rights, unless the acquirer makes a public announcement of an open offer for acquiring shares of such target company in accordance with these regulations :

***Explanation :*** For purpose of determining the quantum of acquisition of additional voting rights under this sub-regulation.

i) gross acquisitions alone shall be taken into account regardless of any intermittent fall in shareholding or voting rights whether owing to disposal of shares held or dilution of voting rights owing to fresh issue of shares by the target company.

(ii) in the case of acquisition of shares by way of issue of new shares by the target company or where the target company has made an issue of new shares in any given financial year, the differences between the pre-allotment and the post-allotment percentage voting rights shall be regarded as the quantum of additional acquisition.

(iii) For the purposes of sub-regulation (1) and sub-regulation (2), acquisition of shares by any person, such that the individual shareholding of such person acquiring shares exceeds the stipulated thresholds, shall also be attracting the obligation to make open offer for acquiring shares of the target company irrespective of whether there is a change in the aggregate shareholding with persons acting in concert.

**4. Acquisition of control:** Irrespective of acquisition of shares or voting rights in a target company, no acquirer shall acquire, directly or indirectly, control over such target company unless the acquirer makes a public announcement of an open offer for acquiring shares of such target company in accordance with these regulations.

**5. Indirect acquisition of shares or control:** (1) For the purposes of regulation 3 and 4,acquisition of shares or voting rights, or control over, any company, that would enable any person and persons acting in concert with him to exercise or direct the exercise of such percentage of voting rights in, or control over, a target company, the acquisition of which would otherwise attract the obligation to make a public announcement of an open offer for acquiring shares under these regulations, shall be considered as an indirect acquisition of shares or voting rights in, or control over the target company.

(2) Notwithstanding anything contained in these regulations, in the case of an indirect acquisition attracting the provisions of sub-regulation (1) where:

(a) the proportionate net asset value of the target company as a percentage of the consolidated net asset value of the entity being acquired;

(b) the proportionate sales turnover of the target company as a percentage of the consolidated sales turnover of the entity being acquired; or

(c) the proportionate market capitalisation of the target company as a percentage of the enterprise value for the entity being acquired; is in excess of eighty per cent, on the basis of the most recent audited annual financial statements, such indirect acquisition shall be regarded as a direct acquisition of the target company for all purposes of these regulations.

**6. Voluntary Offer:** (1) An acquirer, who together with persons acting in concert with him, holds shares or voting rights in a target company entitling them to exercise twenty-five per cent or more but less than the maximum permissible non-public shareholding, shall be entitled to voluntarily make a public announcement of an open offer for acquiring shares in accordance with these regulations) subject to their aggregate shareholding after completion of the open offer not exceeding the maximum permissible non-public shareholding; provided that where an acquirer or any person acting in concert with him has acquired shares to the target company in the preceding fifty-two weeks without attracting the obligation to make a public announcement of an open offer he shall not be eligible to voluntarily make a public announcement of an open offer for acquiring shares under this regulation; provided further that during the offer period such acquirer shall not be entitled to acquire any shares otherwise than under the open offer.

(2) An acquirer and persons acting in concert with him, who have made a public announcement under this regulation to acquire shares of a target company shall not be entitled to acquire any shares of the target company for a period of six months after completion of the open offer except pursuant to another voluntary open offer; provided that such restriction shall not prohibit the acquirer from making a competing offer upon any other person making an open offer for acquiring shares of the target company.

(3) Shares acquired through bonus issue or stock splits shall not be considered for purposes of the dis-entitlement set out in this regulation.

**7. Offer Size :** (1) The open offer for acquiring shares to be made by the acquirer and persons acting in concert with him under regulation 3 and 4 shall be for at least twenty six per cent of total shares of the target company, as of tenth working day from the closure of the tendering period; provided that the total shares of the company as of tenth working day from the closure of the tendering period shall take into account all potential increases in the number of outstanding shares during the offer period contemplated as of the date of the public announcement; provided further that the offer size shall be proportionately increased in case of an increase in total number of shares, after the public announcement, which is not contemplated on the date of the public announcement.

(2) The open offer made under regulation 6 shall be for acquisition of at least such number of shares as would entitle the holder thereof to exercise an additional ten per cent of the total shares of the target company, and shall not exceed such number of shares as would result in the post-acquisition holding of the acquirer and persons acting in concert with him exceeding the maximum permissible non-public shareholding applicable to such target company; provided that in the event of a

competing offer being made, the acquirer who has voluntarily made a public announcement of an open offer under regulation shall be entitled to increase the number of shares for which the open offer has been made to such number of shares as he deems fit; provided further that such increase in offer size shall have to be made within a period of fifteen working days from the public announcement of a competing offer, failing which the acquirer shall not be entitled to increase the offer size.

(3) Upon an acquirer opting to increase the offer size under sub-regulation (2), such open offer shall be deemed to have been made under sub-regulation (2) of regulation 3 and the provisions of these regulations shall apply accordingly.

(4) In the event the shares accepted in the open offer were such that the shareholding of the acquirer taken together with persons acting in concert with him pursuant to completion of the open offer results in their shareholding exceeding the maximum permissible non-public shareholding, the acquirer shall be required to bring down the non-public shareholding to the level specified and within the time permitted under Securities Contract (Regulation), 1957.

(5) The acquirer whose shareholding exceeds the maximum permissible non-public shareholding, pursuant to an open offer under these regulations, shall not be eligible to make a voluntary delisting offer under the Securities and Exchange Board of India Regulations, 2009, unless a period of twelve months has elapsed from the date of the completion of the offer period.

(6) Any open offer made under these regulations shall be made to all shareholders of the target company, other than the acquirer, persons acting in concert with him and the parties to any underlying agreement including persons deemed to be acting in concert with such parties, for the sale of shares of the target company.

**8. Offer Price :** (1) The open offer for acquiring shares under regulation 3, 4, 5 or 6 shall be made at a price not lower than the price determined in accordance with sub-regulation (2) or sub-regulation(3), as the case may be

(2) In the case of direct acquisition of shares or voting rights in, or control over the target company, and indirect acquisition of shares or voting rights in, or

control over the target company where the parameters referred to in sub-regulation (2) of regulation 5 are met, the offer price shall be the highest of:

(a) the highest negotiated price per share of the target company for any acquisition under the agreement attracting the obligation to make a public announcement of an open offer;

(b) the volume-weighted average price paid or payable for acquisitions, whether by the acquirer or by any person acting in concert with him, during the fifty-two weeks immediately preceding the date of the public announcement.

(c) the highest price paid or payable for any acquisition, whether by the acquirer or by any person acting in concert with him, during the twenty-six weeks immediately preceding the date of the public announcement;

(d) the volume-weighted average market price of such shares for a period of sixty trading days immediately preceding the date of the public announcement as traded on the stock exchange where the maximum volume of trading in the shares of the target company are recorded during such period, provided such shares are frequently traded;

(e) where the shares are not frequently traded, the price determined by the acquirer and the manager to the open offer taking into account valuation parameters including, book value, comparable trading multiples, and such other parameters as are customary for valuation of shares of such companies; and

(f) the per share values computed under sub-regulation (5), if applicable.

(3) In the case of an indirect acquisition of shares or voting rights in, or control over the target company, where the parameter referred to in sub-regulation (2) of regulation 5 are not met, the offer price shall be the highest of:

(a) the highest negotiated price per share, if any, of the target company for any acquisition under the agreement attracting the obligation to make a public announcement of an open offer;

(b) the volume-weighted average price paid or payable for any acquisition, whether by the acquirer or by any persons acting in concert with him, during the fifty-two weeks immediately preceding the earlier of, the date on which the primary acquisition is contracted, and the date on which the intention or the decision to make the primary acquisition is announced in the public domain;

(c) the highest price paid or payable for any acquisition, whether by the acquirer or by any person acting in concert with him, during the twenty-six weeks immediately preceding the earlier of, the date on which the primary acquisition is contracted, and the date on which the intension or the decision to make the primary acquisition is announced in the public domain;

(d) the highest price paid or payable for any acquisition, whether by the acquirer or by any person acting in concert with him, between the earlier of, the date on which the primary acquisition is contracted, and the date on which the intention or the decision to make the primary acquisition is announced in the public domain, and the date of the public announcement of the open offer for shares of the target company made under these regulations;

(e) the volume-weighted average market price of the shares for a period of sixty trading days immediately preceding the earlier of, the date on which the primary acquisition is contracted, and the date on which the intention or the decision to make the primary acquisition is announced in the public domain, as traded on the stock exchange where the maximum volume of trading in the shares of the target company are recorded during such period, provided such shares are frequently traded; and

(f) the per share value computed under sub-regulation (5).

(4) In the event the offer price is incapable of being determined under any of the parameters specified in sub-regulation (3), without prejudice to the requirements of sub-regulation (5), the offer price shall be the fair price of shares of the target company to be determined by the acquirer and the manager to the open offer taking

into account valuation parameters including, book value, comparable trading multiples, and such other parameters as are customary for valuation of shares of such companies.

(5) In the case of an indirect acquisition and open offers under sub-regulation (2) of regulation (5) where,

(a) the proportionate net asset value of the target company as a percentage of the consolidated net asset value of the entity or business being acquired;

(b) the proportionate sales turnover of the target company as a percentage of the consolidated sales turnover of the entity or business being acquired, or

(c) the proportionate market capitalization of the target company as a percentage of the enterprise value for the entity or business being acquired;

is in excess of fifteen per cent, on the basis of the most recent audited annual financial statements, the acquirer shall, notwithstanding anything contained in sub-regulation (2) or sub-regulation (3), be required to compute and disclose, in the letter of offer, the per share value of the target company taken into account for the acquisition, along with a detailed description of the methodology adopted for such computation.

(6) For the purpose of sub-regulation (2) and sub-regulation (3), where the acquirer or any person acting in concert with him has any outstanding convertible instruments convertible into shares of the target company at a specific price, the price at which such instruments are to be converted into shares, shall also be considered as a parameter under sub-regulation (2) and sub-regulation (3).

(7) For the purposes of sub-regulation (2) and sub-regulation (3), the price paid for shares of the target company shall include any price paid or agreed to be paid for the shares or voting rights in, or control over the target company, in any form whatsoever, whether stated in the agreement for acquisition of shares or in any incidental, contemporaneous or collateral agreement, whether termed as control premium or as non-compete fees or otherwise.

(8) Where the acquirer has acquired or agreed to acquire whether by himself or through or with persons acting in concert with him any shares or voting rights in the target company during the offer period, whether by subscription or purchase,

at a price higher than the offer price, the offer price shall stand revised to the highest price paid or payable for any such acquisition; provided that no such acquisition shall be made after the third working day prior to the commencement of the tendering period and until the expiry of the tendering period.

(9) The price parameters under sub-regulation (2) and sub-regulation (3) may be adjusted by the acquirer in consultation with the manager to the offer, for corporate actions such as issuances pursuant to rights issue, bonus issue, stock consolidations, stock splits, payment of dividend, de-mergers and reduction of capital, where the record date for effecting such corporate actions falls prior to three working days before the commencement of the tendering period; provided that no adjustment shall be made for dividend declared with a record date falling during such period except where the dividend per share is more than fifty per cent higher than the average of the dividend per share paid during the three financial years preceding the date of the public announcement.

(10) Where the acquirer or persons acting in concert with him acquires shares of the target company under these regulations, the acquirer and persons acting in concert shall pay the difference between the highest acquisition price and the offer price, to all the shareholders whose shares were accepted in the open offer, within sixty days from the date of such acquisition; provided that this provision shall not be applicable to acquisitions under another open offer under these regulations or pursuant to the Securities and Exchange Board of India (Delisting of Equity Shares) Regulations, 2009, or open market purchases made in the ordinary course on the stock exchange, not being negotiated acquisition of shares of the target company whether by way of bulk deals, block deals or in any other form.

(11) Where the open offer is subject to a minimum level of acceptances, the acquirer may, subject to the other provisions of this regulation, indicate a lower price, which will not be less than the price determined under this regulation, for acquiring all the acceptances despite the acceptance falling short of the indicated minimum level of acceptance, in the even the open offer does not receive the minimum acceptance.

(12) In the case of any indirect acquisition, other than the indirect acquisition

referred in sub regulation (2) of regulation 5, the offer price shall stand enhanced by an amount equal to a sum determined at the rate of ten per cent per annum for the period between the earlier of the date on which the primary acquisition is contracted or the date on which the intension or the decision to make the primary acquisition is announced in the public domain, and the date of the detailed public statement, provided such period is more than five working days.

(13) The offer price for partly paid up shares shall be computed as the difference between the offer price and the amount due towards calls-in-areas including calls remaining unpaid with interest, if any, thereon.

(14) The offer price for equity shares carrying differential voting rights shall be determined by the acquirer and the manager to the open offer with full disclosure of justification for the price so determined, being set out in the detailed public statement and the letter of offer; provided that such price shall not be lower than the amount determined by applying the percentage rate of premium, if any, that the offer price for the equity shares carrying full voting rights represents to the price parameter computed under clause (d) of sub-regulation 2, or as the case may be, clause (e) of sub-regulation 3, to the volume weighted average market price of the shares carrying differential voting rights for a period of sixty trading days computed on the same terms as specified in the aforesaid provisions, subject to shares carrying full voting rights and the shares carrying differential voting rights, both being frequently traded shares.

(15) In the event of any of the price parameters contained in this regulation not being available or denominated in Indian rupees, the conversion of such amount into Indian rupees shall be effected at the exchange rate as prevailing on the date preceding the date of public announcement and the acquirer shall set out the source of such exchange rate in the public announcement, the detailed public statement and the letter of offer.

(16) For purposes of clause (e) of sub-regulation (2) and sub-regulation (4), the Board may, at the expense of the acquirer, require valuation of the sh. res by an independent merchant banker other than the manager to the open offer on an independent chartered accountant in practice having a minimum experience of ten

years.

**9. Mode of payment:**

(1) The offer price may be paid:

(a) in cash;

(b) by issue, exchange or transfer of listed shares in the equity share capital of the acquirer or of any person acting in concert;

(c) by issue, exchange or transfer of listed secured debt instruments issued by the acquirer or any person acting in concert with a rating not inferior to investment grade as rated by a credit rating agency registered with the Board;

(d) by issue, exchange or transfer of convertible debt securities entitling the holder thereof to acquire listed shares in the equity share capital of the acquirer or of any person acting in concert; or

(e) a combination of the mode of payment of consideration stated above.)

Provided that where any shares have been acquired or agreed to be acquired by the acquirer and persons acting in concert with him during the fifty-two weeks immediately preceding the date of public announcement constitute more than ten per cent of the voting rights in the target company and has been paid for in cash, the open offer shall entail an option to the shareholders to require payment of the offer price in cash, and a shareholder who has not exercised an option in his acceptance shall be deemed to have opted for receiving the offer price in cash; provided further that in case of revision in offer price the mode of payment of consideration may be altered subject to the condition that the component of the offer price to be paid in cash prior to such revision is not reduced.

(2) For the purposes of clause (b), (d) and (e) of sub-regulation (1), the shares sought to be issued or exchanged or transferred or the shares to be issued upon conversion of other securities, towards payment of the offer price, shall conform to the following requirements:

(a) such class of shares are listed on a stock exchange and frequently traded at the time of the public announcement;

(b) such class of shares have been listed for a period of at least two years preceding the date of the public announcement;

(c) the issuer of such class of shares has redressed at least ninety five per cent of the complaints received from investors by the end of the calendar quarter immediately preceding the calendar month in which the public announcement is made;

(d) the issuer of such class of shares has been in material compliance with the listing agreement for a period of at least two years immediately preceding the date of the public announcement, provided that in case where the Board is the view that a company has not been materially compliant with the provisions of the listing agreement, the offer price shall be paid in cash only:

(e) the impact of auditors' qualifications, if any, on the audited accounts of the issuer of such shares for three immediately preceding financial years does not exceed five per cent of the net profit or loss after tax of such issuer for the respective years; and

(f) the Board has not issued any direction against the issuer of such shares not to access the capital market or to issue fresh shares.

(3) Where the shareholders have been provided with options to accept payment in cash or by way of securities, or a combination thereof, the pricing for the open offer may be different for each option subject to compliance with minimum offer price requirements under regulation 8; provided that the detailed public statement and the letter of offer shall contain justification for such differential pricing.

(4) In the event the offer price consists of consideration to be paid by issuance of securities, which requires compliance with any applicable law, the acquirer shall ensure that such compliance is completed not later than the commencement of the tendering period; provided that in case the requisite compliance is not made by such date, the acquirer shall pay the entire consideration in cash.

(5) Where listed securities are offered as consideration, the value of such securities shall be higher

(a) the average of the weekly high and low of the closing prices of such securities quoted on the stock exchange during the six months preceding the relevant date;

(b) the average of the weekly high and low of the costing prices of such securities quoted on the stock exchange during the two weeks preceding the relevant date; and

(c) the volume-weighted average market price for a period of sixty trading days preceding the date of the public announcement, as traded on the stock exchange when the maximum volume of trading in the shares of the company whose securities are being offered as consideration, are recorded during the six-month period prior to relevant date and the ratio of exchange of shares shall be duly certified by an independent merchant banker (other than the manager to the open offer) or an independent chartered accountant having a minimum experience of ten years.

**10. General exemptions:**

(1) The following acquisitions shall be exempt from the obligation to make an open offer under regulation 3 and 4 subject for fulfillment of the conditions stipulated. Therefore:

(a) acquisition pursuant to inter se transfer of shares amongst qualifying persons, being :

(i) Immediate relatives;

(ii) Persons named as promoters in the shareholding pattern filed by the target company in terms of the listing agreement or these regulations for not less than three years priorto the proposed acquisition;

(iii) a company, its subsidiaries, its holding company, other subsidiaries of such holding company, persons holding not less than fifty per cent of the equity shares of such company other companies in which such persons hold not less than fifty per cent of the equity shares, and their subsidiaries subject to control over such qualifying persons being exclusively held by the same persons;

(iv) Persons acting in concert for not less than three years prior to the proposed acquisition, and disclosed as such pursuant to filings under the listing agreement;

(v) shareholders of a target company who have been persons acting in concert for a period of not less than three years prior to the proposed acquisition and are disclosed as such pursuant to filings under the listing agreement, and any company in which the entire equity share capital is owned by such shareholders in the same proportion as their holdings in the target company without any differential entitlement to exercise voting rights in such company; provided that for purposes of availing of the exemption under this clause :

If the shares of the target company are frequently traded, the acquisition price per share shall not be higher by more than twenty-five per cent of the volume-weighted average market price for a period of sixty trading days preceding the date of issuance of notice for the proposed inter se transfer under sub-regulation (5), as traded on the stock exchange where the maximum volume of trading in the shares of de company are recorded during such period, and if the shares of the target company are infrequently traded, the acquisition price shall not be higher by more than twenty five percent of the price determined in terms of clause (e) of sub-regulation (2) of regulation 8; and

(b) acquisition in the ordinary course of business by;

(i) an underwriter registered with the Board by way of allotment pursuant to underwriting agreement in terms of the Securities and Exchange Board of Indiaof Capital and Disclosure Requirements) Regulations, 2009;

(ii) stock broker registered with the Board on behalf of his client in exercise of lien the shares purchased on behalf of the client under the bye-laws of the stock exchange where such stock broker is a member

iii) A merchant banker registered with the board or a nominated investor in the pro of market making or subscription to the unsubscribed portion of issue in ter Chapter XH of the Securities and Exchange Board of India (lesue of Capital Disclosure Requirements) Regulations, 2009:

(iv) Any person acquiring shares pursuant to a scheme of safety net in terms of regulation 44 of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009;

(v) a merchant banker registered with the Board acting as a stabilising agent or by the promoter or pre-issue shareholder in terms of regulation 45 of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations2009:

(vi) by a registered market-maker of a stock exchange in respect of shares for which le is the market maker during the course of market making:

(vii) a Scheduled Commercial Bank, acting as an escrow agent: and

viii) invocation of pledge by Scheduled Commercial Banks or Public Financial Institutes a pledgee.

(c) acquisitions at subsequent stages, by an acquirer who has made a public announcement an open offer for acquiring shares pursuant to an agreement of disinvestment, a contemplated in such agreement: provided that:

(i) both the acquirer and the seller are the same at all the stages of acquisition, and

(ii) full disclosures of all the subsequent stages of acquisition, if any, have been made the public announcement of the open offer and in the letter of offer.

(d) acquisition pursuant to a scheme:

(i) made under section 18 of the Sick Industrial Companies (Special Provisions) act 1985 (1 of 1986) or any statutory modification or re-enactment thereto

(ii) of arrangement involving the target company as a transferor company or transferee company, or reconstruction of the target company, including amalgamate merger or demerger, pursuant to an order of a court or a competent authority r any law or regulation, Indian or foreign or

(iii) of arrangement not directly involving the target company as a transferor company o as a transferee company, or reconstruction not involving the target company's undertaking, including amalgamations, merger or demerger, pursuantto an order of a court or a competent authority under any law or regulation, Indian or foreign, subject to:

(A) the competent of cash and cash equivalents in the consideration paid beg than twenty-five per cent of the consideration paid under the scheme ; and

(B) where after implementation of the scheme of arrangement, per a indirectly holding at least thirty-three per cent of the voting nights in the entity are the same as the persons who bell the entire voting rights is the implementation of the scheme.

(e) acquisition pursuant to the provisions of the Securitization Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 of 2002).

(f) (acquisition pursuant to the provisions of the Securities and Exchange Board of India (Delisting of Equity Shares) Regulations, 2009:

(g) acquisition by way of transmission, succession or inheritance;

(h) acquisition of voting rights or preference shares carrying young rights arising out of the operation of sub-section (2) of section 87 of the Companies Act, 1956 (1 of 1956).

(2) The acquisition of shares of a target company, not involving a change of control over such target many, pursuant to a scheme of corporate debt restructuring in terms of the Corporate Debt Restructuring Scheme notified by the Reserve Bank of India vide circular no. B.P.BC 15/2104, 114/2001, date August 24, 2001, or any modification or re-notification thereto provided such scheme has been authorised by shareholders by way of a special resolution passed by postal ballot, shall be exempted from be obligation to make an open offer under regulation 3.

(3) An increase in voting rights in a target company of any shareholder beyond the limit attracting in obligation to make an open offer under sub-regulation (1) of regulation 3, pursuant to buy-back of shares shall be exempt from the obligation to make an open offer provided such shareholder reduces his shareholding such that his voting rights fall to below the threshold referred to in sub-regulation (1) of regulation 3 within ninety days from the date on which the voting rights so increase.

(4) The following acquisitions shall be exempt from the obligation to make an open offer under sub regulation (2) of regulation 3,

(a) acquisition of shares by any shareholder of a target company, upto his entitlement, pursuant to a rights issue;

(b) acquisition of shares by any shareholder of a target company, beyond his entitlement. pursuant to a rights issue, subject to fulfillment of the following conditions.

(i) the acquirer has not renounced any of his entitlements in such rights issue; and

(ii) the price at which the rights issue is made is not higher than the ex-rights price of the shares of the target company, being the sum of

(a) the volume weighted average market price of the shares of the target company during a period of sixty trading days ending on the day prior to the date of determination of the rights issue price, multiplied by the number of shares outstanding prior to the rights issue, divided by the tool number of shares outstanding after allotment under the rights issue: provided that such 2 weighted average market price shall be on the basis of trading on thestock exchange where the maximum volume of trading in the shares of such target company is recorded during such period; and

(b) the price at which the shares are offered in the rights issue, multiplied by the number of shares so offered in the rights issue divided by the total number of shares outstanding after allotment under the rights issue:

(c) increase in voting rights in a target company of any shareholder pursuant to buyback of shares, provided that.

(i) Such shareholder has not voted in favour of the resolution authorising the buy-back Companies Act, 1956 (1 of 1956)

(ii) in the case of a shareholder resolution, voting is by way of postal ballot

(iii) Where a resolution of shareholders is not required for the buyback, such shareholder in his capacity as a director, or any other interested director has not voted in favour of the resolution of the board of directors of the target company authorising the buy back of securities under section 77A of the Companies Act, 1956 (1 of 1956); and (r) the increase in voting rights does not result in an acquisition of control by such shareholder over the target company provided further that where the aforesaid conditions are not met, in the event such shareholder reduces his shareholding such that his voting rights fall below the level at which the obligation to make an open offer would be attracted under sub-regulation (2) of regulation 3, within ninety days from the date on which the voting rights so increase, the shareholder shall be exempt from the obligation to make an open offer.

(d) acquisition of shares in a target company by any person in exchange for shares of another target company tendered pursuant to an open offer for acquiring shares under these regulations;

(e) acquisition of shares in a target company from state-level financial institutions or their subsidiaries or companies promoted by them, by promoters of the target company pursuant to an agreement between such transferors and such promoter:

(f) acquisition of shares in a target company from a venture capital fund or a foreign venture capital investor registered with the Board, by promoters of the target company pursuant to an agreement between such venture capital fund or foreign venture capital investor and such promoters.

(5) In respect of acquisitions under clause (a) of sub-regulation (1), and clauses (e) and (f) of sub regulation (4), the acquirer shall intimate the stock exchanges where the shares of the target company are listed, the details of the proposed acquisition in such form as may be specified, at least four working days prior to

the proposed acquisition, and the stock exchange shall forthwith disseminate such information to the public.

(6) In respect of any acquisition made pursuant to exemption provided for in this regulation, the acquirer shall fire a report with the stock exchanges where the shares of the target company are listed. in such forms as may be specified not later than four working days from the acquisition, and the sock exchange shall forthwith disseminate such information to the public.

(7) In respect of any acquisition of or increase in voting rights pursuant to exemption provided for in clause (a) of sub-regulation (1), sub-clause (iii) of clause (d) of sub-regulation (1), clause (h) of sub regulation (1), sub-regulation (2), sub-regulation (3) and clause (c) of sub-regulation (4), clauses (a), (b)and (f) of sub-regulation (4), the acquirer shall, within twenty-one working days of the date of acquisition, submit a report in such form as may be specified along with supporting documents to the Board giving all details in respect of acquisitions, along with a non-refundable fee of rupees twenty five thousand by way of banker's cheque or demand draft payable in Mumbai in favour of the Board.

**11. Exemptions by the Board:**

(1) The Board may for reasons recorded in writing, grant exemption from the obligation to make an open offer for acquiring shares under these regulations subject to such conditions as the Board deems fit to impose in the interests of investors in securities and the securities market.

(2) The Board may for reasons recorded in writing, grant a relaxation from strict compliance with any procedural requirement subject to such conditions as the Board deems fit to impose in the interests of investors in securities and the securities market on being satisfied that:

(a) the target company is a company in respect of which the Central Government or State Government or any other regulatory authority has superseded the board of directors of the target company and has appointed new directors under any law for the time being in force, if:

(i) such board of directors has formulated a plan which provides for transparent, open, and competitive process for acquisition of shares or voting rights in, or control over the target company to secure the smooth and continued operation of the target company in the interests of all stakeholders of the target company and such plan does not further the interests of any particular acquirer;

(ii) the conditions and requirements of the competitive process are reasonable and fair;

(iii) the process adopted by the board of directors of the target company provides for details including the time when the open offer for acquiring shares would be made, completed and the manner in which the change in control would be effected; and

(b) the provisions are likely to act as impediment to implementation of the plan of the target company and exemption from strict compliance with one or more of such provisions is in public interest, the interests of investors in securities and the securities market.

(3) For seeking exemption under sub-regulation (1), the acquirer shall, and for seeking relaxation under sub-regulation (2) the target company shall file an application with the Board, supported by a duly sworn affidavit, giving details of the proposed acquisition and the grounds on which the exemption has been sought.

(4) The acquirer or the target company, as the case may be, shall along with the application referred to under sub-regulation (3) pay a non-refundable fee of rupees fifty thousand, by way of banker's cheque or demand draft payable in Mumbai in favour of the Board.

(5) The Board may after affording reasonable opportunity of being heard to the applicant and after considering all the relevant facts and circumstances, pass a reasoned order either granting or rejecting the exemption or relaxation sought as expeditiously as possible:

Provided that the Board may constitute a panel of experts to which an application for an exemption under sub-regulation (1) may, if considered necessary, be referred to make recommendation on the application to the Board.

(6) The order passed under sub-regulation (5) shall be hosted by the Board on its official website.

**12. Manager to the open offer:**

(1) Prior to making a public announcement, the acquirer shall appoint a merchant banker registered with the Board, who is not an associate of the acquirer, as the manager to the open offer.

(2) The public announcement of the open offer for acquiring shares required under these regulations shall be made by the acquirer through such manager to the open offer.

**13. Timing:**

(1) The public announcement referred to in regulation 3 and 4 shall be made in accordance with regulation 14 and 15, on the date of agreeing to acquire shares or voting rights in, or control over the target company.

(2) Such public announcement:

(a) in the case of market purchases, shall be made prior to placement of the purchase order with the stock broker to acquire the shares, that would take the entitlement to voting rights beyond the stipulated thresholds;

(b) pursuant to an acquirer acquiring shares or voting rights in, or control over the target company upon converting convertible securities without a fixed date of conversion or upon conversion of depository receipts for the underlying shares of the target company shall be made on the same day as the date of exercise of the option to convert such securities into shares of the target company;

(c) pursuant to an acquirer acquiring shares or voting rights in, or control over the target company upon conversion of convertible securities with a fixed date of conversion shall be made on the second working day preceding the scheduled date of conversion of such securities into shares of the target company.

(d) pursuant to a disinvestment shall be made on the same day as the date of executing the agreement for acqusition of shares or voting rights in or control over the target company;

(e) in the case of indirect acquisition of shares or voting rights in, or control over the target company where none of the parameters referred to in sub-regulation (2) of regulation 5 are met, may be made at any time within four working days from the earlier of, the date on which the primary acquisition is contracted, and the date on which the intension or the decision to make the primary acquisition is announced in the public domain;

(f) in the case of indirect acquisition of shares or voting rights in, or control over the target company where any of the parameters referred to in sub-regulation (2) of regulation 5 are met shall be made on the earlier of, the date on which the primar acquisition is contracted, and the date on which the intention or the decision to make the primary acquisition is announced in the public domain;

(g) pursuant to an acquier acquiring shares or voting rights in, or control over the target company, under preferential issue, shall be made on the date on which special resolution is passed for allotment of shares under sub-section (IA) of section 81 of the Companies Act. 1956:

(h) the public announcement pursuant to an increase in voting rights consequential to a buy back not qualifying for exemption under regulation 10, shall be made not later than the ninetieth day from the date of such increase in the voting rights beyond the relevant threshold stipulated in regulation 3;

(i) the public announcement pursuant to any acquisition of shares or voting rights in or control over the target company where the specific date on which title to such shares, voting rights or control is acquired is beyond the control of the acquirer, shall be made not later than two working days from the date of receipt of intimation of having acquired such title.

(3) The public announcement made under regulation 6 shall be made on the same day as the date 'on which the acquirer takes the decision to voluntarily make a public announcement of an open offer for acquiring shares of the target company.

(4) Pursuant to the public announcement made under sub-regulation (1) and sub-regulation (3), a detailed public statement shall be published by the acquirer through the manager to the open offer in accordance with regulation 14 and 15, not later than five working days of the public announcement:

Provided that the detailed public statement pursuant to a public announcement made under clause (e) of sub-regulation (2) shall be made not later than five working days of the completion of the primary regulation of shares or voting rights in, or control over the company or entity holding shares or voting rights in, or control over the target company.

**14. Publication:**

(1) The public announcement shall be sent to all the stock exchanges on which the shares of the target company are listed, and the stock exchanges shall forthwith disseminate such information to the public.

(2) A copy of the public announcement shall be sent to the Board and to the target company at itsregistered office within one working day of the date of the public announcement.

(3) The detailed public statement pursuant to the public announcement referred to in sub-regulation (4) of regulation 14 shall be published in all editions of any one English national daily with wide circulation, any one Hindi national daily with wide circulation, and any one regional language daily with wide circulation at the place where the registered office of the target company is situated and one regional language daily at the place of the stock exchange where the maximum volume of trading in the shares of the target company are recorded during the sixty trading days preceding the date of the public announcement.

(4) Simultaneously with publication of such detailed public statement in the newspapers, a copy of the same shall be sent to;

(i) the Board through the manager to the open offer,

(ii) all the stock exchanges on which the shares of the target company are listed, and the stock exchanges shall forthwith disseminate such information to the public;

(iii) the target company at its registered office, and the target company shall forthwith circulate it to the members of its board.

**15. Contents:**

(1) The public announcement shall contain such information as may be specified, including the following:

(a) name and identity of the acquirer and persons acting in concert with him;

(b) name and identity of the sellers, if any;

(c) nature of the proposed acquisition such as purchase of shares or allotment of shares, or any other means of acquisition of shares or voting rights in, or control over the targer company:

(d) the consideration for the proposed acquisition that attracted the obligation to make an open offer for acquiring shares, and the prices per share, if any;

(e) the offer price, and mode of payment of consideration; and (f) offer size, and conditions as to minimum level of acceptance, if any.

(2) The detailed public statement pursuant to the public announcement shall contain such information as may be specified in order to enable shareholders to make an informed decision with reference to the open offer.

(3) The public announcement of the open offer, the detailed public statement, and any other statement, advertisement, circular, brochure, publicity material or letter of offer issued in relation to the acquisition of shares under these regulations shall not omit any relevant information, or contain any misleading information.

## 16. Filing of letter of offer with the Board:

(1) Within five working days from the date of the detailed public statement made under sub-regulation (4) of regulation 13, the acquirer shall, through the manager to the open offer, file with the Board, a draft of the letter of offer containing such information as may be specified along with a non-refundable fee, as per the following scale, by way of a banker's cheque or demand draft payable in Mumbai in favour of the Board:

| SI No. | Consideration payable under the open offer | Fee (Rs) |
|---|---|---|
| (a) | Upto ten crore rupees | One take twenty five thousands rupees. |
| (b) | More than ten crore rupees, but less than or equal to one thousand crore rupees. | One lack twenty five thousands rupees plus 0.025 per cent of the portion of the offer size in excess of ten crore rupees. |
| c) | More than one thousand crore rupees but less than or equal to five thousand crore rupees. | One crore twenty five lakh rupees plus 0.03125 per cent of the portion of the offer size in excess of one thousand crore rupees. |
| (d) | More than five thousand crore rupees | Two crore twenty fifty lakh rupees plus 0.01 per cent of the portion of the offer size in excess of five thousand crore rupees subject to a maximum of three crore rupees. |

(2) The consideration payable under the open offer shall be calculated at the offer price, assuming full acceptance of the open offer, and in the event the open offer is subject to differential pricing, shall be computed at the highest offer price irrespective of manner of payment of the consideration.

Provided that in the event of consideration payable under the open offer being enhanced owing to a revision to the offer price or offer size the fees payable shall stand revised accordingly, and shall be paid within five working days from the date of such revision.

(3) The manager to the open offer shall provide soft copies of the public announcement, the detailed public statement and the draft letter of offer in accordance with such specifications as may be specified, and the Board shall upload the same on its website.

(4) The Board shall give its comments on the draft letter of offer as expeditiously as possible but not later than fifteen working days of the receipt of the draft letter of offer and in the event of no comments being issued by the Board within such period, it shall be deemed that the Board does not have comments to offer; provided that in the event the Board has sought clarifications or additional information from the manager to the open offer, the period for issuance of comments shall be extended to the fifth working day from the date of receipt of satisfactory reply to the clarification or additional information sought; provided further that in the event the Board specifies any changes, the manager to the open offer and the acquirer shall carry out such changes in the letter of offer before it is dispatched to the shareholders.

(5) In the case of competing offers, the Board shall provide its comments on the draft letter of offerin respect of each competing offer on the same day.

(6) In the event the disclosures in the draft letter of offer are inadequate the Board may call for a revised letter of offer and shall deal with the revised letter to offer in accordance with sub-regulation (4).

**17. Provision of escrow:**

(1) Not later than two working days prior to the date of the detailed public statement of the open offer for acquiring shares, the acquirer shall create an escrow account towards security for performance of his obligations under these regulations, and deposit in escrow account such aggregate amount as per the following scale :

| SI No. | Consideration payable under the open offer | Escrow Amount |
|---|---|---|
| (a) | On the first five hundred crore rupees | an amount equal to twenty-five percent of the consideration. |
| (b) | On the balance consideration. | An additional amount equal to ten per cent of the balance consideration. |

Provided that where an open offer is made conditional upon minimum level of acceptance, hundred percent of the consideration payable in respect of minimum level of acceptance, or fifty per cent of the consideration payable under the open offer, whichever is higher, shall be deposited in cash in the escrow account.

(1) The consideration payable under the open offer shall be computed as provided for in sub regulation

(2) of regulation 16 and in the event of an upward revision of the offer price or of the offer size, the value of the escrow amount shall be computed on the revised consideration calculated, at such revised offer price, and the additional amount shall be brought into the escrow amount prior to effecting such revision.

(3) The escrow amount referred to in sub-regulation (1) may be in the form of:

(a) cash deposited with any scheduled commercial bank;

(b) bank guarantee issued in favour of the manager to the open offer by any scheduled commercial bank; or

(c) deposit of frequenty traded and freely transferable equity shares or other freely transferable securities with appropriate margin: Provided that securities sought to be provided towards escrow account under clause (c) shall be acquired to conform to the requirements set out in sub-regulation (2) of regulation 9.

(4) In the event of the escrow account being created by way of a bank guarantee or by deposit of securities, the acquirer shall also ensure that at least one per cent of the total consideration payable is deposited in cash with a scheduled commercial bank as a part of the escrow account.

(5) For such part of the escrow account as is in the form of a cash deposit with a scheduled commercial bank, the acquirer shall while opening the account, empower the manager to the open offer to instruct the bank to issue a banker's cheque or demand draft or to make payment of the amounts lying to the credit of the escrow account, in accordance with requirements under these regulations.

(6) For such part of the escrow account as is in the form of a bank guarantee, such bank guarantee shall be in favour of the manager to the open offer and shall be kept valid throughout the offer period and for an additional period of

thirty days after completion of payment of consideration of shareholders who have tendered their shares in acceptance of the open offer.

(7) For such part of the escrow account as is in the form of securities, the acquirer shall empower manager to the open offer to realise the value of such escrow account by sale or otherwise, and in the event there is any shortfall in the amount required to be maintained in the escrow account, the manager to the open offer shall be liable to make good such shortfall.

(8) The manager to the open offer shall not release the escrow account until the expiry of thirty daysfrom the completion of payment of consideration to shareholders who have tendered their shares in acceptance of the open offer, save and except for transfer of funds to the special escrow account as required under regulation 21.

(9) In the event of non-fulfillment of obligations under these regulations by the acquirer the Board may direct the manager to the open offer to forfeit the escrow account or any amounts lying in the special escrow account, either in full or in part.

(10) The escrow account deposited with the bank in cash shall be released only in the following manner:

(a) the entire amount to the acquirer withdrawal of offer in terms of regulation 23 as certified:

Provided that in the event the withdrawal is pursuant to clause (c) of sub-regulation (1) of regulation 23, the manager to the open offer shall release the escrow account upon receipt of confirmation of such release from the Board;

(b) for transfer of an amount not exceeding ninety per cent of the escrow account, to the special escrow account in accordance with regulation 21;

(c) to the acquirer, the balance of the escrow account after transfer of cash to the special escrow account, on the expiry of thirty days from the completion of payment of consideration to shareholders who have tendered their shares in acceptance of the open offer, as certified by the manager to the open offer;

(d) the entire amount to the acquirer upon the expiry of thirty days from the completion of payment of consideration to shareholders who have tendered their shares in acceptance of the open offer, upon certification by the manager to the open offer, where the open offer is for exchange of shares or other secured instruments;

(e) the entire amount to the manager to the open offer, in the event of forfeiture for non-fulfillment of any of the obligations under these regulations, for distribution in the following manner, after deduction of expenses, if any, of registered market intermediaries associated with the open offer;

(i) one third of the escrow account to the target company;

(ii) one third of the escrow account to the Investor Protection and Education Fund established under the Securities and Exchange Board of India (Investor Protection and Education Fund) Regulations, 2009; and

(iii) one third of the escrow account to be distributed pro-rata among the shareholders who have accepted the open offer.

**18. Other procedures:**

(1) Simultaneously with the filing of the draft letter of offer with the Board under sub-regulation (1) of regulation 16, the acquirer shall send a copy of the draft letter of offer to the target company at its registered office address and to all stock exchanges where the shares of the target company are listed.

(2) The letter of the offer shall be dispatched to the shareholders whose names appear on the registerof members of the barges company as of the identified date, not later than seven working days from the receipt of comments from the Board or where no comments are offered by the Board, within seven working days from the expiry of the period stipulated in Sub-regulation (4) of regulation 16, provided that where local laws or regulations of any jurisdiction outside India may expose the acquirer or the target company to material risk of civil

regulatory or criminal liabilities in the event the letter of offer in its final were to be sent without material amendments or modifications into such jurisdiction, and the shareholders resident in such jurisdiction hold shares entitling them to less than five per cent of the voting rights of the target company, the acquirer may refrain from dispatch of the letter of offer into such jurisdiction:

Provided further that every person holding shares, regardless of whether he held shares on the identified date or has not received the letter of offer, shall be entitled to tender such shares in acceptance of the open offer.

(3) Simultaneously with the dispatch of the letter of offer in terms of sub-regulation (2), the acquirer shall send the letter of offer to the custodian of shares underlying depositary receipts, if any, of the target company.

(4) Irrespective of whether a competing offer has been made, an acquirer may make upward revisions to the offer price, and subject to the other provisions of these regulations, to the number of shares sought to be acquired under the open offer, at any time prior to the commencement of the last three working days before the commencement of the tendering period.

(5) In the event of any revision of the open offer, whether by way of an upward revision in offer price, or of the offer size, the acquirer shall:

(a) make corresponding increases to the amount kept in escrow account under regulation 17 prior to such revision;

(b) make an announcement in respect of such revisions in all the newspapers in which the detailed public statement pursuant to the public announcement was made; and

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

(6) The acquirer shall disclose during the offer period every acquisition made by the acquirer or persons acting in concert with him of any shares of the target company in such form as may be specified, to each of the stock exchanges on

which the shares of the target company are listed and to the target company as its registered office within twenty-four hours of such acquisition, and the stock exchanges shall forthwith disseminate such information to the public; provided that the acquirer and persons acting in concert with him shall not acquire or sell any shares of the target company during the period between three working days prior to the commencement of the tendering period and until the expiry of the tendering period.

(7) The acquirer shall issue an advertisement in such form as may be specified, one working day before the commencement of the tendering period, announcing the schedule of activities for the open offer, the status of statutory and other approvals, if any, whether for the acquisition attracting the obligation to make an open offer under these regulations or for the open offer, unfulfilled conditions, if any, and their status, the procedure for tendering acceptances and such other material detail as may be specified; provided that such advertisement shall be;

(a) published in all the newspapers in which the detailed public statement pursuant to the public announcement was made; and

(b) simultaneously sent to the Bound, all the stock exchanges on which the shares if the target company are listed and the target company at its registered office.

(8) The tendering period shall start not later than twelve working days from date of receipt of comments from the Board under sub-regulations (4) of regulation 16 and shall remain open for ten working days.

(9) Shareholders who have tendered shares in acceptance of the open offer shall not be entitled to withdraw much acceptance during the tendering period.

(10) The acquirer shall, within ten working days from the last date of the tendering period, complete all requirements under these regulations and other applicable law relating to the open offer inciting payment of consideration to the shareholders who have acceptable the open offer.

(11) The acquirer shall be responsible to pursue all statutory approvals required by the acquirer in order to complete the open offer without any default, neglect or

delay; provided that where the acquirer in unable to make the payment to the shareholders who have accepted the open offer within such owing 10 non-receipt of statutory approvals required by the acquirer, the Board may, where it is satisfied that such non-receipt was not attributable to any willful default, failure or neglect on the part of the acquirer to diligently pursue such approvals, grant extension of time for making payments, subject to the acquirer agreeing to pay interest to the shareholders for the delay at such rate as may be specified:

Provided further that where the statutory approval extends to some but not all shareholders, the acquirer shall have the option to make payment to such shareholders in respect of whom no statutory approvals are required in order to complete the open offer.

(12) (a) The acquirer shall issue a post offer advertisement in such form as may be specified within five working days after the offer period, giving details including aggregate number of shares tendered, accepted, date of payment of consideration.

(b) Such advertisement shall be:

(i) published in all the newspapers in which the detailed public statement pursuant to the public announcement was made; and

(ii) simultaneously sent to the Board, all the stock exchanges on which the shares of the target company are listed, and the target company at its registered office.

**19. Conditional offer:**

(1) An acquirer may make an open offer conditional as to the minimum level of acceptance; provided that where the open offer is pursuant to an agreement, such agreement shall contain a condition to the effect that in the event the desired level of acceptance of the open offer is receive the acquirer shall not acquire any shares under the open offer and the agreement attracting the obligation to make the open offer shall stand rescinded.

(2) Where an open offer is made conditional upon minimum level of acceptances, the acquirer and persons acting in concert with him shall not acquire, during

the offer period, any shares in the target company except under the open offer and any underlying agreement for the sale of shares of the target company pursuant to which the offer is made.

**20. Competing offers:**

(1) Upon a public announcement of an open offer for acquiring shares of a target company being made, any person, other than the acquirer who has made such public announcement, shall be entitled to make a public announcement of an open offer with fifteen working days of the date of the detailed public statement made by the acquirer who has made the first public announcement.

(2) The open offer made under sub-regulation (1) shall be for such number of shares which, when taken together with shares held by such acquirer along with persons acting in concert with him, shall be at least equal to the holding of the acquirer who has made the first public announcement, including the number of shares proposed to be acquired by him under the offer and any underlying agreement for the sale of the target company pursuant to which the open offer is made.

(3) Not withstanding anything contained in these regulations, an open offer made within the period referred to in sub- regulation (1) shall not be regarded as a voluntary open offer under regulation 6, and the provisions of these regulations shall apply accordingly.

(4) Every open offer made under sub- regulation (1) and the open offer first made shall be regarded as competing offers for purposes of the these regulations.

(5) No person shall be entitled to make a public announcement of an open offer for acquiring shares, or enter into any transaction that would attract the obligation to make a public announcement of an open offer for acquiring shares under these regulations, after the period of fifteen working days referred to in sub- regulation (1) and until the expiry of the offer period for such open offer.

(6) Unless the open offer first made is an open offer conditional as to the minimum level acceptances, no acquirer making a competing offer may be made conditional as to be minimum level of acceptance.

(7) No person shall be entitled to make a public announcement of an open offer for acquiring shares, or enter into any transaction that would attract the obligation to make a public announcement of an open offer under these regulations until the expiry of the offer period.

(8) The schedule of activities and the tendering period for all competing offers shall be carried out with identical timeless and the last date for tendering shares in acceptance of the every competing offer shall stand revised to the last date for tendering shares in acceptance of the competing offer last made.

(9) Upon the public announcement of a competing offer, an acquirer who had made a preceding competing offer shall be entitled to revise the terms of his open offer provided the revised terms are more favourable to the shareholders of the target company, provided that the acquirers making the competing offers shall be entitled to make upward revisions of the offer price at any time up to three working days prior to the commencement of the tendering period.

(10) Except for variations made under this regulations, all the provisions of these regulations shall apply to every competing offer.

**21. Payment of consideration:**

(1) For the amount of consideration payable in cash, the acquirer shall open a special escrow account with a banker to an issue registered with the Board and deposit therein, such sum as would, together with cash transferred under clause (b) of sub-regulation (10) of regulation 17, make up the entire sum due and payable to the shareholders as consideration payable under the open offer, and empower the manager to the offer to operate the special escrow account on behalf of the acquirer for the purpose under these regulations.

(2) Subject to provisos to sub-regulation 18, the acquirer shall complete payment of consideration whether in the form of cash or as the cash may be, by issue, exchange or transfer of securities, to all shareholders who have tendered shares in acceptances of the open offer, within ten working days of the expiry of the tendering period.

(3) Unclaimed balances, if any lying to the credit of the special escrow account referred to in sub- regulation (1) at the end of the seven years from date of

deposit thereof, shall be transferred to the Investor Protection and Education Fund established under the Securities and Exchange Board of India (Investor Protection and Education Fund) Regulations, 2009.

**22. Completion of acquisition:**

(1) The acquirer shall not complete the acquisition of shares or voting rights in, or control over, the target company, whether by way of subscription to shares or a purchase of shares attracting the obligation to make an open offer for acquiring shares, until the expiry of the offer period, provided that in case of an offer made under sub-regulation (1) of regulation 20, pursuant to a preferential allotment, the offer shall be completed within the period as provided under sub- regulation (1) of regulations 74 of securities and Exchange Board of India (Issue of capital and Disclosure) Regulations, 2009.

(2) Notwithstanding anything contained in sub-regulation (1) to subject to the acquirer depositing in the escrow account under regulation 17, cash of an amount equal to one hundred per cent of the consideration payable under the open offer assuming full acceptance of the open offer, the parties to such agreement may after the expiry of twenty-one working days from the date of detailed public statement, act upon the agreement and the acquirer may complete the acquisition of shares or voting rights in, or control over the target company as contemplated.

(3) The acquirer shall complete the acquisitions contracted under any agreement attracting the obligation to make an open offer not later than twenty-six weeks from the expiry of the offer period; provided that in the event of any extraordinary and supervening circumstances rendering it impossible to compete such acquisition within such period, the Board may for reasons to be published, may grant an extension of time by such period as it may deem fit in the interests of investors in securities and the securities market.

**23. Withdrawal of open offer**

(1) An open offer for acquiring shares once made shall not be withdrawn except under any of the following circumstances:

(a) statutory approvals required for the open offer or for effecting the acquisitions attracting the obligation to make an open offer under these regulations having been finally refused, subject to such requirements for approval having been specially, disclosed in the detailed public statement and the letter of offer;

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

(c) any condition stipulated in the agreement for acquisition attracting the obligation to make the open offer is not met for reasons outside the reasonable control of the acquirer, and such agreement is rescinded, subject to such conditions having been specifically disclosed in the detailed public statement and the letter of offer; or

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

(2) In the event of withdrawal of the open offer, the acquirer shall through the manager to the open offer, within two working days:

a) make a announcement in the same newspapers in which the public announcement of the open offer was published, providing the grounds and reasons for withdrawal of the open offer, and

b) simultaneously with the announcement, inform in writing to:

(i) the Board;

(ii) all the stock exchanges on which the shares of the target company are listed, and the stock exchanges shall forthwith disseminate such information to the public; and

(iii) the target company at its registered office.

**24. Director of the target Company**

(1) During the offer period, no person representing the acquirer or any person acting in concert with him shall be appointed as director on the board of director of the target company. Whether as an additional director or in a casual vacancy; provided that after an initial period of fifteen working days from the date of detailed public statement, appointment of persons representing the acquirer or persons acting in

concert with him on the board of directors may be effected in the event the acquirer deposits in cash in the escrow account referred to in regulation 17, one hundred per cent of the consideration payable under the open offer:

Provided further that where the acquirer has specified conditions to which the open offer is subject in terms of clause (c) of sub-regulation (1) of regulation 23, no director representing the acquirer may be appointed to the board of directors of the target company during the offer period unless the acquirer has waived or attained such conditions and compliance with the requirement of depositing cash in the escrow account.

(2) Where an open offer is made conditional upon minimum level of acceptances, the acquirer and persons acting in concert shall, notwithstanding anything contained in these regulations, and regardless of the size of the cash deposited in the escrow account referred to regulation 17, not be entitled to appoint any director representing the acquirer or any person acting in concert with him on the board of directors of the target company during the offer period.

(3) During the pendency of competing offers, notwithstanding anything contained in these regulations, and regardless of the size of the cash deposited in the escrow account referred to in regulation 17, by any acquirer or person acting in concert with him, there shall be no induction of any new director to the board of directors of the target company;

Provided that in the event of death or incapacitation of any director, the vacancy arising therefrom may be filled by any person subject to approval of such appointment by shareholders of the target company by way of a postal ballot.

(4) In the event of the acquirer or any person acting in concert is already represented by a director on the board of the target company, such director shall not participate in any deliberations of the board of directors of the target company or vote on any matter in relation to the open offer.

**25. Obligations of the acquirer:**

(1) Prior to making the public announcement of an open offer for acquiring shares under these regulations, the acquirer shall ensure that firm financial arrangements

have been made for fulfilling the payment obligations under the open offer and that the acquirer is able to implement the open offer, subject to any statutory approvals for the open offer that may be necessary.

(2) In the event the acquirer has not declared an intension in the detailed public statement and the letter of offer to alienate any material assets of the target company or of any of its subsidiaries whether by way of sale, lease, encumbrance or otherwise outside the ordinary course of business, the acquirer, where he has acquired control over the target company, shall be debarred from causing such alienation for a period of two years after the offer period:

Provided that in the event the target company or any of its subsidiaries is required to so alienate assets despite the intention to alienate not having been expressed by the acquirer, such alienation shall require a special resolution passed by shareholders of the target company, by way of a postal ballot and the notice for such postal ballot shall inter alia contain reasons as to why such alienation is necessary.

(3) The acquirer shall ensure that the contents of the public announcement, the detailed public statement, the letter of offer and the post-offer advertisement are true, fair and adequate in all material aspects and not misleading in any material particular, and are based on reliable sources, and state the source wherever necessary.

(4) The acquirer and persons acting in concert with him shall not sell shares of the target company held by them, during the offer period.

(5) The acquirer and persons acting in concert with him shall be jointly responsible for fulfillment of applicable obligations under these regulations.

## 26. Obligations of the target company

(1) Upon a public announcement of an open offer for acquiring shares of a target company being made, the board of directors of such target company shall ensure that during the offer period, the business of the target company is conducted in the ordinary course consistent with past practice.

(2) During the offer period, unless the approval of shareholderes of the target company by way of a special resolution by postal ballot is obtained, the board of directors of either the target company or any of its subsidiaries shall not:

(a) alienate any material assets whether by way of sale, lease, encumbrance or otherwise or enter into any agreement thereof outside the ordinary course of business;

(b) effect any material borrowings outside the ordinary course of business;

(c) issue or allot any authorized but unissued securities entitling the holder to voting rights; provided that the target company or its subsidiary may;

(i) issue or allot shares upon conversion of convertible securities issued prior to the public announcement of the open offer, in accordance with predetermined terms of such conversion;

(ii) issue or allot shares pursuant to any public issue in respect of which the red herring prospectus has been filled with the Registrar of Companies prior to the public announcement of the open offer; or

(iii) issue or allot shares pursuant to any rights issue in respect of which the record date has been announced prior to the public announcement of the open offer;

(d) implement any buy-back of shares or effect any other change to the capital structure of the target company;

(e) enter into, amend or terminate any material contracts to which the target company or any of its subsidiaries is a party, outside the ordinary course of business, whether such contract is with a related party, within the meaning of the term under applicable accounting principles, or with any other person; and

(f) accelerate any contingent vesting of a right of any person to whom the target company or any of its subsidiaries may have an obligation, whether such obligation is to acquire shares of the target company by way of employee stock options or otherwise.

(3) In any general meeting of a subsidiary of the target company respect of the matters referred to in sub-regulation (2), the target company and its subsidiaries, if any, shall vote in a manner consistent with the special resolution passed by the shareholders of the target company.

(4) The target company shall be prohibited from fixing any record date for a corporate action on or after the third working day prior to the commencement of the tendering period and until the expiry of the tendering period.

(5) The target company shall furnish to the acquirer within two working days from the identified date, a list of shareholders as per the register of members of the target company containing names, addresses, shareholding and folio number, in electronic form, wherever available, and a list of persons whose applications, if any, for registration of transfer of shares are pending with the target company

Provided that the acquirer shall reimburse reasonable costs payable by the target company to external agencies in order to furnish such information.

(6) Upon receipt of the detailed public statement, the board of dries of the target company shall constitute a committee of independent directors to provide reasoned recommendations on such open offer, and the target company shall publish such recommendations:

(7) The committee of independent directors shall provide its written reasoned recommendations on the open offer to the shareholders of the target company and such recommendations shall be published in such form as may be specified, at least two working days before the commencement of the tendering period, in the same newspapers where the public announcement of the open offer was published, and simultaneously, a copy of the same shall be sent to;

(i) the Board:

(ii) all the stock exchanges on which the shares of the target company are listed, and the stock exchanges shall forthwith disseminate such information to the public.

(iii) the manager to the opens offer, and where there are competing offers, to the manager to the open offer for every competing offer

(8) The board of directors of the target company shall facilitate the acquirer in verification of shares tendered in acceptance of the open offer.

(9) The board of directors of the target company shall make available to all acquirers making competing offers, any information and co-operation provided to any acquirer who has made a competing offer

(10) Upon fulfillment by the acquirer, of the conditions required under these regulations, the board of directors of the target company shall without any delay register the transfer of shares acquired by the acquirer in physical form, whether under the agreement or from open market purchases, or pursuant to the open offer.

**27 Obligations of the manager to the open offer**

(1) Prior to public announcement being made, the manager to the open offer shall ensure that;

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

(b) firm arrangements for funds through verifiable means have been made by the acquirer to meet the payment obligations under the open offer.

(2) The manager shall further ensure that the contents of the public announcement, the detailed public statement and the letter of offer and the post-offer advertisement are true, fair and adequate in all material aspects, not misleading in any material particular, are based on reliable sources, state the source wherever necessary, and are in compliance with the requirements under these regulations.

(3) He shall furnish to the Board a due diligence certificate along with the draft letter of offer filed under regulation 16.

(4) He shall ensure that market intermediaries engaged for the purposes of the open offer are registered with the Bound.

(5) He shall exercise diligence, care and professional judgment to ensure compliance with these regulations.

(6) He shall not deal on his own account in the shares of the target company during the offer period; and finally

(7) He shall file a report with the board within fifteen working days from the expiry of the tendering in such form as may be specified, confirming status of completion of various open offer requirements.

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

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

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

1. **Capitalised Earnings.** The capitalised earnings method is based on the philosophy that the price which a buyer would like to pay for the property of a concern will depend upon the present and expected earning capacity of the business. The present price is paid in the expectations of future returns from such investments. The capitalised earnings will depend upon the (1) Estimate of earnings, and (2) Rate of capitalisation.

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

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

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

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

of money market. The price of a security in the free market will be its most appropriate value. Market value is a device which can be readily applied at any time.

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

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

**Illustration 5.1** A Ltd. wants to take over B Ltd. and the financial details of both the companies areas below:

| | A Ltd. (Rs.) | B Ltd. (Rs.) |
|---|---|---|
| Equity share capital of 10 each | 2,00,000 | 1,00,000 |
| Preference share capital | 40,000 | - |
| Share premium | - | 4,000 |
| Profit and loss account | 76,000 | 8,000 |
| 10% Debentures | 30,000 | 10,000 |
| Total liabilities | 3,46,000 | 1,22,000 |

| | | |
|---|---|---|
| Fixed assets | 2,44,000 | 70,000 |
| Current assets | 1,02,000 | 52,000 |
| Total assets | 3,46,000 | 1,22,000 |
| Profit after tax and preference dividend | 48,000 | 30,000 |
| Market price per share | 24 | 27 |

You are required to determine the share exchange ratio to be offered to the shareholders of B Ltd., based on

(*i*) net assets value, (*ii*) EPS, and

(*iii*) market price. Which should be preferred from the point of view of A Ltd. ?

**Solution :**

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

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

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

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

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

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

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

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

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

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

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

| | A Ltd. | B Ltd. |
|---|---|---|
| *Market price per share* | ₹24 | ₹27 |

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

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

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

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

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

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

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

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

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

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

**Solution :**

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

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

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

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

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

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

= Earnings After the merger × Exchange Ratio

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

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

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

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

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

$= 4{,}80{,}000$

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

| **Impact on EPS of Company X's Shareholders** | ***Rs*** |
|---|---|
| EPS Before Merger | 6.000 |
| EPS After merger | 5.937 |
| Dilution in EPS | 0.063 |

## 5.6 SUMMARY

The objective of this Indian Accounting Standard is to improve the relevance, reliability and comparability of the information that a reporting entity provides in its financial statements about a business combination and its effects. To accomplish that, this Indian Accounting Standard establishes principles and requirements for how the acquirer: (a) recognises and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree; (b) recognises and measures the goodwill acquired in the business combination or a gain from a bargain purchase1 ; and (c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

In exercise of the powers conferred under section 30 of the Securities and Exchange Board of India Act, 1992 (15 of 1992), the Board hereby makes the following Regulations to further amend the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, namely:

1. These regulations may be called the Securities and Exchange Board of India (Substantial Acquisition o fShares and Takeovers) (Second Amendme nt) Regulations, 2018
2. They shall come into force on the date of their publication in the Official Gazette.
3. In the Securities and Exchange Board of (Substantial Acquisition of Shares and Takeovers) Regulations, 2011.

## 5.7 GLOSSARY

- **Accounting Standard:** An accounting standard is a set of practices and policies used to systematize bookkeeping and other accounting functions across firms and over time.
- **Business Combination:** A business combination in which all the combining entities or business are ultimately controlled by the same person/ persons both before and after the combination and such control is not transitory in nature.

## 5.8 SELF ASSESSMENT QUESTIONS

1. Explain accounting standard 103?

______________________________________________________________________

______________________________________________________________________

______________________________________________________________________

______________________________________________________________________

2. Discuss pre-merger Earning per share?

______________________________________________________________________

______________________________________________________________________

______________________________________________________________________

______________________________________________________________________

## 5.9 LESSON END EXERCISE

Solve the below mentioned question :

1. Sunny Lamps Ltd. is taking over Moon Lamps Ltd. As per the agreement, shareholder of Moons Lamps Ltd. would receive 0.7 shares of Sunny Lamps Ltd. for each share held by them. The relevant data for the two companies are as follow:

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

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

**Solution :**

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

*(iii)* **Combined EPS**

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

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

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

*(iv)* **Combined Price–Earning Ratio**

$$= \left(6 \times \frac{16}{20}\right) + \left(5 \times \frac{4}{20}\right) = 5.80$$

*(v)* **Market Value per share After Merger**

= P/E Ratio × EPS

= 5.80 × 5.13

= ₹ 29.754

*(vi)* **Total Market Capitalisation After Merger**

= Market Value per share × No. of shares

= 29.754 × 3,90,000

= ₹ 116.04 lakhs.

## 5.10 SUGGESTED READINGS


- Gupta, Sashi, K. (2015). Financial Management. Kalyani Publisher, New Delhi.
- Jain, S.P and Narang, K.L. (2014). Advanced Acountancy-Vol-II. Kalyani Publisher, New Delhi.
- Gupta, Sashi, K. (2015). Management Accounting. Kalyani Publisher, New Delhi.
- Gupta, Sashi, K. and Mehra, A. (2015). Contemporary Issues in Accounting. Kalyani Publisher, New Delhi.


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# VALUATION OF RATE OF RETURN ON CAPITAL EMPLOYED AND LEASE EVALUATION

| | | |
|---|---|---|
| **M.Com II Sem.** | **Advanced Accounting** | **Unit-II** |
| **M.Com – C 250** | | **Lesson No. 6** |

**STRUCTURE**



## 6.1 INTRODUCTION

Return on capital employed or ROCE is a profitability ratio that measures how efficiently a company can generate profits from its capital employed by comparing net operating profit to capital employed. In other words, return on capital employed shows investors how many dollars in profits each dollar of capital employed generates. ROCE is a long-term profitability ratio because it shows how effectively assets are performing while taking into consideration long-term financing. This is why ROCE is a more useful ratio than return on equity to evaluate the longevity of a company. This ratio is based on two important calculations: operating profit and capital employed. Net operating profit is often called EBIT or earnings before interest and taxes. EBIT is often reported on the income statement because it shows the company profits generated from operations. EBIT can be calculated by adding interest and taxes back into net income if need be. Capital employed is a fairly convoluted term because it can be used to refer to many different financial ratios. Most often capital employed refers to the total assets of a company less all current liabilities. This could also be looked at as stockholders' equity less long-term liabilities. Both equal the same figure.

## 6.2 OBJECTIVES

After going through this lesson, you will be able to understand:

- meaning of return on capital employed;
- procedure for computing profit for return on capital employed;
- precautions to be taken while computing return on capital employed;
- advantages of return on capital employed;
- disadvantages/limitations of return on capital employed; and
- significance of return on capital employed.

## 6.3 BASICS OF RETURN ON CAPITAL EMPLOYED

The prime objective of making investments in any business is to obtain satisfactory return on capital invested. Hence, the return on capital employed is used as a measure of success of a business in realizing this objective.

This ratio is also known as Return on Investment (ROI). It is an overall profitability ratio. It indicates the percentage of return on the capital employed in the business and it can be used to show the efficiency of the business as a whole.

Formula:

$$\text{Return on Capital employed} = \frac{\text{Operating Profit}}{\text{Average Capital employed}} \times 100$$

$$\text{or} \quad \frac{\text{EBIT}}{[\text{Total Assets - Total Liabilities}]}$$

$$\text{or} \quad \frac{\text{EBIT}}{[\text{Long term Liabilities + Shareholders Equity}]}$$

Return on Capital Employed (ROCE) is a profitability ratio that helps to measure the profit or return that a company earns from the capital employed, which is usually expressed in the terms of percentage. It is used to determine the profitability and efficiency of the capital investment of a business entity. It is simply defined as a financial ratio that helps to determine the capital efficiency and effectiveness of business.

Return on Capital Employed is generally calculated on the basis of two major calculations/ components –

Operating profit

Capital employed

Operating Profit

It is the profit that a company earns from its business operations before the deduction of taxes and interests. Therefore, it is also known as earnings before interest and taxes (EBIT). It is calculated by deducting operating expenses and cost of goods sold from revenues.

EBIT= Total revenues – [cost of goods sold (COGS) + Operating Expenses]

**Capital Employed**

It is the total amount of capital invested in the business operations by the shareholders and other sources to earn a profit. It is also known as fund employed. Capital employed is the sum of the equity of shareholders, all the debt liabilities, and all the long-term finance.

Capital Employed= Total assets – current liabilities

Return on equity is another financial ratio used to calculate profit and people often get confused between these two ratios. ROCE is considered better than the Return on Equity as ROCE is helpful in evaluating company's longevity and durability. ROCE is also considered more beneficial as only the percentage return of equity shareholders is calculated in Return on Equity (ROE) whereas in ROCE, the return percentage of all the shareholders/ capital providers is calculated. Return on capital employed of a company should be higher than its cost of capital in order to remain in the market for a long run and only then it will be considered as a good return on capital employed. Higher will be the ROCE of a company greater will be the efficiency.

## 6.4 COMPUTATION OF PROFIT FOR RETURN ON CAPITAL EMPLOYED

Capital employed and operating profits are the main items. Capital employed may be defined in a number of ways. However, two widely accepted definitions are 'gross capital employed' and 'net capital employed'.

Gross capital employed usually means the assets used in the business, while net capital employed refers to total assets minus current liabilities. On the other hand, it refers to the total of capital, capital reserves, revenue reserves (including Profit and Loss a/c balance), debentures and long-term loans.

Computation of Capital Employed:

It may be computed from the asset side as well as from the liabilities side.

If it is computed from the asset side, it will comprise:

(a) Fixed assets:

Land and Buildings, Plant and Machinery, Furniture and Fittings, and Motor Vehicles, etc.

(b) Investments made in the business:

(c) Current Assets:

Inventories, Book Debts less provision for bad and doubtful debts, Bills Receivable, Bank, and Cash, etc.

Less Current Liabilities:

Sundry Creditors, Bills Payable, Bank overdraft, outstanding expenses, etc.

Gross Capital employed = Fixed Assets + Investments+ CurrentAssets

Net Capital employed = Fixed Assets + Investments + Working Capital (Current Assets minus Current Liabilities)

Alternatively, if it is calculated from the liabilities side it will include the following items:

Share Capital:

Equity and Preference Share Capital (issued capital)

Reserve and Surplus:

Capital Reserve, General Reserves, P&L A/C balance

Debentures

Other Long-term loans

## 6.5 PRECAUTIONS TO BE TAKEN WHILE COMPUTING RETURN ON CAPITAL EMPLOYED

(a) The valuation of fixed assets may be done at their replacement cost. The current market prices may be ascertained either by reference to reliable published index numbers, or on valuation of experts. At the same time the provision for depreciation should also be readjusted.

(b) All idle assets should be excluded from the computation. However, standby plant and equipment required for normal working may be included.

(c) All intangible assets like goodwill, patents and trademarks unless they have potential sales value and all fictitious assets like preliminary expenses, discount on issue of shares, etc., should be excluded.

(d) All investments made outside the business should be excluded.

(e) All current assets should be properly valued. Any excess bank balance, which is more than the normal requirements, should not be considered.

Some people suggest that average capital employed should be used in order to give effect to the capital investment throughout the year. It is argued that the profits earned remain in the business throughout the year and are distributed by way of dividends only at the end of the year. Average capital employed may be calculated by two methods.

Under the first method, only the simple arithmetic mean of the total capital employed at the beginning and at the end of the year is found out. Under the second method, it is calculated by adding half of the profits after tax and interest to the opening capital employed.

When net capital employed has been calculated either from the asset side or liabilities side, half of the profits earned during the year may be deducted from the figure so computed in order to arrive at 'average capital employed'.

Operating profit used for the computation of return on capital employed should be the profits earned by such capital. Hence, the net profit should be adjusted, if necessary, for obtaining the true operating profit with the following items:

(a) Any abnormal and non-recurring losses or gains,

(b) Income from investments made outside the business,

(c) Depreciation based on the replacement cost of the asset,

(d) Interest on long-term loans and debentures should be added back.

(e) Profits before the payment of income tax

ROCE is calculated by using a simple formula. Various financial statements like Balance Sheets, Profit/Loss account are used to calculate ROCE. As it is a profitability ratio, it is calculated by dividing net operating profit of the company with the employed capital.

The formula of calculating Return on Capital Employed

ROCE= Net Operating Profit (EBIT) / Capital Employed

OR

ROCE= Net Operating Profit (EBIT) / Total Assets – Current Liabilities

OR

ROCE= Net Operating Profit (EBIT) / Equity + Non- Current Liabilities

Apart from this ROCE can also be calculated with the help of return on capital employed calculators available on the internet. You just have to enter your values and you will get desired output without doing calculations manually.

Return on Capital Employed Ratio exactly shows the profit generated by each unit of capital employed. It is important because it is used to measure the financial performance of a business. It has built a strong position as a financial tool to be used for evaluation in highly capital-intensive sectors like telecommunication, infrastructure engineering, oil and gas companies, power utilities etc. The higher rate of ROCE indicates how effectively a company is utilizing its funds. Before calculating the return on capital employed a level business strategy is necessary to be framed to check the applicability of ROCE in a particular business as ROCE varies from industry to industry.

Industries these days are aware of the advantages of Return on capital employed. Most of the industries, especially highly capital-intensive industries, use this financial tool to achieve maximum profitability from the capital employed.

## 6.6 ADVANTAGES OF RETURN ON CAPITAL EMPLOYED

Some major benefits of ROCE are as follows:

1. Return on Capital Employed focuses on profit.
2. Facilitates improved company's balance sheet management and profitability.

3. Helps managers gain knowledge about the effective utilization of capital.
4. Used for performance measurement of the company and helps investors in making investment decisions.
5. Facilitates comparison of profitability of two companies of same sectors.
6. Useful in evaluating the growth forecast of a company.
7. Companies with high return on capital employed industry average can be spotted with the help of Return on Capital Employed.
8. It is the only measure, which can be said to show satisfactorily the benefits being obtained for the sacrifice involved, the latter being represented by capital invested.
9. It allows external comparisons to be made. The progress of one company or companies may be compared with that of other companies.
10. It is an effective tool for making an internal comparison in respect of different divisions or departments of a company. It may be used as an instrument of control by comparing the relative profitability of different products.
11. It enables the management to make efficient capital budgeting decisions. It can become an integral part of the budgetary control system.
12. It gives ideas for analysis and decisions to bring about effective changes in the financial policies. For example, there should be no borrowing when the rate of interest is higher than the rate of return.
13. If management ensures that an adequate return on capital invested is earned, then many direct benefits such as regular and satisfactory dividends to shareholders, adequate strength to face competition, etc., may accrue to the business concern.

## 6.7 DISADVANTAGES/ LIMITATIONS OF RETURN ON CAPITAL EMPLOYED

Besides the advantages, ROCE also has few drawbacks.

1. One of the major limitations of return on capital employed is that the returns are measured in the book value of assets, which only favours the older companies.
2. Sometimes the ambiguous and debatable nature of ROCE also makes investors think twice.
3. ROCE is calculated on historical data and this again serves as a drawback of ROCE.
4. ROCE is exposed to risk accounting manipulation that can result in elevated returns.

## 6.8 SIGNIFICANCE OF RETURN ON CAPITAL EMPLOYED

Return on Capital employed is considered to be the best measure of profitability in order to assess the overall performance of the business satisfactorily. It is commonly used as a basis for various managerial decisions since it relates to the benefits obtained in the form of income with the sacrifice made in the form of capital invested. A starting point in budgeting and management planning is the determination of a minimum rate of return on capital invested. All business decisions should result in a reasonable (minimum) return. Investments, which generate rates lower than this minimum rate of return, are rejected. However, it is very difficult to set a standard rate of return on capital employed as a number of factors such as business risk, the type of industry, inflation, changes in economic conditions, etc., may influence such a rate. Different views prevail with regard to standard rate. Bank rate, discount rates of gilt-edged securities or some opportunity rate are some of the suggested rates as the norm for this ratio. However, it is left to the discretion of management to set some rate against which they are to compare the actual result with a view to measuring their efficiency, or the overall performance of the business. This ratio could be supplemented with a number of ratios depending upon the purpose for which it is computed.

## 6.9 SUMMARY

The Return on Capital invested is a concept that measures the profit which a firm earns on investing a unit of capital. 'Yield on Capital' is another term employed to express the idea. It is desirable to ascertain this periodically. The profit being the net result of all operations the return on capital expresses all efficiencies or inefficiencies of a business collectively and, thus, is a dependable measure for judging its over all efficiency or inefficiency. On this basis, there can be comparison of the efficiency of one department with that of another, of one plant with that of another, one company with that of another and one industry with that of another. For this purpose, amount of the profits considered is that before making deductions on account of interest, income-tax and dividends and capital is aggregate of all the capital at the disposal of the company, vis., equity capital, reserves, debentures, etc.

The Return on Capital when calculate in this manner would also show whether the company's borrowing policy was economically wise and whether the capital had been employed fruitfully. Suppose, funds have been borrowed at 8% and the Return on Capital is 7.5%, it would have been better not to borrow (unless borrowing was vital for survival). It would also shoe that the firm had not been employing the funds efficiently.

The business can survive only when the return on capital employed is more than the cost of capital employed in the business.

### 6.10 GLOSSARY

- **ROCE**- Return on capital employed
- **EBIT-**Earning before interest and taxes
- **Gross Capital employed** = Fixed Assets + Investments+ Current Assets
- **Net Capital employed** = Fixed Assets + Investments + Working Capital (Current Assets minus Current Liabilities)
- **P&L A/C-** Profit and loss account

### 6.11 SELF ASSESSMENT QUESTIONS

Q.1 Explain the term return on capital employed.

Ans. ______________________________________________

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Q.2 Explain the procedure for calculating return on capital employed.

Ans. ______________________________________________

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Q.3 Discuss the precautions to be taken while computing term return on capital employed.

Ans. ______________________________________________

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Q.4 Discuss the advantages of the term return on capital employed.

Ans. ____________________________________________________

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## 6.12 LESSON END EXERCISE

1. What is meant by return on capital employed? How it is calculated?
2. Discuss the procedure for calculating return on capital employed. Highlights the precautions to be taken while computing return on capital employed.
3. Give the merits and demerits of return on capital employed.
4. What is understand by return on capital employed? Give its significance.

## 6.13 SUGGESTED READINGS


- Jain, S.P and Narang, K.L. (2014). Advanced Accountancy-Vol-II. Kalyani Publisher, New Delhi.
- Gupta, Sashi, K. (2015). Management Accounting. Kalyani Publisher, New Delhi.
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# NET ASSET APPROACH AND LIABILITY APPROACH METHOD

| M.Com II Sem. | Advanced Accounting | Unit-II |
|---|---|---|
| M.Com – C 250 | | Lesson No. 7 |

**STRUCTURE**



## 7.1 INTRODUCTION

It is a clear fact that every business entity is operating in the market to earn a profit. Profit making is the major objective of every business firm and this can be achieved only when a company is highly efficient. Effective and optimum utilization of company's funds and capital leads to greater efficiency which ultimately leads to higher profitability. It is also important for business firms to benchmark their performance against the competitors in the market. Therefore, it becomes necessary for a business firm to have a financial tool that can act as a base for its performance measurement on a yearly basis. This is where the return on capital employed i.e. ROCE helps companies to measure their business performance and efficiency. ROCE also allows comparison of a company with the other companies within the same sector/industry.

## 7.2 OBJECTIVES

After going through this lesson, you will be able to

- gain an insight into the term return on capital employed;
- make valuation of return on capital employed; and
- & its various aspects that may help them in calculating business profit against the capital employed.

## 7.3 AN INSIGHT INTO THE TERM RETURN ON CAPITAL EMPLOYED

The term capital employed has been given different meanings by different accountants. Some of the popular meanings are as follows:

- Sum total of all assets whether fixed or current.
- Sum total of fixed assets.
- Sum total of long-term funds employed in the business, i.e.,

Share Capital + Reserves and Surplus + Long-term Capital - (Non-business Assets + Fictitious Assets)

However, the term capital employed is generally used in the meanings given in the point third above.

The term 'Operating Profit' means 'Profit before interest and Tax'. The term 'Interest means 'Interest on long-term borrowings'. Interest on short-term borrowings will be deducted for computing operating profit. Non-trading incomes such as interest on Government securities or non-trading losses or expenses such as loss on account of fire, etc., will also be excluded

## 7.4 PROFITABILITY IN RELATION TO CAPITAL EMPLOYED

The following ratios are calculated while calculating return on capital employed

1. Return on gross investment or gross capital employed
2. Return on net investment or net capital employed
3. Return on shareholder's investment or shareholder's capital employed.
4. Return on equity shareholder investment or equity shareholder capital employed.

**1. RETURN ON GROSS CAPITAL EMPLOYED**

This ratio establishes the relationship between net profit and the gross capital employed. The term gross capital employed refers to the total investment made in business. The conventional approach is to divide Earnings After Tax (EAT) by gross capital employed.

$$\text{Return on gross capital employed} = \frac{\text{Earnings After Tax (EAT)} \times 100}{\text{Gross Capital Employed}}$$

**2. RETURN ON NET CAPITAL EMPLOYED**

It is calculated by dividing Earnings Before Interest & Tax (EBIT) by the net capital employed. The term net capital employed in the gross capital in the business minus current liabilities. Thus it represents the long-term funds supplied by creditors and owners of the firm.

$$\text{Return on net capital employed} = \frac{\text{Earnings Before Interest \& Tax (EBIT)} \times 100}{\text{Net Capital Employed}}$$

**3. RETURN ON SHARE CAPITAL EMPLOYED**

This ratio establishes the relationship between earnings after taxes and the shareholder investment in the business. This ratio reveals how profitability the owners' funds have been utilized by the firm. It is calculated by dividing Earnings after tax (EAT) by shareholder capital employed.

$$\text{Return on share capital employed} = \frac{\text{Earnings After Tax (EAT)} \times 100}{\text{Shareholder Capital Employed}}$$

**4. RETURN ON EQUITY SHARE CAPITAL EMPLOYED**

Equity shareholders are entitled to all the profits remaining after the all outside claims including dividends on preference share capital are paid in full. The earnings may be distributed to them or retained in the business. Return on equity share capital investments or capital employed establishes the relationship between earnings after tax and preference dividend and equity shareholder investment or capital employed or net worth. It is calculated by dividing earnings after tax and preference dividend by equity shareholder's capital employed.

Return on equity share capital employed =

$$\frac{\text{Earnings After Tax (EAT), Preference Dividends} \times 100}{\text{Equity Share Capital Employed}}$$

## 7.5 COMPONENTS OF RETURN ON CAPITAL EMPLOYED

Return on capital employed is an overall profitability ratio. It indicates the percentage of return on the capital employed in the business and it can be used to show the efficiency of the business as a whole.

The main components of capital employed are as follow:

1. Capital employed
2. Operating profits

Capital employed may be defined in a number of ways. However, two widely accepted definitions are 'gross capital employed' and 'net capital employed'.

Gross capital employed usually means the assets used in the business, while net capital employed refers to total assets minus current liabilities. On the other hand, it refers to the total of capital, capital reserves, revenue reserves (including Profit and Loss a/c balance), debentures and long-term loans. Operating profit is the earning available after interest and taxes.

## 7.6 VALUATION OF RETURN ON CAPITAL EMPLOYED

Capital employed can be calculated either by the net assets approach or by the liability approach method.

### 7.6.1 Asset Approach

If it is computed by the asset approach, it will comprise:

(a) Fixed assets : Land and Buildings, Plant and Machinery, Furniture and Fittings, and Motor Vehicles, etc.

(b) Investments made in the business:

(c) Current Assets : Inventories, Book Debts less provision for bad and doubtful debts, Bills Receivable, Bank, and Cash, etc.

Less Current Liabilities : Sundry Creditors, Bills Payable, Bank overdraft, outstanding expenses, etc.

Gross Capital employed = Fixed Assets + Investments+ CurrentAssets

Net Capital employed = Fixed Assets + Investments + Working Capital (Current Assets minus Current Liabilities)

### 7.6.2 Liability Approach

Alternatively, if it is calculated from the liabilities side, it will include the following items:

Share Capital : Equity and Preference Share Capital (issued capital)

Reserve and Surplus : Capital Reserve, General Reserves, P&L A/C balance

Debentures

Other Long-term loans

While calculating net capital employed either from the asset side or liabilities side, half of the profits earned during the year may be deducted from the figure so computed in order to arrive at 'average capital employed'.

Operating profit used for the computation of return on capital employed should be the profits earned by such capital. Hence, the net profit should be adjusted, if necessary, for obtaining the true operating profit with the following items:

(a) Any abnormal and non-recurring losses or gains,

(b) Income from investments made outside the business,

(c) Depreciation based on the replacement cost of the asset,

(d) Interest on long-term loans and debentures should be added back.

(e) Profits before the payment of income tax

**Illustration 7.1**

From the following financial statements, calculate Return on Capital employed:

Profit and Loss Account for the year ended 31-12-2002

| | Rs. | | Rs. |
|---|---|---|---|
| To Cost of goods sold | 1,50,000 | By Sales | 2,50,000 |
| To Interest on debentures | 5,000 | By Income from investment | 5,000 |
| To Provision for Taxation | 50,000 | | |
| To Net Profit c/d | 50,000 | | |
| | 2,55,000 | | 2,55,000 |

**Balance Sheet as on 31-12-2002**

| Liabilities | Rs. | Assets | Rs. |
|---|---|---|---|
| Share Capital: | | Fixed Assets | 2,25,000 |
| Preference | 50,000 | Investments in Govt. Bonds | 50,000 |
| Equity | 1,00,000 | Current Assts | 75,000 |
| Reserves | 50,000 | | |
| P & L A/C | 50,000 | | |
| 10% Debentures | 50,000 | | |
| Provision for Taxation | 50,000 | | |
| | 3,50,000 | | 3,50,000 |

Solution:

$$\text{Return on Capital employed} = \frac{\text{Operating Profit}}{\text{Average Capital employed}} \times 100$$

Operating :

Profit = Net Profit before interest and tax minus income from investments

= Rs.50,000 + 5,000 + 50,000 – 5,000 = Rs.1,00,000

Capital employed = Fixed Assets + Current Assets – Provision for Taxation

= Rs.2,25,000 + 75,000- 50,000 = Rs.2, 50,000

OR

= Share capital + Reserves + P&L a/c + Debentures – Government Bonds

= Rs. 1,50,000 + 50,000 + 50,000 + 50,000 -50,000

= Rs.2,50,000

Average Capital employed = Capital employed – 1/2 (Profits earned during the year)

= Rs.2, 50,000 – 25,000 = Rs.2, 25,000

$$\text{Return On Capital employed} = \frac{\text{Rs.1,00,000}}{\text{Rs.2,25,000}} \times 100 = \frac{400}{9}$$

$$= 44.4\% \text{ (app.)}$$

OR

Return on Closing Capital employed

$$= \frac{\text{Rs.1,00,000}}{\text{Rs.2,50,000}} \times 100 = 40\%$$

The computation of return on capital employed (ROCE) can be understood with the help of the following example:

**Illustration 7.2**

From the following figures extracted from the Income Statement and the Balance Sheet of Messrs Ali & Sons Pvt. Ltd., calculate the Return on Total Capital employed:

| Particulars | Amount (Rs.) |
|---|---|
| Fixed assets | 4,50,000 |
| Current assets | 1,50,000 |
| Investment in Govt. securities | 1,00,000 |
| Sales | 5,00,000 |
| Cost of goods sold | 3,00,000 |
| Share capital | 3,00,000 |
| Reserves | 1,00,000 |
| Debentures | 1,00,000 |
| Income from investments | 10,000 |
| Interest on debentures at 10% | |
| Provision for tax at 50% of net profits | |

**Solution:**

It will be appropriate to prepare the Profit and Loss Account and Balance sheet of the company before computation of the '**return on capital employed (ROCE)**'.

**Profit and Loss Account**

| **Details** | Rs. | **Details** | Rs. |
|---|---|---|---|
| Cost of goods sold | 3,00,000 | Sales | 50,00,000 |
| Interest on debentures | 10,000 | Income from investments | 1,50,000 |
| Provision for taxation | 1,00,000 | | |
| Net profit after tax | 1,00,000 | | |
| | | | |
| | 5,10,000 | | 5,10,000 |

**Balance Sheet**

| Liabilities | Rs. | Assets | Rs. |
|---|---|---|---|
| Share capital | 3,00,000 | Fixed assets | 4,50,000 |
| 10% debentures | 1,00,000 | Current assets | 1,50,000 |
| Profit and loss account | 1,00,000 | Investment in Govt. Securities | 1,00,000 |
| Provision for taxation | 2,00,000 | | |
| Total | 7,00,000 | | 7,00,000 |

Return on total capital employed = Net operating profit before interest and tax / Total capital employed = 2,00,000 / 5,00,000 x 100 = 40 %

Net operating profit = Net profit + Provision for tax - Income from investments + Interest on Debentures

= Rs.1,00,000 + Rs.1,00,000 - Rs.10,000 + Rs.l0,000

= Rs.2,00,000

Capital employed = Fixed assets + Current assets - Provision for taxation

= Rs.4,50,000 + Rs.1,50,000 -Rs.1,00,000

= Rs.6,00,000 - Rs.1,00,000

= Rs.5,00,000

Return on Investment (ROI) can be computed for computing the return for different purpose. Some of the ratios that are calculated are as follows:

**(1) Return on Shareholder's Funds:**

In case, it is desired to work out the profitability of the company from the shareholders point of view, it should be computed as follows:

(Net Profit after Interest and Tax / Shareholders' funds) × 100

The term Net Profit here means 'Net Income after Interest and Tax'. It is different from the 'Net Operating Profit' which is used for computing the 'Return on Total Capital Employed' in the business. This is because the shareholders are interested in Total Income after Tax including Net Non-operating Income (i.e., Non-operating Incomes-Non-operating Expenses).

Taking the figures from the example above the Return on Shareholder's Funds can be computed as follows:

(Rs.1,00,000 / Rs.5,00,000) × 100

= 20 %

**(2) Return on Gross Capital Employed:**

The term **Gross Capital employed** means the total of Fixed Assets and the Current Assets employed in the business. The formula for its computation can be put as follows:

(Net profit before Interest and Tax / Gross Capital employed) × 100

Gross capital employed = Fixed assets + Current assets

The students are advised to give their assumptions regarding computation of 'Net Profit' as well as 'Capital employed' while calculating the Return on Investment (ROI).

**Average Capital Employed:**

Some people prefer to use 'Average Capital employed' (or average total assets, as the case may be) in place of only 'Capital employed' (or Total Assets). Average Capital employed is the average of the capital employed at the beginning and at the end of the accounting period.

ROI = (Net profit before interest and tax / Average capital employed) × 100
Average capital employed = (Opening capital employed + Ending capital employed) / 2

**Important:** It should be noted that while computing "Return on Investment" according to any of the above methods 'Abnormal Gains or Losses' should always be excluded from Net profit.

## 7.7 SUMMARY

Companies with higher ROCE and greater efficiency are favoured by investors because such companies tend to be more stable compared to the companies with low

ROCE. We have learned the importance of return on capital employed and every Industry should consider ROCE as a powerful tool to get higher returns, therefore, it must be given attention. Hence, we can say that calculating your profits with the return on capital employed can bring more stability and efficiency to your business.

## 7.8 GLOSSARY

- **Capital employed** = Fixed assets + Current assets - Provision for taxation
- **ROI** = (Net profit before interest and tax / Average capital employed) × 100
- **Average capital employed** = (Opening capital employed + Ending capital employed) / 2
- **Net operating profit** = Net profit + Provision for tax - Income from investments + Interest on Debentures

## 7.9 SELF ASSESSMENT QUESTIONS (SAQ)

Q.1 What is gross capital employed? How it is calculated?

Ans. ____________________________________________________________

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Q.2 What is net capital employed? How it is calculated?

Ans. ____________________________________________________________

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Q.3 What is average capital employed? How is it calculated?

Ans. _______________________________________________________

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## 7.10 LESSON END EXERCISE

1. The following is the balance sheet of M/S Bharat Ltd. for the year ending 31st December 2018

| Liabilities | Amount (Rs.) | Assets | Amount (Rs.) |
|---|---|---|---|
| 50,000 equity shares of ₹ 10 each fully paid | 5,00,000 | Goodwill | 50,000 |
| | | Freehold property | 1,00,000 |
| 20,000 Preference shares of ₹ 20 each fully paid | 4,00,000 | Plant & machinery | 2,00,000 |
| | | Land & buildings | 4,00,000 |
| P&L (including ₹40,000 current year's profits) | 1,00,000 | Furniture | 45,000 |
| | | Stock | 1,75,000 |
| 5% debentures | 1,00,000 | Debtors | 55,000 |
| Bills payable | 60,000 | Cash at bank | 1,50,000 |
| Creditors | 40,000 | Preliminary expenses | 25,000 |
| Total | 12,00,000 | | 12,00,000 |

The value of land and building will be Rs. 4,50,000 and Plant and Machinery Rs. 1,80,000. Calculate:

i. Gross capital employed ii. Net Capital Employed iii Average capital employed iv Return on Net Capital Employed.

2. Following are the summarised profit and loss account and balance sheet of X Ltd. for the year ended 31st December, 2017

**Profit and Loss Account**

| | Rs. | | Rs. |
|---|---|---|---|
| To opening stock | 1,50,000 | By sales | 13,00,000 |
| " purchases | 8,50,000 | By closing stock | 2,00,000 |
| " wages | 50,000 | | |
| " freight and carriage | 20,000 | | |
| " Gross profit | 4,30,000 | | |
| | 15,00,000 | | 15,00,000 |
| To office and administrative expenses | 2,00,000 | By gross profit | 4,30,000 |
| "selling and distribution expenses | 10,000 | By interest on Govt. securities | 12,000 |
| "Interest on debentures | 10,000 | By profit on sale of plant | 8,000 |
| "interest on bank over draft | 5,000 | | |
| "Depreciation | 15,000 | | |
| "loss on sale of machine | 10,000 | | |
| "provision for tax | 1,00,000 | | |
| "net profit | 1,00,000 | | |
| | 4,50,000 | | 4,50,000 |

**Balance Sheet**

| Liabilities | Amount (Rs.) | Assets | Amount (Rs.) |
|---|---|---|---|
| Equity share capital | 4,00,000 | Land &building (net) | 2,50,000 |
| 8% preference share capital | 2,00,000 | Plant & machinery | 3,00,000 |
| Reserves | 60,000 | Investments in Govt. securities | 1,00,000 |
| Profit & loss A/C | 40,000 | Stocks | 2,00,000 |
| 10% debentures | 1,00,000 | Sundry debtors | 1,00,000 |
| Bank overdraft | 50,000 | Cash | 40,000 |
| Other current liabilities | 1,50,000 | Discount on issue of shares | 10,000 |
| Total | 10,00,000 | Total | 10,00,000 |

You are required to calculate:

(i) Return on gross capital employed.

(ii) Return on net capital employed.

## 7.11 SUGGESTED READINGS


- Jain, S.P and Narang, K.L. (2014). Advanced Accountancy-Vol-II. Kalyani Publisher, New Delhi.
- Gupta, Sashi, K. (2015). Management Accounting. Kalyani Publisher, New Delhi.
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# VALUATION OF RATE OF RETURN ON CAPITAL EMPLOYED AND LEASE EVALUATION

| | | |
|---|---|---|
| **M.Com II Sem.** | **Advanced Accounting** | **Unit-II** |
| **M.Com – C 250** | | **Lesson No. 8** |

**STRUCTURE**



## 8.1 INTRODUCTION

Lease financing is one of the important sources of medium- and long-term financing where the owner of an asset gives another person, the right to use that asset against periodical payments. The owner of the asset is known as lessor and the user is called lessee. The periodical payment made by the lessee to the lessor is known as lease rental. Under lease financing, lessee is given the right to use the asset but the ownership lies with the lessor and at the end of the lease contract, the asset is returned to the lessor or an option is given to the lessee either to purchase the asset or to renew the lease agreement.

## 8.2 OBJECTIVES

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

- the meaning of lease financing;
- types of lease financing;
- forms of lease financing;
- the advantages and disadvantages lease financing to the lessor; and
- the advantages and disadvantages lease financing to the lessee.

## 8.3 LEASE EVALUATION: BASICS OF LEASING

Leasing has emerged as an important source of long term financing of the corporate enterprises during the recent few years. Leasing is an arrangement under which a company acquires the right to make use of the assets without holding title to it. In other words, in a lease agreement the lessor, i.e., the owner of the asset permits the lessee to use the asset for a specified payment but retains the title over the property. A lease thus is an agreement between the lessor and the lessee.

The lease agreement also sets forth the period covered by the lease, cancellation provisions, rental payments, additional rents or purchase options, allocations of maintenance and other expenses and other features of the agreement. Since leasing represents an alternative to ownership, leasing can be viewed as a specialised means for generating funds. In exchange for the use of the asset the company can issue a claim against its future cash flows, long term debt equity or lease obligations. Viewed in this way leasing is strictly a financing decision. But it should also be remembered that it is not a way of avoiding financing.

It is financing because if the company chooses leasing instead of owning the asset by means of borrowing it incurs a contractual obligation to make payments of fixed amounts at specified times. The lease, therefore, is analogous to any other financial claim issued by the company. The important question is the cost of the lease in relation to other financing alternatives.

## 8.4 TYPES OF LEASE ARRANGEMENTS

Depending upon the transfer of risk and rewards to the lessee, the period of lease and the number of parties to the transaction, lease financing can be classified into two categories i.e. Financial lease and Operating lease.

i. **Financial Lease :** It is the lease where the lessor transfers substantially all the risks and rewards of ownership of assets to the lessee for lease rentals. In other words, it puts the lessee in the same condition as he/she would have been if he/she had purchased the asset. Finance lease has two phases: The first one is called primary period. This is non-cancellable period and in this period, the lessor recovers his total investment through lease rental. The primary period may last for indefinite period of time. The lease rental for the secondary period is much smaller than that of primary period.

   **Features of Finance Lease:**

   From the above discussion, following features can be derived for finance lease:

   1. A finance lease is a device that gives the lessee a right to use an asset.
   2. The lease rental charged by the lessor during the primary period of lease is sufficient to recover his/her investment.
   3. The lease rental for the secondary period is much smaller. This is often known as peppercorn rental.
   4. Lessee is responsible for the maintenance of asset.
   5. No asset-based risk and rewards is taken by lessor.
   6. Such type of lease is non-cancellable; the lessor's investment is assured.

ii. **Operating Lease :** Lease other than finance lease is called operating lease. Here risks and rewards incidental to the ownership of asset are not transferred by the lessor to the lessee. The term of such lease is much less than the economic life of the asset and thus the total investment of the lessor is not recovered through lease rental during the primary period of lease. In case of operating lease, the lessor usually provides advice to the lessee for repair, maintenance and technical knowhow of the leased asset and that is why this type of lease is also known as service lease.

**Features of Operating Lease:**

Operating lease has following features:

1. The lease term is much lower than the economic life of the asset.
2. The lessee has the right to terminate the lease by giving a short notice and no penalty is charged for that.
3. The lessor provides the technical knowhow of the leased asset to the lessee.
4. Risks and rewards incidental to the ownership of asset are borne by the lessor.
5. Lessor has to depend on leasing of an asset to different lessee for recovery of his/her investment.

## 8.5 FORMS OF LEASE FINANCING

Broadly speaking, lease financing may take different forms like sale and lease back, direct leasing, operating leasing and leveraged leasing. We shall describe, in brief, the characteristic features of these forms of lease financing.

1. **Sale and Lease Back :**

   Under a sale and lease back, a company owning an asset sells to another party and leases it back. This type of lease arrangement exists if company A, already the owner of a property sells it to B and immediately leases it for continued use.

The new lessee, A, then has in his possession the use of the property as well as the cash received from the sale. Thus, the seller gives up the title to the asset but retains its use. The main advantage of this kind of arrangement to the company that sells and then leases back is that it receives cash from sale of the asset which could be reinvested in the business while still making economic use of the asset during the lease period.

The sale and lease back is mostly found in real estate financing and financial institutions prominently insurance companies and financial companies play the role of lessors who buy a property from a business concern and then lease it back to the company.

2. **Direct Leasing:**

   In contrast with sale and lease back arrangement, under direct leasing the company acquires the right to use the property that it did not previously own. Direct leasing may be arranged through either the manufacturer or a financial institution.

   Finance companies and independent leasing companies usually enter into the business of acquiring property for their clients who are in need of certain assets for their business purposes. Once the financial institution owns the property, a direct lease is arranged under usual terms and conditions.

3. **Operating Leasing:**

   In operating lease, lease facility is provided on a period to period basis. Under this arrangement, no long-term obligation is imposed on either the lessor or lessee and the agreement is cancellable at the option of either the owner or user of assets after giving a certain stipulated notice. This type of lease may be written, say, on a month-to-month basis without any specified expiration date.

4. **Financial Leasing:**

   Financial lease, as opposed to operating lease, is a non-cancellable contract covering intermediate to long-term period. The lessee is normally responsible for maintenance, insurance and taxes and for this reason financial lease is also called net lease. Original cost of the asset is fully amortized. The agreement provides that the lease will cover the service life of the asset.

For example, if a firm leases an asset with an expected life of 12 years, the lease period will be approximately 12 years. Where an asset has an indefinite life, as in the case of an office building, the lease will be written for as long a period as 20 years. In this case, the building cost would be fully amortized even though it may have a residual value at the end of the lease period.

Thus, full amortization and non-cancel-ability are the key features that distinguish financial lease from operating lease. Non-cancel-ability implies that the lessee is legally obliged to make all the lease payments regardless of whether he continues to use the assets, and thus can cancel only by paying off the entire contract. Default by the lessee can lead to insolvency just as in the case of a debt contract.

5. **Leveraged Leasing:**

   In leveraged leasing the lessee contracts to make periodic payments during the lease period and in return, is entitled to the use of the asset over that period of time. The lessor owns the property but acquires it partly by contributing his own funds and partly by taking loans from the financial institutions.

6. **Domestic Lease:**

   If all parties in the lease belong to same country

7. **International Lease:**

   A lease in which the parties are domiciled from different countries.

The financial institution usually provides loan against the mortgage on the asset as well as by the assignment of the lease and lease payment. Thus, the lessor is the owner and the borrower. As the owner of the asset, he is entitled to deduct all depreciation charges associated with the asset as well as utilize the entire investment allowance facility.

## 8.6 ADVANTAGES AND DISADVANTAGES OF LEASE FINANCING

At present leasing activity shows an increasing trend. Leasing appears to be a cost-effective alternative for using an asset. However, it has certain advantages as well as disadvantages.

Advantages of Leasing to the Lessor:

1. **Higher Profits:**

   The lessor acting prudently can make high profits from leasing of the asset. The profits will take care of his cost of capital as well as the risk involved.

2. **Tax Benefits:**

   The lessor being the owner of the asset can claim various tax benefits such as depreciation, investment allowance, etc. In fact, leasing has been successfully employed by the leasing companies to reduce their tax liabilities.

3. **Quick Returns:**

   The lessor gets quick returns in the form of lease rentals as compared to investment in other projects which have a longer gestation period.

4. **Increased Sales:**

   Lease financing through third parties has helped manufacturers to increase their sales. The lessors are also in a position to demand certain concessions from the manufacturers.

**Disadvantages for the Lessor**

1. **High Risk of Obsolescence:**

   The lessor has to bear the risk of obsolescence especially in the present era of rapid technology developments.

2. **Competitive Market:**

   As a number of leasing companies have emerged in recent years in India, the lessor has to face a tough competition from Indian as well as foreign companies. Due to this competition, the lessor may not be able to obtain sufficient lease rentals to recover the cost of the asset and his expected profit on investment as well as taking the risk.

3. **Price-Level Changes:**

   Inspite of the increase in prices of assets due to inflation, the lessor gets only fixed rentals based on previous costs.

4. **Management of Cash flows:**

   The success of a leasing business depends to a large extent upon efficient use of cashflows which are very difficult to manage because of unexpected market fluctuations.

5. **Increased Cost due to Loss of User Benefits:**

   The lessor is not entitled to certain benefits available to buyers who are actual users of the assets such as concession in sales tax, duties, etc. This increases the cost of the asset and compels the lessor to charge higher lease rentals.

6. **Long-term Investment:**

   It usually takes a long time to recover the cost of the lessor in the capital outlays through lease rentals. Thus, lease rentals received may not represent actual realised profits because of inherent risks involved. Payment of dividends out of present earnings may ultimately result into payment out of capital.

**Advantages and Disadvantages of Leasing for the Lessee**

After reading this chapter you will learn about the Advantages and Disadvantages of Leasing for the Lessee.

Advantages of Leasing to the Lessee:

(i) **Avoidance of Initial Cash Outlay:**

Leasing enables a firm to acquire the use of an asset without making capital investment in buying the asset. The lessee may avail 100% finance from lease financing and avoid even initial investment in margin money as required under loan financing. However, some leasing companies demand that first lease rent should be paid in advance.

**(ii) Minimum Delay:**

Usually, leasing companies take much lessor time in processing the lease proposal as compared to the lengthy procedure involved in the term-loan financing. Thus, a firm can avoid delay in the use of an asset by taking it on lease.

**(iii) Easy Source of Finance:**

Leasing provides one of the easiest sources of intermediate and long- term financing. It does not require any mortgage of the assets because the ownership of asset leased remains with the lessor and is not transferred to the lessee.

Moreover, various restrictive provisions imposed in term loan financing are avoided. The initial cost of raising finance through leasing is also much lesser than that of raising long-term loans.

**(iv) Shifting the Risk of Obsolescence:**

In the present era of rapid changing technologies, a firm has to bear the risk of obsolescence if it purchases the asset. The firm (lessee) can easily shift this risk upon the lessor by acquiring the use of the asset on lease rather than buying the same.

**(v) Enhanced Liquidity:**

Sale and leaseback arrangement enables a firm to improve its liquidity position by realising cash from the sale of fixed assets and retaining the economic use of the same. Thus, the lessee can salvage its working capital crisis through lease financing.

**(vi) Conserving Borrowing Capacity:**

Leasing is a form of financing that does not reduce or affect the borrowing capacity of the lessee firm. It is considered to be a hidden form of debt which does not appear as a liability in the balance sheet of the lessee. Thus, it does not affect the debt equity ratio of the firm acquiring use of an asset through leasing.

**(vii) Tax Planning and Differential Tax Advantage:**

As lease rentals are considered as a revenue expense while determining taxable profits, it is advantageous for the lessee in minimising tax liabilities. Moreover, the lessor who is usually in the higher tax bracket passes on the benefit of depreciation advantage to the lessee in the form of reduced lease payments.

The lessee can also arrange to adjust lease rentals in such a way that it reduces his tax liability and thus helps him in tax planning.

**(viii) Higher Return on Capital Employed:**

Since the lessee acquires only the right to use the asset without owning it, such asset does not appear on the asset side of the balance sheet. This implies higher earnings against capital employed and higher rate of return on capital employed.

**(ix) Convenience and Flexibility:**

Operating or service leases are usually cancellable enabling the lessee firm to terminate the lease if it does not require the use of the asset, any more. Hence, it is very convenient and flexible mode of financing fixed assets.

**(x) Lesser Administrative and Maintenance Costs:**

Under a ‘ gross lease’ arrangement, the lessee can avail the specialised services of the lessor for maintenance of the asset leased. Even in case of operating lease agreement there could be a provision of maintaining the asset by the lessor.

Although, the lessor charges for such maintenance and service costs by way of higher rentals, the lessee's overall administrative and service costs are reduced because of specialised services of the lessor.

**Disadvantages of Leasing for the Lessee:**

**(i) Higher Cost:**

The lease rentals include a margin for the lessor as also the cost of risk of obsolescence; it is, thus, regarded as a form of financing at higher cost.

**(ii) Loss of Moratorium Period:**

The lease rentals do not take care of the gestation period. It usually takes a long time before the asset generates funds to pay it back. The term loan provides certain moratorium period in repayments for that reason. But no such moratorium is permitted under lease' arrangements.

**(iii) Risk of Being Deprived of the Use of Asset:**

The lessee may be deprived of the use of the asset due to the deterioration in the financial position of the lessor or winding up of the leasing company.

**(iv) No Alteration or Change in Asset:**

As the lessee is not the owner of the asset, he cannot make any substantial changes in the asset. Contrary to it, in case of outright purchase the buyer can modify or alter the asset to increase its utility.

**(v) Loss of Ownership Incentives:**

There are certain advantages of owning the assets, such as depreciation and investment allowance, In case of lease; the lessee is not entitled to such benefits.

**(vi) Penalties on Termination of Lease:**

The lessee is usually required to pay certain penalties if he terminates the lease before the expiry of the lease period.

**(vii) Loss of Salvage Value of the Asset:**

An asset generally has certain salvage value at the expiry of the useful life. As the lessee does not become the owner of the asset, he cannot realise the salvage value at the expiry of the lease rather he has to return the asset to the lessor.

**Advantages and Disadvantages of Acquiring Capital Assets on Lease**

**Advantages:**

There are several advantages of acquiring capital assets on lease:

1. **Alternative Use of Funds:**

   A lease agreement makes available an asset to use without making any huge investments. The firm is obliged to make periodic rental payment only. Thus, the firm may make alternative use of the funds saved due to lease agreement.

2. **Beneficial for Small Firms:**

   As small firms do suffer from paucity of funds, they can acquire assets on lease agreement. Thus, leasing becomes a boon more especially for small firms to use the most required and costly assets and, thus are immensely benefited.

3. **Flexibility and Convenience:**

   The lease agreement can be tailor-made in respect of lease period and lease rentals according to the convenience and requirements of all lessees.

4. **Free from Restrictive Covenants:**

   While lending the financial institutions impose several restrictive covenants on the borrowers like management, debt- equity norms, dividend declaration, etc. But, there are no such restrictions while financing through a lease agreement. That is the way a lease agreement arranges cheaper and faster credit to borrower, i.e. lessee.

5. **Tax Shielding:**

   When a tax paying lessor enters into a lease agreement, he generally passes a part of tax benefit to the lessee also by charging lower rental rates. As a result of this, the real cost of the assets to the lessee works out to be lower than what it would have been if he were the owner of the asset.

6. **Improvement in Liquidity:**

   Leasing enables the lessee to improve their liquidity position by adopting the sale and lease back technique.

Theoretically, thus, leasing has been accepted as a better alternative to financing the business operations because of the benefits it offers to the parties involved in the transaction.

## 8.7 SUMMARY

Leasing has emerged as an important source of long-term financing of corporate enterprises during the recent few decades. Leasing is an arrangement under which a company acquires the right to make use of the asset without holding title to it. A lease, thus, is the written agreement allowing the economic use of the assets for a stated period of time.

The lease agreement is signed by both owner of the assets, called the lessor and the user, called the lessee. The lessor permits the lessee the use of the asset for a specified payment but retains title to the property.

The lease agreement sets forth the period covered by the lessee, provisions for payment of taxes, insurances, maintenance expenses and the like, provisions for renewal of the lease or purchase of the asset at expiration and the timing and amounts of periodic rental payments during the lease period.

Since leasing represents an alternative to ownership, leasing can be viewed as a specialized means of garnering funds. In exchange for the use of the asset the company can issue a claim against the future cash flows, long-time debt, equity or lease obligations. Viewed in this way, leasing is strictly a financing decision.

If a company chooses leasing instead of owning the assets by means of borrowing, it incurs a contractual obligation to make payments of fixed amounts at specified times. The lease, therefore, is analogous to any other financial claim issued by the company. In that the payments are fixed and contractual a lease is the functional equivalent of debt.

## 8.8 GLOSSARY

- **Financial Lease-** It is the lease where the lessor transfers substantially all the risks and rewards of ownership of assets to the lessee for lease rentals.
- **Operating Lease-** Lease other than finance lease is called operating lease. Here risks and rewards incidental to the ownership of asset are not transferred by the lessor to the lessee.
- **Sale and Lease Back**- The sale and lease back is mostly found in real estate financing and financial institutions prominently insurance companies and financial companies play the role of lessors who buy a property from a business concern and then lease it back to the company.
- **Direct Leasing**- Direct leasing may be arranged through either the manufacturer or a financial institution.
- **Operating Leasing**- In operating lease, lease facility is provided on a period to period basis. Under this arrangement, no long-term obligation is imposed on either the lessor or lessee and the agreement is cancellable at the option of either the owner or user of assets after giving a certain stipulated notice.
- **Financial Leasing-** Financial lease, as opposed to operating lease, is a non-cancellable contract covering intermediate to long-term period.
- **Leveraged Leasing-** In leveraged leasing the lessee contracts to make periodic payments during the lease period and in return, is entitled to the use of the asset over that period of time.

## 8.9 SELF ASSESSMENT QUESTIONS

Q1. What do you understand by lease financing?

Ans. ____________________________________________________________

____________________________________________________________

____________________________________________________________

____________________________________________________________

____________________________________________________________

____________________________________________________________

Q2. Explain the term financial lease.

Ans. ____________________________________________________________

____________________________________________________________

____________________________________________________________

____________________________________________________________

____________________________________________________________

____________________________________________________________

3. Write a brief note on operating lease.

Ans. ____________________________________________________________

____________________________________________________________

____________________________________________________________

____________________________________________________________

____________________________________________________________

____________________________________________________________

## 8.10 LESSON END EXERCISE

1. What is lease financing? Explain the various forms of lease financing.
2. Discuss the various types of lease financing. Discuss the features of financial and operating lease.
3. Highlights the advantages and disadvantages of lease financing.

## 8.11 SUGGESTED READINGS


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# VALUATION OF RATE OF RETURN ON CAPITAL EMPLOYED AND LEASE EVALUATION

| M.Com II Sem. | Advanced Accounting | Unit-II |
|---|---|---|
| M.Com – C 250 | | Lesson No. 9 |

**STRUCTURE**



## 9.1 INTRODUCTION

Leasing is an arrangement under which a company acquires the right to make use of the assets without holding title to it. In other words, in a lease agreement the lessor, i.e., the owner of the asset permits the lessee to use the asset for a specified payment but retains the title over the property. A lease thus is an agreement between the lessor and the lessee.

## 9.2 OBJECTIVES

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

- the difference between financial lease and operating lease;
- financial evaluation of leasing from Lesse's point of view; and
- financial evaluation of leasing from Lesse's point of view.

## 9.3 DIFFERENCE BETWEEN FINANCIAL LEASE AND OPERATING LEASE

An agreement in which the lessor allows the lessee to use a particular asset, for a fixed term which covers the major part of the economic life of the asset, without the transfer of title but with the transfer of risk and rewards is known as Finance Lease. It is also known as the capital lease.

In a finance lease, the ownership of the asset is transferred to the lessee when the lease term expires. The lessee has the option to buy the asset at a nominal amount i.e. a price which is less than the fair market value of the asset. The lease returns the full payout, i.e. principal (cost) plus interest thereon of the asset, in a single lease. The present value of Minimum Lease Payments (MLP) at the beginning of the lease agreement is more than or equal to the total Fair Market Value of the asset leased. The finance lease is non-cancellable in nature i.e. it can be canceled only if: the lessor allows or the happening of any contingent event or the lessee enters into a lease agreement with the Lessor for the same asset. However, if the Lessee cancels the lease agreement any losses incurred to the lessor will be borne by the lessee.

An agreement in which the lessee is allowed to use an asset with the permission of the lessor, for a limited term which is smaller than the economic life of the asset, without the transfer of title, risk and reward is known as Operating Lease. An Operating lease is more like a rental agreement, and that is why the rental payments for the use of the asset are charged a rental expense in the Profit and Loss Account in the books of the Lessee.

At the end of the operating lease, the asset is neither transferred to the lessee nor he has the right to purchase the asset at a price less than the Fair Market Value of the asset. The leased asset is transferred to the lessor at the expiry of the lease term. There is no security that the lessor will get the complete payout regarding the cost and return of the asset as the same asset is leased again and again by the lessor to many customers. The operating lease is cancellable in nature and so, it can be canceled by any of the parties.

**Key Differences Between Finance (Capital) Lease and Operating Lease**

The following are the major differences between finance (capital) lease and operating lease:

1. The lease agreement in which the risk and rewards are transferred with the transfer of an asset is known as Finance Lease. The lease agreement in which the risk and rewards are not transferred with the transfer of the asset is known as Operating Lease.
2. Finance Lease is a sort of loan agreement in which the lessor plays the role of financier. As opposed to the Operating Lease, which is similarly like a rental agreement.
3. Finance Lease is for the long term as it covers the maximum part of the life of the asset. Unlike, Operating Lease, which is for a shorter period.
4. An Operating lease is more flexible as compared to the Finance Lease.
5. In the finance lease, the ownership of the asset is transferred to the lessee at the end of the lease term, by paying a nominal amount which is equal to the fair market value of the asset. Conversely, in operating lease, there is no such kind of option.
6. In Finance Lease, the lessee bears the risk of obsolescence whereas in Operating Lease the lessor bears the risk for so.
7. Any cost for repairs and maintenance will be borne by the lessee in the finance lease, but the cost of repairs and maintenance will be borne by the lessor in operating lease.

## COMPARISON CHART

| BASIS FOR COMPARISON | FINANCE LEASE | OPERATING LEASE |
|---|---|---|
| Meaning | A commercial arrangement in which the lessor allows the lessee to use the asset for the maximum part of its economic life against payment of rentals is known as finance lease. | A commercial arrangement in which the lessor allows the lessee to use the asset for a term smaller than the economic life of the asset against the payment of rentals is known as operating lease. |
| Nature | Loan Agreement | Rental Agreement |
| Lease Term | The lease term of finance lease is longer as compared to operating lease. | The lease term of operating lease is short. |
| Risk Bearing for obsolescence | Rests with the lessee | Rests with the lessor |
| Transferability of risk and rewards | From the lessor to the lessee, with the transfer of asset. | Does not transfers from the lessor to the lessee, with the transfer of the asset. |
| Cancellation of the lease | Only on the happening of certain specified event. | Cancellation of the lease can be done |
| Tax Benefit | Depreciation and finance charges are allowable as a deduction to lessee. | Lease rent is allowable as a deduction to lessee. |
| Cost of Repairs and Maintenance | Are to be borne by the lessee. | Are borne by the lessor. |
| Bargain Purchase Option | The lease contains an option where the lessee can purchase the equipment at the price less than the Fair Market Value. | No such option in this regard |

## 9.4 FINANCIAL EVALUATION OF LEASE FROM LESSEE'S POINT OF VIEW (Lease or Buy/Lease or Borrow Decisions):

Once a firm has evaluated the economic viability of an asset as an investment and accepted/selected the proposal, it has to consider alternate methods of financing the investment. However, in making an investment, the firm need not own the asset. It is basically interested in acquiring the use of the asset.

Thus, the firm may consider leasing of the asset rather than buying it. In comparing leasing with buying, the cost of leasing the asset should be compared with the cost of financing the asset through normal sources of financing, i.e., debt and equity.

Since, payment of lease rentals is similar to payment of interest on borrowings and lease financing is equivalent to debt financing, financial analysts argue that the only appropriate comparison is to compare the cost of leasing with that of cost of borrowing. Hence, lease financing decisions relating to leasing or buying options primarily involve comparison between the cost of debt-financing and lease financing.

The evaluation of lease financing decisions from the point of view of the lessee involves the following steps:

(i) Calculate the present value of net-cash flow of the buying option, called NPV (B).

(ii) Calculate the present value of net cash flow of the leasing option, called NPV (L)

(iii) Decide whether to buy or lease the asset or reject the proposal altogether by applying the following criterion:

(a) If NPV (B) is positive and greater than the NPV (L), purchase the asset.

(b) If NPV (L) is positive and greater than the NPV (B), lease the asset.

(c) If NPV (B) as well as NPV (L) are both negative, reject the proposal altogether.

Since many financial analysts argue that the lease financing decisions arise only after the firm has made an accept-reject decision about the investment; it is only the comparison of cost of leasing and borrowing options.

The following steps are involved in such an analysis:

(i) Determine the present value of after-tax cash outflows under the leasing option.

(ii) Determine the present value of after-tax cash outflows under the buying or borrowing option.

(iii) Compare the present value of cash outflows from leasing option with that of buying/borrowing option.

(iv) Select the option with lower presented value of after-tax cash outflows.

We have illustrated the above analysis in the following illustrations.

**Illustration 9.1**

A limited company is interested in acquiring the use of an asset costing Rs. 5,00,000. It has two options:

(i) To borrow the amount at 18% p.a. repayable in 5 equal installments or

(ii) To take on lease the asset for a period of 5 years at the year end rentals of Rs. 1,20,000.

The corporate tax is 50% and the depreciation is allowed on w.d.v. at 20%. The asset will have a salvage of Rs. 1,80,000 at the end of the 5th year.

You are required to advise the company about lease or buy decision. Will decision change if the firm is allowed to claim investment allowance at 25%?

Note:

(1) The present value of Re. 1 at 18% discount factor is:

| | | |
|---|---|---|
| 1st year | – | .847 |
| 2nd year | – | .718 |
| 3rd year | – | .609 |
| 4th year | – | .516 |
| 5th year | – | .437 |

(2) The present value of an annuity of Re. 1 at 18% p.a. is Rs. 3.127.

Solution:

*(i)* **Calculation of loan instalment**

$$\text{Loan Instalment} = \frac{\text{Amount of Loan}}{\text{P.V. Factor of Annuity}}$$

$$= \frac{5,00,000}{3.127}$$

$= ₹\ 1,59,898$ appx.

*(ii)* **Schedule of Loan Payment**

| Year | Loan Balance at beginning of the year | Loan Instalment | Interest Payment | Principal Payment | Loan Balance at the end of the year |
|---|---|---|---|---|---|
| | (₹) | (₹) | (₹) | (₹) | (₹) |
| 1. | 5,00,000 | 1,59,898 | 90,000 | 69,898 | 4,30,102 |
| 2. | 4,30,102 | 1,59, 898 | 77,418 | 82,480 | 3,47,622 |
| 3. | 3,47,622 | 1,59,898 | 62,572 | 97,326 | 2,50,296 |
| 4. | 2,50,296 | 1,59,898 | 45,053 | 1,14, 845 | 1,35,451 |
| 5. | 1,35,451 | 1,59,832* | 24,381 | 1,35,451 | Nil |

* The amount of loan instalment in the last year is different from the equal payments because of compensation for rounding error.

*(iii)* **Calculation of Present Value of After-Tax Cash Outflows under Borrowing/Buying Option**

| Year end | Loan Instalment (₹) | Tax Saving on Interest (₹) | Tax Saving on Dep. (after-tax) (₹) | Tax Saving on Total (₹) | Net cash Outflow (₹) | P.V. factor at 18% | P.V. of after tax Net cash Outflow (₹) |
|---|---|---|---|---|---|---|---|
| Col. 1 | 2 | | | 3 | 4 = 2–3 | 5 | 6 |
| 1. | 1,59,898 | 45,000 | 50,000 | 95,000 | 64,898 | .847 | 54,969 |
| 2. | 1,59,898 | 38,709 | 40,000 | 78,709 | 81,189 | .718 | 58,294 |
| 3. | 1,59,898 | 31,286 | 32,000 | 63,286 | 96,612 | .609 | 58,837 |
| 4. | 1,59,898 | 22,527 | 25,600 | 48,127 | 1,11,771 | .516 | 57,674 |
| 5. | 1,59,832 | 12,190 | 20,480 | 32,670 | 1,27,162 | .437 | 55,570 |
| | | | | | | Total : | 2,85,344 |
| | | | *Less* : P.V. of salvage at the end of 5th year (1,80,000 × .437) | | | | 78,660 |
| | | | | | | | 2,06,684 |

*(iv)* **Calculation of Present Value of After-Tax Cash Outflows under Lease Option**

| Year end | Lease Rental | Tax Savings on Lease Rent | After-Tax Cash Outflow | P.V. Annuity Factor at 18% | Total P.V. of Cash Outflows |
|---|---|---|---|---|---|
| | (₹) | (₹) | (₹) | (₹) | (₹) |
| 1–5 | 1,20,000 | 60,000 | 60,000 | 3.127 | 1,87,620 |

(v) Evaluation:

As the present value of after-tax cash outflows under the leasing option is lesser than the present value of after-tax cash outflows of the buying option, it is advisable to take the asset on lease.

(vi) Decision if Investment Allowance is allowed:

In case Investment Allowance is allowed on purchase of asset the total of present value of net cash outflows will decrease by the present value of tax savings on investment allowance as below:

| | |
|---|---|
| Investment Allowance : | ₹ |
| (allowed at the end of 1st year) $5,00,000 \times \frac{25}{100}$ | 1,25,000 |
| Tax Savings (50%) | 62,500 |
| P.V. Factor at the end of year 1 | .847 |
| P.V. of Tax Savings on Investment Allowance | 52,938 |
| Hence, P.V. of Cash Outflows in Buying Option shall be = ₹ 2,06,684-52,938 | 1,53,746 |

In that case, the P.V. of cash outflows under buying option shall be lesser than the P.V. of cash outflows under leasing option and the company should buy the asset.

## 9.5 FINANCIAL EVALUATION OF LEASING FROM LESSOR'S POINT OF VIEW

The financial viability of leasing out an asset from the point of view of lessor can be evaluated with the help of the two time adjusted methods of capital budgeting:

(a) Present Value Method

(b) Internal Rate of Return Method.

(a) Present Value Method:

This method involves the following steps:

(i) Determine cash outflows by deducing tax advantage of owning an asset, such as investment allowance, if any.

(ii) Determine cash inflows after-tax as below:

(ii) Determine the present value of cash outflows and after tax cash inflows by discounting at weighted average cost of capital of the lessor.

(iv) Decide in favour of leasing out an asset if P.V. of cash inflows exceeds the P.V. of cash outflows, i.e., if the NPV is +ve; otherwise in case N.P.V. is -ve, the lessor would lose on leasing out the asset.

The above technique has been explained with the help of the following example.

**Illustration 9.2**

From the information given below, you are required to advise about leasing out of the asset:

| | | |
|---|---|---|
| Cost of Equipment | ₹ 4,00,000 | |
| Average Cost of Capital to the lessor | 12% | |
| Depreciation (Allowable) | 20% | on original cost |
| Expected Life of Asset | 5 | years |
| Salvage Value | Nil | |
| Lease Rent payable at the end of each of 5 years | ₹ 1,50,000 | |
| Corporate Tax (applicable to lessor) | 50% | |
| P.V. of an annuity of Re. 1 for 5 years at 12% is ₹ 3.605 | | |

Solution:

| | |
|---|---|
| *(i)* **Calculation of Cash Outflow** | **(₹)** |
| Cost of Equipment | 4,00,000 |
| *Less* : Tax Advantage, if any | Nil |
| Cash Outflow | 4,00,000 |
| *(ii)* **Calculation of After-Tax Cash Inflows** | **(₹)** |
| Lease Rental | 1,50,000 |
| *Less* : Depreciation | 80,000 |
| Earnings Before Tax (EBT) | 70,000 |
| *Less* : Tax at 50% | 35,000 |
| Earnings After Tax (EAT) | 35,000 |
| *Add* : Depreciation | 80,000 |
| Cash Inflows After Tax (CFAT) | 1,15,000 |

*(iii)* **Calculation of Present Value (P.V.) of Cash Outflows**

| ***Year (₹)*** | ***Cash Outflow (₹)*** | ***P.V. Discount Factor at 12%*** | ***P.V. of Cash Outflow (₹)*** |
|---|---|---|---|
| 0 | 4,00,000 | 1.00 | 4,00,000 |

*(iv)* **Calculation of P.V. of Cash Inflows**

| ***Year*** | ***Cashflow After Tax (CFAT) ₹*** | ***P.V. Annuity Discount Factor at 12%*** | ***P.V. of Cash Inflows ₹*** |
|---|---|---|---|
| 1-5 | 1,15,000 | 3.605 | 4,14,575 |

| *(iv)* **Calculation of Net Present Value** | **₹** |
|---|---|
| Present value of Cash Inflows | 4,14,575 |
| *Less* : P.V. of Cash Outflows | 4,00,000 |
| Net Present value of Cash flows | 14,575 |

Since the present value of cash inflows is more than the present value of cash outflows or says N.P.V. is positive, it is desirable to lease out the asset.

(b) Internal Rate of Return Method:

The internal rate of return can be defined as that rate of discount at which the present value of cash- inflows is equal to the present value of cash outflows.

It can be determined with the help of the following mathematical formula:

C = A1/(1+r) + A2/(1+r)2 + A3/(1+r)3 + … … … … + An/(1+r)n

where, C = Initial Outlay at time Zero.

A1, A2, … … … An = Future net cash flows at different periods.

2,3 …….. , = Numbers of years

r = Rate of discount of internal rate of return.

The Internal rate of return can also be determined with the help of present value tables.

The following steps are required to practice the internal rate of return method:

(1) Determine the future net cash flows for the period of the lease. The net cash inflows are estimated future net cash flows for the period of the lease. The net cash inflows are estimated future earnings, from leasing out the asset, before depreciation but after taxes.

(2) Determine the rate of discount at which the present value of cash inflows is equal to the present value of cash outflows. This may be determined as follows:

**(a) When the annual net cash flows are equal over the life of the asset:**

Firstly, find out Present Value Factor by dividing initial outlay (cost of the investment) by annual cash flow, i.e., Present Value Factor = Initial Outlay/Annual Cash Flow. Then, consult present value annuity tables with the number of year equal to the life of the asset and find out the rate at which the calculated present value factor is equal to the present value given in the table.

Illustration 3:

| | |
|---|---|
| Initial Outlay | ₹ 50,000 |
| Life of the Asset | 5 years |
| Estimated Annual Cash-flow | ₹ 12,500 |
| Calculate the Internal Rate of Return. | |

Solution:

$$\text{Present Value Factor} = \frac{\text{Initial Outlay}}{\text{Annual Cash Flow}}$$

$$= \frac{50,000}{12,500} = 4.$$

Consulting Present Value Annuity Tables for 5 years periods at Present Value Factor of 4. (For Present Value Tables see Appendix A and B given at the end of the book)

Internal Rate of Return =8% approx.

(as seen from the table that at 8% for 5 year period, the present value is 3.9927 which is nearly equal to 4.)

**(b) When the annual cash flows are unequal over the life of the asset:**

In case annual cash flows are unequal over the life of the asset, the internal rate of return cannot be determined according to the technique suggested above. In such cases, the internal rate of return is calculated by hit and trial and that is why this method is also known as hit and trial yield method.

We may start with any assumed discount rate and find out the total present value of all the cash flows by consulting present value tables.

The so calculated total present value of cash inflows as compared with the present value of cash outflows which is equal to the cost of the initial investment where total investment is to be made in the beginning. The rate, at which the total present value of all cash inflows equals the initial outlay, is the internal rate of return. Several discount rates may have to be tried until the appropriate rate is found. The calculation process may be summed up as follows.

(i) Prepare the cash flow table using an arbitrary assumed discount rate to discount the net cash flow to the present value.

(ii) Find out the Net Present Value by deducting from the present value of total cash flows calculated in (i) above the initial cost of the investment.

(iii) If the Net Present Value (NPV) is positive, apply higher rate of discount.

(iv) If the higher discount rate still gives a positive net present value, increase the discount rate further until the NPV becomes negative.

(v) If the NPV is negative at this higher rate, the internal rate of return must be between these two rates:

(3) Accept the proposal if the internal rate of return is higher than or equal to the minimum required rate of return, i.e. the cost of capital or cut off rate.

(4) In case of alternative proposals select the proposal with the highest rate of return as long as the rates are higher than the cost of capital or cut-off rate.

**Illustration 9.3**

Initial Investment – Rs. 60,000

Life of the Asset – 4 years

Estimated Net Annual Cash Flows:

| | ₹ |
|---|---|
| 1st Year | 15,000 |
| 2nd Year | 20,000 |
| 3rd Year | 30,000 |
| 4th Year | 20,000 |

Compute the internal rate of return and also advise the lessor about the leasing out decision if his expected minimum rate of return is 15%.

Note:

Present Value Factor at various rates of discount.

| Year | 10% | 12% | 14% | 15% | 16% |
|---|---|---|---|---|---|
| 1 | .909 | .892 | .877 | .869 | .862 |
| 2 | .826 | .797 | .769 | .743 | .756 |
| 3 | .751 | .711 | .674 | .657 | .640 |
| 4 | .683 | .635 | .592 | .571 | .552 |

Solution:

**P.V. Cash Flows Table at Various Assumed Discount Rates of 10%, 12%, 14% & 15%**

| Year | Annual Cash Flow ₹ | Discount rate 10% P.V.F. | 10% P.V. ₹ | 12% P.V.F. | 12% P.V. ₹ | 14% P.V.F. | 14% P.V. ₹ | 15% P.V.F. | 15% P.V. ₹ |
|---|---|---|---|---|---|---|---|---|---|
| 1 | 15,000 | .909 | 13,635 | .892 | 13,380 | .877 | 13,155 | .869 | 13,035 |
| 2 | 20,000 | .826 | 16,520 | .797 | 15,940 | .769 | 15,380 | .756 | 15,120 |
| 3 | 30,000 | .751 | 22,530 | .711 | 21,330 | .674 | 20,220 | .657 | 19,710 |
| 4 | 20,000 | .683 | 13,660 | .635 | 12,700 | .592 | 11,840 | .571 | 11,420 |
| | | | 66,345 | | 63,350 | | 60,595 | | 59,285 |

(1) The present value of cash flows at 14% rate of discount is Rs. 60,595 and at 15% rate of discount it is t 59,285. So the initial cost of investment which is Rs. 60,000 falls in between these two discount rates. At 14% the NPV is+ 595 but at 15% the NPV is – 715, we may say that IRR = 14.5% (approx).

(2) As the IRR is less than the minimum required rate of return, the lessor should not lease out the asset.

## 9.6 SUMMARY

Lease financing decisions relating to leasing or buying options primarily involve comparison between the cost of debt-financing and lease financing. The evaluation of lease financing decisions from the point of view of the lessee involves the following steps:

(i) Calculate the present value of net-cash flow of the buying option, called NPV (B).

(ii) Calculate the present value of net cash flow of the leasing option, called NPV (L)

(iii) Decide whether to buy or lease the asset or reject the proposal altogether by applying the following criterion:

(a) If NPV (B) is positive and greater than the NPV (L), purchase the asset.

(b) If NPV (L) is positive and greater than the NPV (B), lease the asset.

(c) If NPV (B) as well as NPV (L) are both negative, reject the proposal altogether.

Since many financial analysts argue that the lease financing decisions arise only after the firm has made an accept-reject decision about the investment; it is only the comparison of cost of leasing and borrowing options.

The following steps are involved in such an analysis:

(i) Determine the present value of after-tax cash outflows under the leasing option.

(ii) Determine the present value of after-tax cash outflows under the buying or borrowing option.

(iii) Compare the present value of cash outflows from leasing option with that of buying/borrowing option.

(iv) Select the option with lower presented value of after-tax cash outflows.

The financial viability of leasing out an asset from the point of view of lessor can be evaluated with the help of the two time adjusted methods of capital budgeting:

(a) Present Value Method

(b) Internal Rate of Return Method.

(a) Present Value Method:

This method involves the following steps:

(i) Determine cash outflows by deducing tax advantage of owning an asset, such as investment allowance, if any.

(ii) Determine cash inflows after-tax as below:

(ii) Determine the present value of cash outflows and after tax cash inflows by discounting at weighted average cost of capital of the lessor.

(iv) Decide in favour of leasing out an asset if P.V. of cash inflows exceeds the P.V. of cash outflows, i.e., if the NPV is +ve; otherwise in case N.P.V. is -ve, the lessor would lose on leasing out the asset.

## 9.7 GLOSSARY

- **NPV-** Net present Value Method
- **IRR-** Internal Rate of Return Method
- **P.V.F**– Present Value Factor
- **EAT-** Earning After Tax
- **EBT-** Earning Before Tax

## 9.8 SELF ASSESSMENT QUESTIONS

Q1. Differentiate between financial lease and operating lease.

Ans. ______________________________________________________________

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Q2. Explain the steps involved in the financial evaluation of lease from the Lesse's point of view.

Ans. ______________________________________________________________

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Q3. Explain the IRR method of lease evaluation.

Ans. ______________________________________________________________

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## 9.9 LESSON END EXERCISE

1. How financial evaluation of lease is done from the Lessor's point of view? Explain your answer with suitable example.

2. How financial evaluation of lease is done from the Lesse's point of view? Explain your answer with suitable example.
3. Calculate the IRR with imaginary figures.
4. Calculate the net present value of cash flows with the help of imaginary figures.

## 9.10 SUGGESTED READINGS


- Jain, S.P and Narang, K.L. (2014). Advanced Accountancy-Vol-II. Kalyani Publisher, New Delhi.
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# VALUATION OF RATE OF RETURN ON CAPITAL EMPLOYED AND LEASE EVALUATION

| | | |
|---|---|---|
| **M.Com II Sem.** | **Advanced Accounting** | **Unit-II** |
| **M.Com – C 250** | | **Lesson No. 10** |

**STRUCTURE**



## 10.1 INTRODUCTION

The lease is a finance agreement in which lessor (owner of the asset) purchases the asset and let the lessee (user of the asset) use the asset for a limited period against periodic payments, i.e. lease rentals. The terms and conditions of the lease are written in the lease deed. Finance or capital lease and operating lease are two types of lease. Finance Lease is a lease in which the risk and rewards are transferred to the lessee with the transfer of the asset. Unlike, Operating Lease, in which the risks and rewards are not transferred to the lessee with the transfer of the asset. Therefore, the lease is an alternative to buying the asset out of owned or borrowed funds. One of the major difference between a finance lease and an operating lease is, the former cannot be cancelled, during the primary lease period, whereas the latter can be cancelled by the lessee.

## 10.2 OBJECTIVES

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

- methods of computing lease rentals; and
- methods used in evaluation of lease decisions.

## 10.3 METHODS OF COMPUTING LEASE RENTALS

The following six main steps are involved in computing lease rentals.

1. Determine the cost of the asset which includes the actual purchase price and expenses like freight, insurance, taxes and installation, etc.
2. Determine the cash flows to the lessor on account of ownership of the asset. These include tax advantage provided by depreciation and investment allowance.
3. Calculate the present value of cash flows as determined in step 2.
4. Subtract the present value of cash flows of ownership advantage from the cost of the asset determined in step 1 so as to determine the minimum required net recovery through lease rentals.
5. Calculate the post-tax lease rentals by dividing the minimum required net recovery through lease rentals by present value factor of annuity.
6. Compute the pre-tax lease rentals by adjusting the post-tax lease rentals for the tax factor. The above method of computing lease rentals can be followed from the following illustration.

**Illustration 10.1**

Sunny Leasing is considering to lease out an equipment costing Rs. 10,00,000 for five years, which is the expected life of the equipment, and has an estimated salvage value of Rs. 1,00,000. Sunny Leasing can claim a depreciation of 20% on w.d.v. of the asset but is not eligible for investment allowance.

The firm falls under a tax rate of 50% and the minimum post-tax required rate of return is 12%. You are required to calculate the lease rental which the firm should charge.

Note:

(1) Present Value Factor at 12% discount rate is as below:

Year 1 = .893; Year 2= .797; Year 3 = .712; Year 4 = .636 and Year 5 = .567

(2) Annuity Discount Factory at 12% for 5 years = 3.605.

Solution:

**(i) The cost of the equipment = ₹ 10,00,000 (given)**

**(ii) Calculation of cash flows to the lessor on account of ownership of the asset :**

| *Year* | *Amount of Depreciation* (₹) | *Tax Advantage on Dep.* (₹) | *Tax advantage on Investment Allowance* (₹) | *Salvage Value* (₹) | *Total C.F.* (₹) |
|---|---|---|---|---|---|
| 1. | 2,00,000 | 1,00,000 | Nil | — | 1,00,000 |
| 2. | 1,60,000 | 80,000 | — | — | 80,000 |
| 3. | 1,28,000 | 64,000 | — | — | 64,000 |
| 4. | 1,02,400 | 51,200 | — | — | 51,200 |
| 5. | 81,920 | 40,960 | — | 1,00,000 | 1,40,960 |

**(iii) Calculation of Present Value of Cash Flow :**

| *Year* | *Cash Flows* (₹) | *P.V. Factor at 12%* | *P.V. of Cash Flolw* ₹ |
|---|---|---|---|
| 1 | 1,00,000 | .893 | 89,300 |
| 2 | 80,000 | .797 | 63,760 |
| 3 | 64,000 | .712 | 45,568 |
| 4 | 51,200 | .636 | 32,563 |
| 5 | 1,40,960 | .567 | 79,924 |
| | | Total : | 3,11,115 |

**(iv) Minimum required net recovery through lease rentals :**

MRLR = ₹ 10,00,000–3,11,115
= ₹ 6,88,885

(v) Post-tax Lease Rental (PTLR) $= \frac{6,88,885}{3.605}$
= ₹ 1,91,092

(vi) Pre-tax Lease Rental (LR) $= 1,91,092 \times \frac{100}{50}$ = Rs. 3,82,184

∴ Lease Rent expressed in terms of lease financing

$= 3,82,184 \times \frac{1,000}{10,00,000} \times \frac{1}{12}$

= 31.85 per thousand per month.

## 10.4 METHODS USED IN LEASE EVALUATION DECISIONS

The methods used in evaluation of lease decision are as follows:-

1. Present Value Method
2. Cost of Capital Method
3. Bower-Herringer-Williamson Method.

**1. Present Value Method:**

Under this method the present value of lease rentals are compared with the present value of the cost of an asset acquired on outright purchase by availing a loan. In leasing, the tax advantage in payment of lease rentals will reduce the cash outflow.

In case an asset is purchased by borrowing a loan, the repayment of principal and interest charges on loan is considered as cash outflow and it is reduced by tax advantage of depreciation claim and interest charge. The present value of the net cash outflows over the period of lease is considered to ascertain the present value over the lease/loan period. The alternative with low total present value of cash outflow will be selected.

**2. Cost of Capital Method:**

Under this method, the rate of cost of capital is calculated for the payments of instalments and then it is compared with the cost of capital of the other available sources of finance such as fresh issue of equity capital, retained earnings, debentures, term loans etc. The lease option is chosen if the rate is lower than the cost of equity capital etc. This method does not require the prior selection of any discounting rate.

3. Bower-Herringer-Williamson Method:

Under this method, the financial and tax aspects of lease financing are considered separately.

The following steps are involved in evaluation of lease decision:

Step 1:

Make a comparison of the present value of cost of debt with the discounted value of gross amount of lease rentals. The rate of discount applicable is being the gross cost of debt capital. Then, obtain the total present value of a financial advantage/ disadvantage of leasing.

Step 2:

Again compute the comparative tax benefit during the lease period and discount it at an appropriate cost of capital. The total present value is the operating advantage/ disadvantage of leasing.

Step 3 – When the present value of operating advantage of lease is more than its financial disadvantage, then select the leasing. When the present value of financial advantage is more than operating disadvantages, then select the leasing.

**Illustration 10.2**

Vindhya Papers Ltd. planning to install a captive generator set at its plant. Its Finance Manager is asked to evaluate the alternatives either to purchase or acquire generator on lease basis.

| Buying | Initial cost Rs. 5,00,000 | Residual Value Rs. 1,60,000 |
|---|---|---|
| Leasing for 5 years | Annual lease rental Rs. 1,50,0000 to lessee in 5 years time | Residual value Rs. 90,000 returned |

Depreciation @ 20% p.a. on written down value. Corporate tax rate 40%. After tax cost of debt is 14%.

The time gap between the claiming of the tax allowance and receiving the benefit is one year.

Evaluate the lease or buy decision based on the above information.

Solution:

Alternative (1) : Buying

| Year | Cost or W.D.V. | Depreciation @ 20% | Corporate tax @40% |
|---|---|---|---|
| 1 | 5,00,000 | 1,00,000 | 40,000 |
| 2 | 4,00,000 | 80,000 | 32,000 |
| 3 | 3,20,000 | 64,000 | 25,600 |
| 4 | 2,56,000 | 51,200 | 20,480 |
| 5 | 2,04,800 | - | - |
| Less: Residual value | 1,60,000 | - | - |
| | 44,800 | 44,800 | 17,920 |

Calculation of Net Present Value

| Year | Cost (Rs.) | Tax relief (Rs.) | Net cashflow (Rs.) | P.V. factor @ 14% | P.V. (Rs.) |
|---|---|---|---|---|---|
| 0 | (5,00,000) | - | (5,00,000) | - | (5,00,000) |
| 1 | - | - | - | 0.8772 | - |
| 2 | - | 40,000 | 40,000 | 0.7695 | 30,780 |
| 3 | - | 32,000 | 32,000 | 0.6750 | 21,600 |
| 4 | - | 25,600 | 25,600 | 0.5921 | 15,158 |
| 5 | 1,60,000 | 20,480 | 1,80,480 | 0.5194 | 93,741 |
| 6 | - | 17,920 | 17,920 | 0.4556 | 8,164 |
| | | | | N P V = | (3,30,557) |

Alternative (2) : Leasing

| Year | Lease rentals (Rs.) | Tax relief (Rs.) | Net cashflow (Rs.) | P.V. @ 14% | P.V. (Rs.) |
|---|---|---|---|---|---|
| 0 | (1,50,000) | - | (1,50,000) | - | (1,50,000) |
| 1 | (1,50,000) | - | (1,50,000) | 0.8772 | (1,31,580) |
| 2 | (1,50,000) | 60,000 | (90,000) | 0.7695 | (69,255) |
| 3 | (1,50,000) | 60,000 | (90,000) | 0.6750 | (60,750) |
| 4 | (1,50,000) | 60,000 | (90,000) | 0.5921 | (53,289) |
| 5 | 90,000 | 60,000 | 1,50,000 | 0.5194 | 77,910 |
| 6 | (Share residual value) | 60,000 | 24,000 | 0.4556 | 10,934 |
| | Tax on residual value | (36,000) | | | |
| | | | | NPV = | (3,76,030) |

Analysis:

From the above analysis, by applying the discounted cashflow technique, we can observe that the net present value of cash outflow is higher in case of leasing decision i.e., Rs. 3,76,030 as compared to buying decision it is only Rs. 3,30,557. The company may go for purchase of the generator instead of acquiring on lease basis.

## 10.5 SUMMARY

Nowadays many business concerns enter into these lease agreement because the company does not have directly to bear the cost of the financing the asset. Therefore, the finance lease and operating lease are getting popular. One of the best advantages of these lease agreement is that the depreciation and interest charges are tax deductible in nature, and so they are allowable as deduction. Similarly, the lease rentals are also tax deductible in case of the operating lease and hence they are allowed as deduction.

## 10.6 GLOSSARY

- **Residual value**-Scrap value
- **N.P.V**- Net Present Value
- **P.V.F**- Present Value Factor
- **C.F**- Cash Flows
- **Financial Lease**- The lease agreement in which the risk and rewards are transferred with the transfer of an asset is known as Finance Lease.
- **Operating Lease**-The lease agreement in which the risk and rewards are not transferred with the transfer of the asset is known as Operating Lease.

## 10.7 SELF ASSESSMENT QUESTIONS

Q1. What is financial lease?

Ans. ______________________________________________

______________________________________________

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______________________________________________________________

Q2. What is operating lease?

Ans. ______________________________________________________________

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______________________________________________________________

Q1. Highlights the difference between financial lease and operating lease?

Ans. ______________________________________________________________

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______________________________________________________________

______________________________________________________________

**10.8 LESSON END EXERCISE**

1. Explain the methods of computing lease rentals with suitable examples.
2. Discuss the methods used in lease evaluation decisions with suitable example.
3. Differentiate between financial lease and operating lease.
4. A limited company is interested in acquiring the use of an asset costing Rs. 5,00,000. It has two options:

(i) To borrow the amount at 18% p.a. repayable in 5 equal instalments or

(ii) To take on lease the asset for a period of 5 years at the year end rentals of Rs. 1,20,000.

The corporate tax is 50% and the depreciation is allowed on w.d.v. at 20%. The asset will have a salvage of Rs. 1,80,000 at the end of the 5th year.

You are required to advise the company about lease or buy decision. Will decision change if the firm is allowed to claim investment allowance at 25%?

Note:

(1) The present value of Re. 1 at 18% discount factor is:

| | | |
|---|---|---|
| 1st year | – | .847 |
| 2nd year | – | .718 |
| 3rd year | – | .609 |
| 4th year | – | .516 |
| 5th year | – | .437 |

(2) The present value of an annuity of Re. 1 at 18% p.a. is Rs. 3.127.

5. J.K Leasing is considering to lease out an equipment costing Rs. 12,00,000 for five years, which is the expected life of the equipment, and has an estimated salvage value of Rs. 2,00,000. J.K Leasing can claim a depreciation of 20% on w.d.v. of the asset but is not eligible for investment allowance.

The firm falls under a tax rate of 50% and the minimum post-tax required rate of return is 13%. You are required to calculate the lease rental which the firm should charge.

Note:

(1) Present Value Factor at 12% discount rate is as below:

Year 1 = .893; Year 2= .797; Year 3 = .712; Year 4 = .636 and Year 5 = .567

(2) Annuity Discount Factory at 12% for 5 years = 3.605.

6. Illustration 3:

Initial Investment – Rs. 60,000

Life of the Asset – 4 years

Estimated Net Annual Cash Flows:

| | ` |
|---|---|
| 1st Year | 15,000 |
| 2nd Year | 20,000 |
| 3rd Year | 30,000 |
| 4th Year | 20,000 |

Compute the internal rate of return and also advise the lessor about the leasing out decision if his expected minimum rate of return is 15%.

Note:

Present Value Factor at various rates of discount.

| Year | 10% | 12% | 14% | 15% | 16% |
|---|---|---|---|---|---|
| 1 | .909 | .892 | .877 | .869 | .862 |
| 2 | .826 | .797 | .769 | .743 | .756 |
| 3 | .751 | .711 | .674 | .657 | .640 |
| 4 | .683 | .635 | .592 | .571 | .552 |

**10.9 SUGGESTED READINGS**


- Jain, S.P and Narang, K.L. (2014). Advanced Accountancy-Vol-II. Kalyani Publisher, New Delhi.
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# CONSOLIDATED FINANCIAL STATEMENTS

| | | |
|---|---|---|
| **M.Com II Sem.** | **Advanced Accounting** | **Unit-III** |
| **M.Com – C 250** | | **Lesson No. 11** |

**STRUCTURE:**

## 11.1 INTRODUCTION

When a company wants to grow or survive in a competitive environment, it needs to restructure itself. The creation of holding and subsidiary companies is one of the form of corporate restructuring or business combination. The procedure involves acquisition of shares in the absorbed company, and not its assets with or without liabilities. The separate legal entity of the absorbed company is, therefore, not disturbed. In other words, the subsidiary company continuous its business as usual because acquisition of controlling interest by another company does not mean its liquidation.

## 11.2 OBJECTIVES

After going through this lesson you should be able to understand the meaning, objectives, merits, demerits and distinction between holding company and subsidiary company.

## 11.3 BASICS OF HOLDING COMPANIES

**Meaning :**

A holding company is one which may acquire either the whole or the majority of the shares of another company so as to have controlling interest in such a company or companies. The controlling company is known as the 'holding company' and the so controlled company or the company whose shares have been acquired is known as *'subsidiary company'* and both together are known as 'group of company'. Holding companies are able to nominate the majority of the directors of subsidiary company. The company gets such right which it purchase more than fifty percent shares of another company. So, the holding company is one which controls one or more other companies either by means of holding more than fifty percent shares in that company or companies or by having power to appoint the whole or majority of the directors of those companies. A company controlled by holding company is known as subsidiary company.

**Basics :**

A holding company is a parent business entity-usually a corporation or LLC-that doesn't manufacture anything, sell any products or services, or conduct any other business operations. Its purpose, as the name implies, is to hold the controlling stock or membership interests in other companies. Some of the subsidiary companies it owns actually do manufacture, sell, or otherwise conduct business. These are called operating companies. Other subsidiaries hold real estate, intellectual property, vehicles, equipment, or anything else of value that is used by the operating companies.

The holding company can own 100% of the subsidiary, or it can own just enough stock or membership interests to control the subsidiary. Having control means it has enough stock or membership interests to ensure that a vote of owners will go its way. This can be 51%, or where there are many owners, it can be a much lower percentage.

Each subsidiary has its own management who run the day-to-day business. The holding company's management is responsible for overseeing how the subsidiaries are run. They can elect and remove corporate directors or LLC managers, and can make major policy decisions like deciding to merge or dissolve. The people running the holding company do not participate in the operating companies' day-to-day decision making.

## 11.4 LEGAL DEFINITION

A holding company is better defined in the context of the definition of a subsidiary company.

Section 4 of the Companies Act, 1956 defines a subsidiary company. According to this section, (1) a company shall be deemed to be a subsidiary company of another if and only if:

(a) that other company controls the composition of its Board of Directors; or

(b) that other:

(i) when the first mentioned company is an existing company in respect of which the holders of preference shares issued before the commencement of this Act have the same voting rights in all respects as the holders of equity shares, exercises or controls more than half of the total voting power of such company;

(ii) when the first mentioned company is another company, holds more than half in nominal value of its equity share capital; or (c) the company is a subsidiary of any company which is that other company's subsidiary".

For example, company S is a subsidiary of company H and company R is a subsidiary of company S. Company R becomes a subsidiary of company H, by virtue of clause (c) above. Further, if company W is a subsidiary of company R, company W will also be a subsidiary of company S and consequently also of company H.

**Subsidiary Company :** From Section 4 (as reproduced ahove it is clear that a company is a subsidiary of a holding company in any of the following three cases:

1. When the holding company controls the composition of the Board of Directors of the Subsidiary company i.e., the holding company is able to appoint or dismiss the majority of directors of the subsidiary company.
2. Where the holding company holds more than 50% in nominal value of the equity share capital of the subsidiary company i.e., the holding company holds the majority of voting power in the subsidiary company.
3. When a subsidiary company is a holding company of another subsidiary company, the original holding company is also a holding company of that other subsidiary company.

## 11.5 WHOLLY OWNED AND PARTLY OWNED SUBSIDIARIES

A wholly owned subsidiary company is one in which all the shares with voting rights of 100% are owned by the holding company whereas in a partly owned subsidiary, only the majority of shares (i.e. more than 50%) are owned by the holding company.

In a wholly owned subsidiary, there -is no minority interest because all the shares with voting rights are held by the holding company. On the other hand, in a partly owned subsidiary company, there is a minority interest because less than 50% shares with voting rights are held by outsiders other than the holding company.

Section 42 of the companies Act, 1956 prohibits a subsidiary company from holding shares in the holding company but a subsidiary company may continue to be a member of its holding company if it was a member thereof at the commencement of the Act or before becoming a subsidiary company.

AS-21 on Consolidated Financial Statements gives the following definitions:

A subsidiary is an enterprise that is controlled by another enterprise (known as the parent).

A parent is an enterprise that has one or more subsidiaries.

A group is a parent and all subsidiaries.

Thus, AS-21 calls holding company, a parent company.

## 11.6 OBJECTIVES OF HOLDING COMPANY

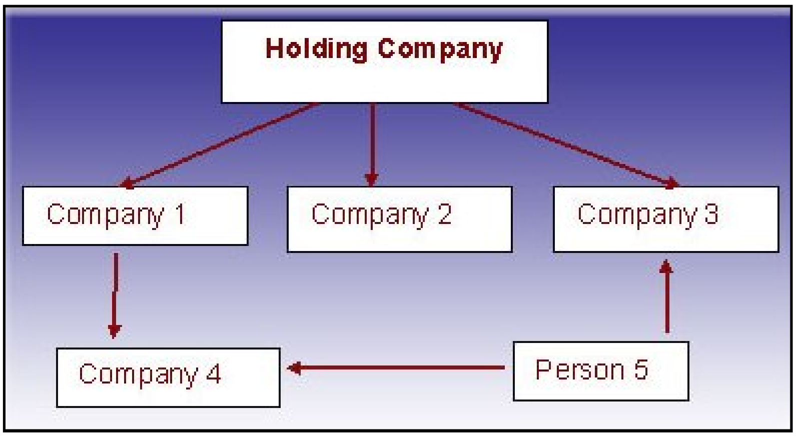
**The main objectives of holding company are :**

1. To promote combination movement so that competition may be eliminated i.e., bringing a number of companies under one control.
2. To eliminate the middlemen.
3. To economies in production and management
4. To achieve an assured market for the product of the company.
5. To ensure a smooth supply of raw materials.
6. To attract the foreign capital for the expansion of a business.
7. To collect the additional capital and expand the business on large scale.
8. To improve the goodwill of subsidiary company before the public.
9. To optimise the company's performance.
10. To get control over the management of subsidiary company.

## 11.7 DIFFERENCE BETWEEN HOLDING COMPANY AND SUBSIDIARY COMPANY

**Holding Company :** When a company acquires controlling interest in the affairs of another company, it is known as the holding company. **Holding company** does not have any business operations bit it owns assets. **Holding company** controls the composition of board of directors due to its controlling capacity. The Companies Act identifies some points about holding company and these points are as follows:

**Structure of Holding Company**




- Its assets may consist in whole or in part of shares in another company
- Holding companies' shares and other interests may be held either directly or through a nominee.
- Holding companies' interest should be in the form of holding more than fifty percent of shares or voting rights in that other company.
- Holding companies' voting right gives power directly or indirectly to appoint the majority of the directors in that other company otherwise than by virtue of the provision of a trust deed.

**Subsidiary Company:** Subsidiary company is a company that more than fifty percent of issued share capital or voting power is held by another company or the majority of directors can be appointed by another company. A **subsidiary company** may be a public limited or private limited company. Where the shares of such a company are held as security by a company the ordinary business of which is lending of money or where the majority of directors can be appointed by a company by virtue of powers contained in a debenture trust-deed, the former company will not be deemed to be a **subsidiary company** of the latter. E.g. NIKE Inc. has more than 100 subsidiary companies e.g. NIKE India Pvt. Ltd., NIKE Lightning c.v., NIKE Maxim c.v. etc.

## 11.8 MERITS OF HOLDING COMPANIES

Holding company offers several advantages. Let us discuss those advantages in detail.

(1) **Better quality Decisions:** The holding companies allow the better quality decisions at all levels of the company. The holding company concentrates on the corporate policies and strategies and the operating levels in the implementation.

(2) **Better Utilization of Resources:** Holding companies facilitate the better utilization of the financial and the other resources of the companies. The holding company pools the resources of group of enterprises. (3) Easy method of Acquiring Control: Through this method organizations have to spend less in acquiring the control of the other company.

(4) **Reduces Competition:** Competition among the two companies is totally eliminated as both of the companies are managed by the same group.

(5) **Easy Rid from Subsidiary:** If the company wants to get rid of the subsidiary; it can easily do so by selling the shares of the subsidiary in the open market.

(6) **Income tax benefits:** Separate identities are maintained by both the companies so that they can avail the tax benefits by carrying forward their losses of the previous years.

(7) **Efficient Management:** It becomes easier to manage both the companies as both the companies maintain their separate identities. This increases the efficiency of the management.

(8) **Enhances Corporate Planning:** The holding company is able to concentrate to corporate planning, acquisition, and update technology and building of corporate culture on sound business principles.

(9) **Managerial and Commercial Culture:** The management of the holding company promotes the commercial and managerial culture instead of bureaucratic culture.

The following are the other merits of holding companies:

**10.** Subsidiary companies maintain their goodwill due to having separate identities.

**11.** The fruits of monopoly or near monopoly may be enjoyed as the public may not be aware of the existence of combination. Hence, no resentment in the minds of the people.

**12.** The holding companies may require to invest a comparatively small amount in order to have control on the subsidiaries companies.

**13.** Subsidiary companies maintain their separate identities which make it possible to carry forward losses for income tax purposes.

**14.** The financial position and profitability of each undertaking is known as these companies have to prepare their own accounts.

**15.** It is easy to give up the control of the holding company simply by disposing of the shares in the subsidiary companies.

**16.** Holding company may be able to secure economies in production and management.

**17.** It is quite easy to form a holding company. The promoters can buy the shares in the open market. The consent of the shareholders of the subsidiary company is not required.

18. Competition between holding & subsidiary companies can be avoided if they are in the same line of business.

19. Secrecy can be maintained as the authority and decision making are centralised. It can protect itself from adverse publicity.

## 11.9 DEMERITS OF HOLDING COMPANIES

Holding company suffers from several disadvantages. Let us discuss those disadvantages in detail.

(1) **Secret Reserves:** To the detriment of the minority interest, the unscrupulous directors can easily create secret reserves.

(2) **Difficulty in Ascertaining Financial Position:** The creditors in the subsidiary company and the shareholders in the holding company may not be aware of the true financial position of the company.

(3) **Mismanagement:** When in the holding company number of constituents is more and there is not equivalent management efficiency, it results in the mismanagement of the operations of the company.

(4) **Fraud in Inter-Company Transactions:** There are more chances of fraud due to the inter-company transactions. This is due to the reason that inter-company transactions are settled at very high or very low price according to the requirement of the holding company.

(5) **Forced Appointment of the Directors:** The subsidiary company is sometimes forced by the holding company to appoint some directors or the officers in the company.

(6) **Difficulty in Valuation of Stock:** It becomes difficult to value the stock as the stock of the company consists of huge quantity of inter-company goods.

(7) **Oppression of Minority Shareholders**: There is always the fear of oppression of minority shareholders as the financial and other resources are totally managed in a way that suits the interest of the holding company.

Following are the main disadvantages of holding companies:

**(8)** Fraudulent manipulation of accounts is possible especially if the accounts of various companies are made up to different dates.

**(9)** Inter company transactions are often entered at unduly low prices in order to suit the holding companies.

**(10)** There is the danger of oppression of minority shareholders.

**(11)** Accounting difficulties may arise inappraising the financial position of companies due to inter-company transactions done on too high or too low prices.

**(12)** The true financial position of the subsidiary companies may not be known to the shareholders of the holding company.

**(13)** The creditors and outside shareholders may not be aware of the true financial position of the subsidiary companies.

**(14)** Officers or directors (of the choice of holding company) at undue high remuneration may have to be appointed in the subsidiary companies.

## 11.10 SUMMARY

To conclude we can say that a holding company is one which holds either whole or majority of the shares of another company or control the management of the other company, and the other company is called its subsidiary. These subsidiaries have their separate existence and are managed by independent governing boards (in case of public enterprises) and Holding Company (in case of commercial enterprises). In India, the organisation of the Steel Authority of India Ltd., the Coal Authority of India Ltd., the General Insurance Corporation of India and the State Trading Corporation of India as holding companies (in public enterprises) are the instances of this form. A holding company is able to exercise control over the management of other companies by virtue of its share ownership. According to Bon-bright and Menons "The holding company is often described as a super corporation which, by virtue of its share ownership and hence voting right in other corporations, is in a position to exercise control or materially influence the management of those other corporations known as subsidiaries"

## 11.11 GLOSSARY

- **Holding Company**- A holding company is one which directly or indirectly acquires either all or more than half the number of Equity shares in one or more companies so as to secure a controlling interest in such companies, which are then known as subsidiary companies
- **Capital Profit**- Balance of profit and loss a/c and reserves on or before the date of purchase of shares by the holding company.

## 11.12 SELF ASSESSMENT QUESTIONS

Q 1. Write a short note on AS 21 on consolidated financial statements.

____________________________________________

____________________________________________

____________________________________________

____________________________________________

Q.2 Give the legal definition of holding company.

____________________________________________

____________________________________________

____________________________________________

____________________________________________

## 11.13 LESSON END EXERCISE

Q.1 What do you mean by holding company? Also explain the various objectives of holding company?

Q.2 What do you mean by holding company? Explain the merits and demerits of holding company ?

## 11.14 SUGGESTED READINGS


- M.C Shukla and Grewal, "Advanced Accounts-II", S.Chand, New Delhi.
- Jain,S.P and Narang, K.L. "Advanced Accounts-II", Kalyani Publisher, New Delhi
- Maheshwari,S.N "Advanced Accounts-II", Vikash Publisher, New Delhi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# CONSOLIDATED FINANCIAL STATEMENTS

| M.Com II Sem. | Advanced Accounting | Unit-III |
|---|---|---|
| M.Com – C 250 | | Lesson No. 12 |

**STRUCTURE**

## 12.1 INTRODUCTION

Section 4 of the companies Act, 1956 defines a subsidiary company. A company is a subsidiary of another if and only if – a) That other company controls the composition of its Board of Directors; or b) That other – i) Where the first mentioned company is an existing company in respect of which the holders of Preference shares issued before the commencement of this Act have the same voting rights in all respect as the holders of Equity shares exercises or controls more than half of the total voting power of such company. ii) Where the first mentioned company is any other company, holds more than half in nominal value of its Equity share Capital so or iii) The company is a subsidiary of any company which is that other company's subsidiary.

## 12.2 OBJECTIVES

After going through this lesson, you should be able to understand the rationale of holding companies.

## 12.3 RATIONALE OF HOLDING COMPANIES

Rationale of Holding Companies is that:

(a) It allows better quality decisions to be taken at all levels. In case of public enterprises the Government to concentrate on macro policy,, the holding company on corporate policies and strategies and the operating levels on implementation within the framework of established strategies.

(b) It leads to a better utilisation of financial and other reserves by pooling the reserves of group of enterprises like finance, R & D, marketing and human resources. The holding company is well suited to the task of rationalisation of public sector through mergers, vertical integration, inter-group transfers and allocation of social costs.

(c) The management of holding company could promote commercial and managerial culture rather than bureaucratic systems.

(d) By grouping of enterprises into holding companies a large number could be reduced to manageable levels from the point of co-ordination and span of control. It provides enterprises scope to share and undertake relevant R & D work to update technology in order to become more competitive. It could be a strategy to turn around the sick public enterprises.

(e) The holding company is able to concentrate on corporate planning, acquisition and update technology and building of corporate culture an sound business principles.

## 12.4 ACCOUNTS OF HOLDING COMPANY

A holding company is required to attach certain documents relating to its subsidiaries. The provisions relating to this have been laid down in Section 212 of the Companies Act. Section 212 reads as under:

(1) There shall be attached to the balance sheet of a holding company having a subsidiary or subsidiaries at the end of the financial year as at which the holding company's balance sheet is made out, the following documents in respect of such subsidiary or of such subsidiaries, as the case maybe:

(a) a copy of the balance sheet of the subsidiary;

(b) a copy of its profits and loss account;

(c) a copy of the report of its Board of Directors;

(d) a copy of the report of its auditors;

(e) a statement of the holding company's interest in the subsidiary as specified in sub-section (3) (1) the statement referred to in sub-section (5), if any; and (g) the report referred to in sub-section (6), if any. (2) (a) The balance sheet referred to in clause (a) of sub-section (1) shall be made out in accordance with requirements of this Act— -

(i) as at the end of the financial year of the subsidiary, where such financial year coincides with the financial year of the holding company;

(ii) as at the end of the financial year of the subsidiary last before that of the holding company where the financial year of the subsidiary does not coincide with that of the holding company.

The profit and loss account and the reports of the Board of directors and .of the auditors, referred to in clauses (b), (c) and (d) of sub-section (1), shall be made out, in accordance with requirements of this Act, for the financial year of the subsidiary referred to' in clause (a). (c) Where the financial year of the subsidiary does not coincide with that of the holding company, the financial year aforesaid of the subsidiary shall not end on a day which proceeds the day on which the holding company's financial year ends by more than six months. (d) Where the financial year of a subsidiary is shorter in duration than that of its holding company, references to the financial year of the subsidiary in clauses (a), (b) and (c) shall be constructed as references to two or more financial years of the subsidiary the duration of which in the aggregate, is not less than the duration of the holding company's year. (3) The statement referred to in clause (e) of sub-section (1) shall specify— (a) the extent of the holding company's interest in the subsidiary at the end of the financial years or of the last of the financial years of the subsidiary referred to in sub-section (2). (b) the net aggregate amount, so far as it concerns members of the holding company and is not dealt with in the company's accounts of the subsidiary's profits after deducting its losses or vice versa: (i) for the financial year or years of the subsidiary aforesaid ; and (ii) for the previous financial years of the subsidiary since it became the holding company's subsidiary; (c) the net aggregate amount of the profits of the subsidiary after deducting the losses or vice versa (i) for the financial year or years of the subsidiary aforesaid; and (ii) for the previous financial years of the subsidiary since it became the holding company's subsidiary; so far as those profits are dealt with, the provision is made for those losses in the company's accounts. (4) Clauses (b) and (c) of sub-section (3) shall apply only to profits and losses of the subsidiary which may properly be treated in the holding company's accounts as revenue profits or losses, and the profits or losses attributable to shares in subsidiary for the time being held by the holding company or any other of its subsidiaries shall not (for that or any other purpose) be treated as aforesaid so far as they are profits or losses for the period before the date on or as from which the shares were acquired by the company or any of its subsidiaries, except that they may be in a proper case be so treated where: (a) the company is itself the subsidiary of another body corporate; and (b) the shares were acquired from that body corporate or a subsidiary of it ; and for the purpose of determining whether any profits or losses are to be treated as profits or losses for the said period, the profit or loss for any financial year of the subsidiary may, if it is not practicable to apportion it with reasonable accuracy by reference to the facts, be treated as accruing from day to day during that year and be apportioned accordingly. (5) Where the financial year or years of a subsidiary referred to sub-section (2) do not coincide with the financial year of the holding company, a statement containing information on the following matters shall also be attached to the balance sheet of the holding company: (a) whether there has been any, and, if so, what change in holding company's interest in the subsidiary between the end of the financial year or of the last of the financial years of the subsidiary and the end of the holding company's financial year; (b) details of any material changes which have occurred between the end of the financial year or of the last of the financial years of the subsidiary and the end of the holding company's financial year in respect of—

(i) the subsidiary's fixed assets;

(ii) its investments

(iii) the money lent by it;

(iv) the moneys borrowed by it for any purpose other than for meeting current liabilities.

(6) If for any reason, the Board of Directors of the holding company is unable to obtain information on any of the matters required to be specified by sub-section (4) a report in writing to that effect shall be attached to the balance sheet of the holding company.

(7) The documents referred to in clauses (e), (f) and (g) of sub-section (1) shall be signed by the persons by whom the balance sheet of the holding company is required to be signed.

(8) The Central Government may, on the application or with the consent of the Board of Directors of the company, direct that in relation to any subsidiary, the provisions of this section shall not apply, or shall apply only to such extent as may be specified in the direction.

(9) If any such person as is referred to in sub-section (6) of section 209 fails to take all reasonable steps to comply with the provisions of this section, he shall in respect of each offence, be punishable with imprisonment for a term which may extend to

six months, or with fine which may extend to one thousand rupees or with both; Provided that in any proceeding against a person in respect of an offence under this section, it shall be a defense to prove that a competent and reliable person was charged with the duty of seeing that the provisions of this section were complied with and was in a position to discharge that duty: Provided further that no person shaH he sentenced to imprisonment for any such offence unless it was committed willfully. (10) If any person, not being a person referred to in sub-section (6) of Section 209 having been charged by the Board of Directors as the case may be, with the duty of seeing that the provisions of this section are compiled with, makes default in doing so, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to one thousand rupees, or with both.

Provided that no person punished shall be sentenced to imprisonment for any such offence unless it was committed willfully.

**Illustration 12.1** A Ltd., B Ltd. and C Ltd. are subsidiaries of H Ltd. H Ltd.'s accounts for the year ending 31st March, 2008 have been prepared. In respect of the income from the subsidiaries H Ltd. accounts only for dividend, if any, received from.

**Particulars in respect of the subsidiaries are:**

| | *A Ltd.* | *B Ltd.* | *C Ltd.* |
|---|---|---|---|
| Equity Share Capital of Rs. 100 each on date of respective Balance Sheets (Rs.) | 10,00,000 | 15,00,000 | 20,00,000 |
| Financial year ends on | 31st March | 31st Dec. | 31st Oct. |
| Shares held by H Ltd. on 31-3-2008 | 8,000 | 9,000 | 12,000 |
| Shares purchased by H Ltd. from 1-4-2007 to 31-3-2008 | Nil | Nil | Nil |
| Dividend received in 2007-08 by H Ltd. in respect of last year from (Rs.) | — | — | 1,80,000 |
| Dividend received in 2007-08 by H. Ltd. in respect of earlier years (Rs.) | 1,60,000 | — | — |
| Total divisible profit for the last year (Rs.) | 3,00,000 | 4,00,000 | 5,00,000 |
| Total undistributed profits for earlier years since they became subsidiaries' of H. Ltd. (Rs.) | 8,00,000 | 9,00,000 | 15,00,000 |

B Ltd. purchased fixed assets for Rs. 2,00,000 and lent an amount of Rs. 1,00,000 upto 3 1-3- 2008 since the last closing. C Ltd. purchased investments for Rs. 1,25,000 and borrowed Rs. 1,00,000 upto 31-3-2008 since the last closing.

Prepare the statements pursuant to Section 212 of the Companies Act, 1956 to be furnished long with accounts of H Ltd. for the year ended 31st March, 2008.

**SOLUTION**

Statement in accordance with Section 212 of the Companies Act, 1956 relating to the subsidiary companies for the year ending 31st March, 2008.

| | A Ltd. | B Ltd. | C Ltd. |
|---|---|---|---|
| 1. Financial year of the subsidiary companies ending on | 31-3-2008 | 31-12-2007 | 31-10-2007 |
| 2. (a) Number of shares of subsidiary companies held at the end of the financial year on 31-3-2008 | 8,000 | 9,000 | 12,000 |
| (b) Extent of holding in the subsidiary companies | 80% $\left(\frac{8,000}{10,000} \times 100\right)$ | 60% $\left(\frac{9,000}{15,000} \times 100\right)$ | 60% $\left(\frac{12,000}{20,000} \times 100\right)$ |
| 3. Changes in the interest of H Ltd. between the end of the financial year of the subsidiary and the end of the financial year (31-3-2008) of H Ltd. | | | |
| (a) Number of shares | Nil | Nil | Nil |
| (b) Extent of holding | Nil | Nil | Nil |
| 4. Net aggregate profit of the subsidiary companies so far as it concerns the members of H Ltd. | | | |
| (a) Not dealt with in the accounts of H Ltd. for the year ending 31-3-2008 | Rs. | Rs. | Rs. |
| (i) for subsidiary companies' financial year ending as above in (1) | 2,40,000 (80% of 3,00,000) | 2,40,000 (60% of 4,00,000) | 1,20,000 (60% of 2,00,000 i.e. 5,00,000 less 3,00,000 total dividend given by C Ltd.) |
| (ii) for earlier years of the subsidiary since it became subsidiary of H Ltd. | 4,80,000 80% of 6,00,000 (i.e. 8,00,000 less 2,00,000 total dividend given by A Ltd. in respect of earlier years) | 5,40,000 (60% of 9,00,000) | 9,00,000 (60% of 15,00,000) |
| (b) Dividend received dealt with in the accounts of H Ltd. for the | | | |

| | | | |
|---|---|---|---|
| year ending 31-3-2008<br>(*i*) for the subsidiary's financial year as in (1) above | — | — | 1,80,000 |
| (*ii*) for earlier years of the subsidiary since it became subsidiary of H. Ltd. | 1,60,000 | — | — |
| 5. Material changes between the end of the financial year of the subsidiary and 31-3-2008 | | | |
| (*i*) Fixed assets (purchase) | — | 2,00,000 | — |
| (*ii*) Investments (purchase) | — | — | 1,25,000 |
| (*iii*) Amount lent by subsidiary | — | 1,00,000 | — |
| (*iv*) Amount borrowed by subsidiary | — | — | 1,00,000 |

**Working Notes :**

***Calculation of Extent of Holding in the Subsidiaries***

| | *A Ltd.* | *B Ltd.* | *C Ltd.* |
|---|---|---|---|
| Share Capital (Rs.) | 10,00,000 | 15,00,000 | 20,00,000 |
| Number of shares having paid up value of Rs. 100 each | 10,000 | 15,000 | 20,000 |
| | $\left(\frac{\text{Rs. } 10,00,000}{\text{Rs. } 100}\right)$ | $\left(\frac{\text{Rs. } 15,00,000}{\text{Rs. } 100}\right)$ | $\left(\frac{20,00,000}{\text{Rs. } 100}\right)$ |
| Shares held by H Ltd. | 8,000 | 9,000 | 12,000 |
| Extent of Holding by H Ltd. | 80% | 60% | 60% |
| | $\left(\frac{8,000}{10,000} \times 100\right)$ | $\left(\frac{9,000}{15,000} \times 100\right)$ | $\left(\frac{12,000}{20,000} \times 100\right)$ |

Financial Year of Holding Company and Subsidiary. In this regard, Section 213 of the Companies Act, 1956, reads as below:

(1) Where it appears to the Central Government desirable for a holding company or holding company's subsidiary, to extend its financial year so that the subsidiary's financial year may end with that of the holding company, and for that purpose to postpone the submission of the relevant accounts to a general meeting, the Central Government may, on the application or with the consent of the Board of Directors of the company whose financial year is to be extended, direct that in the case of that company the submission of accounts to a general meeting, the holding of an annual general meeting or the making of an annual return, shall not be required to be submitted, held or made, earlier than the dates specified in the direction, notwithstanding anything to the contrary in this Act or in any other Act for the time being in force.

(2) The Central Government shall, on the application of the Board of Directors of a holding company or a holding company's subsidiary, exercise the powers conferred on that Government by sub-secti6n (1) if it is necessary so to do, in order to secure that the end of the financial year of the subsidiary does not precede the end of the holding company's financial year by more than six months, where that is not the case at the commencement of this Act, or at the date on which the relationship of holding company and subsidiary comes into existence where that date is later than the commencement of this Act."

Rights of Holding Company's Representatives and Members. With regard to the rights of holding company's representatives and members, Section 214 of the Companies Act, 1956, reads as follows '(1) A holding company may, by resolution, authorise representatives named in the resolution to inspect the books of account kept by any of its subsidiaries, and the books of account of any such subsidiary shall be open to inspection by those representatives at any time during business hours."''(2) The rights conferred by section 235 upon members of a company may be exercised, in respect of any subsidiary, by members of the holding company as if they alone were members of the subsidiary."

Under Section 235, members of the holding company can apply for investigation of affairs of the subsidiary company.

Requirements of Schedule VI. The Balance Sheet of holding company must disclose, in the prescribed form of Balance Sheet as per Schedule VI, the following items in relation to its subsidiary or subsidiaries:

**On the Assets Side**

(1) Under Investments
Investments in shares, debentures or bonds of subsidiary companies.

(2) Under Loans and Advances: - Advances and loans to subsidiaries.

**On the Liabilities Side**

(1) Under Secured Loans: Loans and advances from subsidiaries.

(2) Under Unsecured Loans: Loans and advances from subsidiaries.

(3) Under Current Liabilities and Provisions: Subsidiary companies.

## 12.5 CONSOLIDATED BALANCE SHEET AND PROFIT & LOSS ACCOUNT

- **Consolidated Balance Sheet**

In India, although a holding company is not required by law to prepare a Consolidated Balance Sheet but preparation of Consolidated Balance Sheet is of much help to the holding company to show the clear picture. Therefore, in addition to the "legal" Balance Sheet as prescribed in Schedule VI, the holding company may also publish a Consolidated Balance Sheet in which the assets and liabilities of all the subsidiaries are given along with its own assets and liabilities as the Balance Sheet of a head office incorporates the assets and liabilities of its branches.

Shareholders of a holding company are interested in knowing the affairs of the subsidiary company as part of their money given to the holding company is invested in the subsidiary company. So, it becomes safe for directors of the holding company to disclose to the shareholders of the holding company the extent to which they are entitled to the net assets of the subsidiary company. In short, the purpose of consolidated financial statements is to present primarily for the benefit of shareholders and creditors of the parent company, financial information about the economic activities of the group as a whole e.g., economic resources controlled by the group, the obligations of the group and results the group achieves. By way of Consolidated Balance Sheet, the investments of the holding company in the subsidiary company are replaced by net assets of the subsidiary company.

**Note:** In case if the holding company acquires whole of the shares of subsidiary company, then all assets and liabilities of the subsidiary company becomes the assets and liabilities of the holding company. While preparing a Consolidated Balance Sheet, investment of the holding company in the subsidiary-should be replaced by the assets and liabilities of the subsidiary company if all the shares of the subsidiary company have been purchased by the holding company. Share capital of the subsidiary company is not taken in the consolidated balance sheet because it gets itself adjusted in the investment in shares of the subsidiary company acquired by the holding company.

- **CONSOLIDATION OF PROFIT & LOSS ACCOUNTS:**

Apart from the usual items of gains, incomes, losses and expenses which will appear in the loss accounts of both the holding and the subsidiary companies and which will therefore ---- some adjustments will be required. The following are the most important:-

1. The profit of the subsidiary company arising before the date of acquisition of shares in the subsidiary company and belonging to the holding company should be debited to the consolidated Profit and Loss Account and credited to Capital Reserve or Goodwill as the case may be. In case there is a loss, the Consolidated Profit and Loss Account will be credited and Capital Reserve or goodwill debited.

2. In respect of the proportion of the profits of the subsidiary company which belongs to the minority shareholders, their account should be credited by debit to the Consolidated Profit and Loss Account. In case of loss, the Minority Shareholders, Suspense Account should be debited and the Consolidated Profit and Loss Account credited.

3. All items internal to the holding and subsidiary companies should be eliminated. If the subsidiary company has passed entries for proposed dividend and the holding company has also taken credit for its share of the dividends, there will be a cancellation from both sides of the Consolidated Profit and Loss Account. If the proposed dividend has not been passed through the holding company's books, the debit in respect of proposed dividend will be reduced by the holding company's share in the Consolidated Profit and Loss Account; the corresponding liability in the Balance Sheet will also be reduced.

4. Reserve for unrealised profit in respect of inter -company transactions relating to goods will have to be created by debit to the Consolidated Profit and Loss Account and credit to Stock Reserve Account.

   The transfer of goods between the holding company and the subsidiary company should be eliminatd from both sides of the Consolidated Profit and Loss Account.

5. Debenture interest or dividends received by the holding company from the subsidiary will have to be eliminated from both sides of the Consolidated Profit and Loss

Account.

No adjuestment is required in respect of tax on dividends or on interest on debentures paid by the subsidiary company to the holding company. In case of interest outstanding or accruing, care should be taken to see that both the holding and subsidiary companies pass entries. Then the debenture interest will be cancelled from both sides of the Consolidated Profit and Loss Account, so far as it relates to the debentures held by the holding company.

6. In case Cumulative Preference Shares are held by outsiders and in case the dividend --- arrear, such arrear may be shown by way of a note in the Consolidated balance ----- alternatively, the amount due by way of dividends should be debited to the Consolidated Profit and Loss Account and credited to the Minority Shareholders Account and ---- a liability in the consolidated Balance Sheet.For instance, if the subsidiary value is

## 12.6 MINORITY INTEREST

When some of the shares of the subsidiary company are held by outsiders (i.e., other than the holding company), their interest is in the subsidiary company is known as minority interest and is shown on the liabilities side of the consolidated Balance Sheet. The share of the outsiders in the subsidiary company is called minority interest because they are having less than 50% of shares of the subsidiary company. For instance, if the subsidiary value is Rs. 50,00,000/- and 10% of this is owned by other, the value of the minority interest then would be Rs. 5,00,000/-.

The minority interest is calculated as follows:

| | |
|---|---|
| Face value of shares held by outsiders | xxx |
| Add: Proportionate share of the capital profit | xxx |
| Add: Proportionate share of the capital profit | xxx |
| Less: Proportionate share of subsidiary company's losses | xxx |
| Proportionate decrease in the value of the assets of the subsidiary company | xxx |
| **Value of Minority Interest** | **xxx** |

If preference shares are held by outsiders, the paid-up value of such shares together with dividend thereon (if there are profits) is also added to the value of the minority interest or shown separately. Proportionate share of the subsidiary company's profit and reserves belonging to the outsiders is calculated keeping in view the value of equity shares held by them and the value, of the preference shares held is not considered because profits and reserves belong to equity shareholders and not to preference shareholders. Having shown the amount of the minority interest in the consolidated Balance Sheet as a liability, all the assets and liabilities of the subsidiary company are merged up with those of the holding company thereby eliminating investment in shares of the subsidiary company.

## 12.7 COST OF CONTROL/GOODWILL OR CAPITAL RESERVE

If the price paid for the purchase of shares of the subsidiary company by the holding company is more than the paid-up value of the shares, the excess amount paid represents payment for goodwill or cost of acquiring control of the subsidiary company if there exist no reserves or profit or loss balance in the subsidiary company on the date of acquisition of shares of the subsidiary company. On the other hand, if the shares are purchased at a price which is less than the paid-up value of the shares, the less amount paid represents capital reserve or profit. Thus, if 10,000 shares of Rs. 10 each are purchased at Rs. 1,10,000, the excess amount of Rs. 10,000 (i.e., Rs. 1,10,000 — Rs. 100,000) is goodwill and will be shown in Consolidated Balance Sheet as goodwill on the assets side. On the other hand, if the price paid for 10,000 shares is Rs. 80,000, the less amount of Rs. 20,000 is capital profit and will be shown on the liabilities side as capital reserve.

## 12.8 PRE-ACQUISITION (OR CAPITAL) RESERVES AND PROFITS

The balance of reserves and profits of the subsidiary company on or before the date of the purchase of shares by the holding company is treated as capital profits. The outsiders' share of such reserves and profits is added to the minority interest as pointed out earlier and the balance of such reserves and profits are capital profits of the holding company and are shown as capital reserve in the Consolidated Balance Sheet. In case of cost of control or goodwill, share of such profits belonging to the holding company is adjusted to goodwill and reduces the cost of control or goodwill.

Similarly, losses of the subsidiary company such as debit balance of profit and loss account, preliminary expenses, discount on issue of shares and debentures, underwriting commission etc. shown in the Balance Sheet on the date of the purchase of shares are divided into two parts i.e., share of the minority shareholders and share of the holding company. Share of the outsiders is deducted from the amount of the minority interest and share of the holding company is added to the cost of control or goodwill or reduced from capital profit which has become available on purchase of shares of the subsidiary company at a price lower than the paid-up value.

## 12.9 REVENUE (OR POST-ACQUISITION) PROFITS

Any profit of the subsidiary company earned after the date of the purchase of shares by the holding company are treated as revenue profits. Holding company's share of such profits is added to the profits of the holding company and share of such profits belonging to the minority shareholders is added to the amount of the minority interest. Thus, to decide whether profits and reserves of the subsidiary company are capital profits or revenue profits, date of purchase by the holding company is the deciding factor. Profits or reserves shown in the Balance Sheet of the subsidiary company on or before the date of purchase of shares are treated as capital profits and profits earned by the subsidiary company after the purchase of shares by the holding company are called revenue profits.

## 12.10 SUMMARY

Rationale of Holding Companies is that: It allows better quality decisions to be taken at all levels. In case of public enterprises the Government to concentrate on macro policy,, the holding company on corporate policies and strategies and the operating levels on implementation within the framework of established strategies. It leads to a better utilisation of financial and other reserves by pooling the reserves of group of enterprises like finance, R & D, marketing and human resources. The holding company is well suited to the task of rationalisation of public sector through mergers, vertical integration, inter-group transfers and allocation of social costs. The management of holding company could promote commercial and managerial culture rather than bureaucratic systems. By grouping of enterprises into holding companies a large number could be reduced to manageable levels from the point of co-ordination and span of control. It provides enterprises scope to share and undertake relevant R & D work to update technology in order to become more competitive. It could be a strategy to turn around the sick public enterprises. The holding company is able to concentrate on corporate planning, acquisition and update technology and building of corporate culture an sound business principles.

## 12.11 GLOSSARY

- **Revenue Profit-** Balance of profit and loss a/c and reserves after the date of purchase of shares by the holding company.
- **Minority Interest-** Outsiders interest in the subsidiary company.
- **Capital Profit-** Profit earned on or before the date of purchase of shares by holding company
- **Post-acquisition Profit-** Profit earned on or before the date of purchase of shares by holding company

## 12.12 SELF ASSESSMENT QUESTIONS

**Q.1 What is capital profit?**

______________________________________________

______________________________________________

______________________________________________

**Q.2 What is revenue profit?**

______________________________________________

______________________________________________

______________________________________________

## 12.13 LESSON END EXERCISE

Q.1 What is minority interest? How it is calculated?

Q.2 Give the conceptual framework of holding company. Also discuss the advantages and dis-advantages of holding companies.

## 12.14 SUGGESTED READINGS


- M.C Shukla and Grewal, "Advanced Accounts-II", S.Chand, New Delhi.
- Jain,S.P and Narang, K.L. "Advanced Accounts-II", Kalyani Publisher, New Delhi
- Maheshwari,S.N "Advanced Accounts-II", Vikash Publisher, New Delhi


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# CONSOLIDATED FINANCIAL STATEMENTS

| M.Com II Sem. | Advanced Accounting | Unit-III |
|---|---|---|
| M.Com – C 250 | | Lesson No. 13 |

**STRUCTURE:**

## 13.1 INTRODUCTION

Dividends are payments made by a corporation to its shareholder members. It is the portion of corporate profits paid out to stockholders. When a corporation earns a profit or surplus, that money can be put to two uses: it can either be re-invested in the business (called retained earnings), or it can be distributed to shareholders. There are two ways to distribute cash to shareholders: share repurchases or dividends. Many corporations retain a portion of their earnings and pay the remainder as a dividend.

## 13.2 OBJECTIVES

After going through this lesson you should be able to understand the advanced treatment of dividend.

## 13.3 FORMS OF PAYMENT OF DIVIDEND

A dividend is allocated as a fixed amount per share. Therefore, a shareholder receives a dividend in proportion to their shareholding. For the joint stock company, paying dividends is not an expense; rather, it is the division of after tax profits among shareholders. Retained earnings (profits that have not been distributed as dividends) are shown in the shareholder equity section in the company's balance sheet - the same as its issued share capital. Public companies usually pay dividends on a fixed schedule, but may declare a dividend at any time, sometimes called a special dividend to distinguish it from the fixed schedule dividends.

Cooperatives, on the other hand, allocate dividends according to members' activity, so their dividends are often considered to be a pre-tax expense.

Dividends are usually paid in the form of cash, store credits (common among retail consumers' cooperatives) and shares in the company (either newly created shares or existing shares bought in the market.) Further, many public companies offer dividend reinvestment plans, which automatically use the cash dividend to purchase additional shares for the shareholder.

The word "dividend" comes from the Latin word "*dividendum*" ("thing to be divided").

Following are the forms of Dividends :

**(i) Cash dividends** (most common) are those paid out in currency, usually via electronic funds transfer or a printed paper check. Such dividends are a form of investment income and are usually taxable to the recipient in the year they are paid. This is the most common method of sharing corporate profits with the shareholders of the company. For each share owned, a declared amount of money is distributed. Thus, if a person owns 100 shares and the cash dividend is GBP £0.50 per share, the holder of the stock will be paid GBP £50. Dividends paid are not classified as an expense, but rather a deduction of retained earnings. Dividends paid does not show up on an Income Statement but does appear on the Balance Sheet.

**(ii) Stock or scrip dividends** are those paid out in the form of additional stock shares of the issuing corporation, or another corporation (such as its subsidiary corporation). They are usually issued in proportion to shares owned (for example, for every 100 shares of stock owned, a 5% stock dividend will yield 5 extra shares). If the payment involves the issue of new shares, it is similar to a stock split in that it increases the total number of shares while lowering the price of each share without changing the market capitalization, or total value, of the shares held. (See also Stock dilution.)

**(iii) Property dividends** or dividends ***in specie*** (Latin for "in kind") are those paid out in the form of assets from the issuing corporation or another corporation, such as a subsidiary corporation. They are relatively rare and most frequently are securities of other companies owned by the issuer, however they can take other forms, such as products and services.

**(iv)Interim dividends** are dividend payments made before a company's annual general meeting (AGM) and final financial statements. This declared dividend usually accompanies the company's interim financial statements.

**(v) Other dividends** can be used in structured finance. Financial assets with a known market value can be distributed as dividends; warrants are sometimes distributed in this way. For large companies with subsidiaries, dividends can take the form of shares in a subsidiary company. A common technique for "spinning off" a company from its parent is to distribute shares in the new company to the old company's shareholders. The new shares can then be traded independently.

## 13.4 RELIABILITY OF DIVIDENDS

Two metrics are commonly used to examine a firm's dividend policy. *Payout ratio* is calculated by dividing the company's dividend by the earnings per share. A payout ratio greater than 1 means the company is paying out more in dividends for the year than it earned.

*Dividend cover* is calculated by dividing the company's cash flow from operations by the dividend. This ratio is apparently popular with analysts of income trusts in Canada. Dividends are payments made by a corporation to its shareholder members. It is the portion of corporate profits paid out to stockholders.

- **Dividend dates**

Any dividend that is declared must be approved by a company's Board of Directors before it is paid. For public companies, there are four important dates to remember regarding dividends. These are discussed in detail with examples at the Securities and Exchange Commission site

1. **Declaration date** is the day the Board of Directors announces its intention to pay a dividend. On this day, a liability is created and the company records that liability on its books; it now owes the money to the stockholders. On the declaration date, the Board will also announce a date of record and a payment date.

2. **In-dividend date** is the last day, which is one trading day before the *ex-dividend date*, where the stock is said to be *cum dividend* ('with [**in**cluding] dividend'). In other words, existing holders of the stock and anyone who buys it on this day will receive the dividend, whereas any holders selling the stock lose their right to the dividend. After this date the stock becomes *ex dividend*.

3. **Ex-dividend date** (typically 2 trading days before the *record date* for U.S. securities) is the day on which all shares bought and sold no longer come attached with the right to be paid the most recently declared dividend. This is an important date for any company that has many stockholders, including those that trade on exchanges, as it makes reconciliation of who is to be paid the dividend easier. Existing holders of the stock will receive the dividend even if they now sell the stock, whereas anyone

who now buys the stock will not receive the dividend. It is relatively common for a stock's price to decrease on the ex-dividend date by an amount roughly equal to the dividend paid. This reflects the decrease in the company's assets resulting from the declaration of the dividend. The company does not take any explicit action to adjust its stock price; in an efficient market, buyers and sellers will automatically price this in.

**4. Book Closure Date** Whenever a company announces a dividend pay-out, it also announces a date on which the company will ideally temporarily close its books for fresh transfers of stock.

**5. Record Date** Shareholders registered in the **stockholders of record** on or before the **date of record** will receive the dividend. Shareholders who are not registered as of this date will not receive the dividend. Registration in most countries is essentially automatic for shares purchased before the ex-dividend date.

**6. Payment Date** is the day when the dividend cheques will actually be mailed to the shareholders of a company or credited to brokerage accounts.

- **Dividend-reinvestment**

Some companies have dividend reinvestment plans, or DRIPs, not to be confused with scrips. DRIPs allow shareholders to use dividends to systematically buy small amounts of stock, usually with no commission and sometimes at a slight discount. In some cases, the shareholder might not need to pay taxes on these re-invested dividends, but in most cases they do.

**1. Dividend Taxation**

In many countries, such as the U.S.A. and Canada, income from dividends is taxed, albeit at a lower rate than ordinary income. Though in most cases, the lower tax rate is due to profits being taxed initially as Corporate tax.

**2. Australia and New Zealand**

In Australia and New Zealand, companies also forward franking credits or imputation credits to shareholders along with dividends. These franking credits represent the tax paid by the company upon its pre-tax profits. One dollar of company tax paid generates one franking credit. Companies can forward any proportion of franking up to a maximum amount that is calculated from the prevailing company tax rate: for each dollar of dividend paid, the maximum level of franking is the company tax rate divided by (1 - company tax rate). At the current 30% rate, this works out at 0.30 of a credit per 70 cents of dividend, or 42.857 cents per dollar of dividend. The shareholders who are able to use them offset these credits against their income tax bills at a rate of a dollar per credit, thereby effectively eliminating the double taxation of company profits. This system is called dividend imputation.

**3. UK**

The UK's taxation system operates along similar lines to Australia and New Zealand: when a shareholder receives a dividend, the basic rate of income tax is deemed to already have been paid on that dividend. This ensures that double taxation does not take place, however this creates difficulties for some non-taxpaying entities such as certain trusts, charities and pension funds which are not allowed to reclaim the deemed tax payment and thus are in effect taxed on their income.

**4. India**

In India, companies declaring or distributing dividend, are required to pay a Corporate Dividend Tax in addition to the tax levied on their income. Dividend received is exempt in the hands of the shareholder's, in respect of which Corporate Dividend Tax has been paid by the company.

- **Effect on stock price**

After a stock goes ex-dividend (i.e.. the financial obligation for the company to pay the dividend to the holder), the stock price should drop.

To calculate the amount of the drop, the traditional method is to view the financial effects of the dividend from the perspective of the company. Since the company has paid say £x in dividends per share out of its cash account on the left hand side of the balance sheet, the equity account on the right side should decrease an equivalent amount. This means that a £x dividend should result in a £x drop in the share price.

A more accurate method of calculating this price is to look at the share price and dividend from the after-tax perspective of a share holder. The after-tax drop in the share price (or capital gain/loss) should be equivalent to the after-tax dividend. For example, if the tax of capital gains Tcg is 35%, and the tax on dividends Td is 15%, then a £1 dividend is equivalent to £0.85 of after tax money. To get the same financial benefit from a capital loss, the after tax capital loss value should equal £0.85. The pre-tax capital loss would be £0.85/(1-Tcg) = £0.85/(1-35%) = £0.85/65% = £1.30. In this case, a dividend of £1 has led to a larger drop in the share price of £1.30, because the tax rate on capital losses is higher than the dividend tax rate.

Finally, security analysis that does not take dividends into account may mute the decline in share price, for example in the case of a Price–earnings ratio target that does not back out cash; or amplify the decline, for example in the case of Trend following.

## 13.5 ADVANCED TREATMENT OF DIVIDEND

Dividends may be received out of capital or revenue profits of the subsidiary company. Dividends received by the holding company from the capital profits of the subsidiary company are credited to Investment in Shares of the Subsidiary Account thereby reducing the cost of control or increasing capital reserve. On the other hand, dividends received out of the revenue profits (i.e., post-acquisition profits) are treated as income and credited to Profit and Loss Account by the holding company. If dividend declared partly out of capital profits (i.e., pre-acquisition profits) and partly out of revenue profits (i.e., post-acquisition profits), the dividend received is divided into two parts in proportion to its declaration out of capital profits and revenue profits. The dividend pertaining to the first part (i.e., capital profits) is credited to Investment Account reducing the cost of control or increasing the capital reserve and dividend pertaining to the second part (i.e., revenue profits) is credited to Profit and Loss Account.

It may be noted that in the absence of information whether dividend has been declared out of pre-acquisition or post-acquisition profits, it is assumed that dividend is out of profits for the year for which the dividend is declared.

## 13.6 TREATMENT OF PROPOSED DIVIDEND

If the proposed dividend appears in the Balance Sheet of subsidiary company, holding company's share of such dividend will appear with the Profit and Loss Account balance in the consolidated Balance Sheet and share of such dividend belonging to minority shareholders will be added to the minority interest. Proposed dividend need not be shown in the consolidated Balance Sheet because it has been added to the minority interest and Profit and Loss Account balance of the holding company.

If proposed dividend is not given in the Balance Sheet of the subsidiary company or directors of this company have not appropriated the profits for proposed dividend, then the following procedure is followed:

(i) Calculate the cost of control and minority interest etc. in the usual manner without any adjustment for proposed dividend.

(ii) Deduct from minority interest its share of proposed dividend and show the same as a separate item in the Consolidated Balance Sheet.

## 13.7 TREATMENT OF INTERIM DIVIDEND

Interim dividends are those dividends which are declared by the company in between two annual general meetings. The amount of interim dividend paid by subsidiary company during the accounting year is to be added to revenue profits of the subsidiary company before distribution among holding company and minority shareholders. Afterwards holding company's share will be deducted from the profits of the holding company and minority share from the minority interest, Interim dividend will not be shown anywhere in the Consolidated Balance Sheet.

Unclaimed dividend appearing in the Balance Sheet of the Subsidiary Company will be added in full to the total of minority interest.

## 13.8 BONUS SHARES

Bonus paid to the shareholders can be either cash honus or capital bonus. A company gives cash bonus to its shareholders only when it has larger reserves and sufficient cash to pay bonus. It is also seen that the payment of cash bonus does not affect the working capital of the company. On the other hand, in case of capital bonus, en the company wants to share the accumulated reserves'with the shareholders but it is not in a position to pay cash bonus because it adversely affects the working capital of the company. Capital bonus is given by making partly paid shares as fully paid without getting cash from the shareholders or it is given by the of free fully paid shares know as bonus shares.

**Basic Characteristics of Bonus Shares**

(a) Bonus shares can he issued to the existing members only.

(b) Bonus shares are issued as fully paid i.e. partly paid bonus shares cannot be issued.

(c) The right of bonus shares cannot be renudciated.

- **Conditions for Issue of Bonus Shares**

(a) The bonus issue is not made unless the partly paid shares, if any, are made fully paid-up.

(b) The company has not defaulted in payment of interest or principal in respect of fixed deposits and interest on existing debentures or principal on redemption.

(c) The company has sufficient reason to believe that it has not defaulted in respect of payment of statutory dues of the employees such as contribution to provident fund, gratuity, bonus etc.

(d) A company which announces its bonus issue after the approval of the Board of Directors must implement the proposal within a period of six months from the date of such approval and shall not have the option of changing the decision.

- The articles of association of the company shall contain a provision for capitalisation of reserves; ete.

- If there is no such provision in t.he articles the company shall pass a resolution at its general body meeting making provisions in the articles of association for capitalisation.

- **Circumstances for Issue of Bonus Shares**

**Following circumstances warrant the issue of bonus shares:**

(i) When a company has accumulated large reserves (whether capital or revenue) and it wants to capitalise these reserves by issuing bonus shares.

(ii) When the company is not in a position to give cash bonus because it adversely affects its working capital.

(iii) When the value of fixed assets far exceeds the amount of the capital.

(iv) When the higher rate of dividend is not advisable for the distribution of the accumulated reserves because shareholders will demand the same rate of dividend in future which the directors may not be able to give. To obviate this difficulty, bonus shares are issued to facilitate the payment of the regular dividend from year to year.

v) When there is a big difference between the market value and paid up value of shares of the company i.e. market; value of shares far exceeds the nominal value of shares.

A company issuing bonus shares is better placed in the market. There is a sharp rise in the prices of equity shares following the declaration of bonus issue.

(v) When there is a big difference between the market value and paid up value of shares of the company i.e., market value of shares far exceeds the nominal value of shares.

A company issuing bonus shares is better placed in the market. There is a sharp rise in the prices of equity shares fonowing the declaration of bonus issue.

**Provisions of the Companies Act Regarding Issue of Bonus Shares**

According to Section 52 of the Companies Act, 2013 the Securities Premium Reserve may be applied in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares. Section 55 provides that the Capital Redemption Reserve Account may be applied by the company in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares. As per Section 63 of the Companies Act, 2013, a cornpany may issue fully paid bonus shares to its members in any manner out of

(i) its free reserves;

(ii) the securities premium account; or

(iii) the capital redemption reserve account.

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

**SEBI (i.e., Securities and Exchange Board of India) Guidelines for Issue of Bonus Shares**

**Bonus issues are regulated by guidelines, 2003 issued hy SEBI and came into force w.e.f. 27-1-2003. The text of these guidelines is given as follows:**

(i) These guidelines are applicable to existing listed companies who shall forward a certificate duly signed by the issuer and duly counter signed by its satutory auditor or by a company secretary in practice to the effect that the terms and conditions for issue of bonus shares as laid down in these guidelines have been complied with.

(ii) Issue of bonus shares after any public/rights issue is subject to the condition that no bonus issue shall be made which will dilute the value or right of the holders of debentures, convertible fully or partly. In other words, no company shall, pending conversion of FCDs/PCDs, issue any shares by way of bonus unless similar benefit is extended to the holders of such FCDs/PCDs, through reservation of shares in proportion to such convertible part of FCDs or PCDs. The shares so reserved may be issued at the tinle of conversion(s) of such debentures on the same terms on which the bonus issues were made.

(iii) The bonus issue is made out of the free reserves built out of the genuine profits or securities premium reserve collected in cash only.

(iv) Reserves created by revaluation of fixed assets are not capitalised.

(v) The declaration of bonus issue, in lieu of dividend, is not made.

(vi) The bonus issue is not made unless the partly-paid shilres. if any existing, are made fully paid-up.

(vii) The company-

1. has not defaulted in payment of interest or principal in respect of fixed deposits and interest on existing debentures or principal on redemption

thereof, and

2. has sufficent reason to believe that it has not defaulted in respect of the payment of statutory dues of the employees such as contribution to provident fund, gratuity, bonus etc.

viii) A company which announces its bonus issue aftcr the approval of the Board of Directors must implement the proposals within a period of six months from the date of such approval and shall not have the option of changing the decision.

ix) There should be a provision in the Articles of Association of the company for capitalisation of reserves, etc. and if not, the company shall pass a Resolution at its General Body Meeting making provisions in the Articles of Association for capitalisation.

x) Consequent to the issue of bonus shares if the subscribed and paid-up capital exceed the authorised share capital, a Resolution shall be passed by the company at its General Body Meeting for' increasing the authorised capital.

**Free Reserves that can be Used for Issue of Bonus Shares**

1. Surplus Account (i.e., credit balance of Profit and Loss A/c carried forward).
2. General reserve.
3. Dividend equalisation reserve.
4. Realised capital profits and reserves arising from profit on sale of fixed assets received in cash.
5. Balance ill debenture redemption reserve after redemption of debentures.
6. Capital Redemption Reserve Account created at the time of redemption of redeemable preference shares out of the profits.
7. Securities Premium Reserve Account collected in cash only.

It may be remembered that both the above accounts can be utilised only for issuing fully paid bonus shares and not for making partly paid shm:es fully paid shares.

**Reserves (i.e., not Free Reserves) not Available for issue of Bonus Shares**

1. Capital reserve arising due to revaluation of assets.
2. Securities premium reserve arising on issue of shares on amalgamation or take over.
3. Investment allowance reserve/Development rebate reserve before expiry of 8 years of creation.
4. Balance in Debenture Redemption Reserve Account before redemption takes place.
5. Surplus arising from a change in the method of charging depreciation.

**Accounting Treatment**

(A) If the bonus is utilised by making existing partly paid shares fully paid shares, the entries will be as follows;

| | | |
|---|---|---|
| (1) | Surplus Account | Dr. |
| | or General Reserve Account | Dr. |
| | or Capital Profit Account | Dr. |
| | To Bonus to Shareholders Account | |
| | (Being amount transferred for bonus payable to shareholders) ; | |
| (2) | Share Final Call Account | Dr. |
| | To Share Capital Account | |
| | (Being final call due on shares) | |
| (3) | Bonus to Shareholders Account | Dr. |

To Share Final Call Account

(Being bonus to shareholders utihsed to make the final call paid-up)

(B) If the payment of bonus is made by the issue of free fully paid bonus shares, the following Journal Entries will be recorded;

| | | |
|---|---|---|
| (1) | Surplus Account | Dr. |
| | or General Reserve Account | Dr. |
| | or Capital Redemption Reserve Account | Dr. |
| | or Securities Premium Reserve Account | Dr. |
| | or Capital Reserve Account | Dr. |
| | or Any Other Reserve Account | Dr. |
| | To Bonus to Shareholders Account | |
| | (Being arnount transferred for issue of bonus shares) | |
| (2) | Bonus to Shareholders Account | Dr. |
| | To Share Capital Account | |
| | To Securities Premium Reserve Account<br>(Being issue of bonus shares) | (if bonus shares are<br>issued at a premium) |

From the entries given above, it is clear that issue of bonus shares represents the addition to share capital of the company, but shareholders' fund remains unchanged because reserves are decreased by a responding amount.

While preparing the balance sheet of the company after the issue of bonus shares, the number of shares led as bonus shares and the source from which such shares are issued must be disclosed in the balance sheet.

After the issue of bonus shares, other things remaining the same, the price of shares will come down. Total value of shares held by a shareholder will rernain unaltered.

For example, suppose. A held 100 shares before issue of bonus shares when the market value of a share was ₹ 30. Suppose the company shares a bonus issue of one share for every 2 shares held; the shareholder in the example will get 50 us share8. His total holding will be 150 shares. The value of a share will come down to ₹ 20 i.e. ₹ 30 – 1.00 Thus, total value of his holding will be ₹ 3,000 (150 × ₹ 20) i.e. value which was before the share of bonus shares. i.e ₹ 100 shares @ ₹ 30. It is because net assets available for shareholder are not red by issue of bonus shares.

The issue of bonus shares can be profitable to shareholders if the company maintains the rate of dend per share after the issue of bonus shares as before. After the issue of bonus shares, shareholders start getting more dividend as they are in possession of increased number of shares.

The imhalance between the lower amount of paid-up capital and the higher arnount. of net worth which an account of accumulated reserves can he corrected by capitalising reserves by issuing bonus shares. By issue of bonus shares the paid-up share capital will increase and will become representative capital in tion to the earning capacity. It. will curb speculation in the prices of shares and as a result prices of res of the company will stabilise. It can be made dear by taking the following example, Suppose a company has the following sumrnarised Balance Sheet:

| | | | |
|---|---|---|---|
| | ₹ | | ₹ |
| Capital | 25,00,000 | Net Assets | 50,00.000 |
| rerves, | 25,00,000 | | |
| | 50,00,000 | | 50.00,000 |

Suppose further that the company earns ₹ 6,25,000 per year. A superficial view will show that the company earns 25% on its capital $\dfrac{\text{i.e. ₹ 6,25,000 (Profits)}}{\text{₹ 25,00,000(Share Capital)}} \times 100$. This may give the feeling that company's rate of earning is very high and customers are being exploited. But if reserves of ₹ 26,00.000 capitalised by issue of bonus shares, the feeling of high rate of earning will be washed away because of earning will be only 12.5%

(i.e., $\dfrac{₹\ 6,25,00\ (\text{Profits})}{₹\ 25,00,000\ (\text{Share Capital})} \times 100^{\cdot}$

**ILLUSTRATION 13.1** – Balance Sheet of Do Well. Ltd. as on 31st March, 2016 was as follows:

| | ₹ |
|---|---|
| **1. Equity and Liabilities** | |
| (1) *Shareholders' Funds* | |
| (a) Share Capital : | |
| Equity Shares of ₹ 10 each | 2,00,000 |
| (b) Reserves and Surplus : | |
| Surplus Account | 1,20,000 |
| (2) *Non current Liabilities* | |
| 6% Debentures | 1,20,000 |
| (2) *Current Liabilities* | |
| Creditors | 60,000 |
| Proposed Dividend | 20,000 |
| Total Equity and Liabilities | 5,20,000 |
| ***II. Assets*** | |
| (1) *Non-current Assets* | |
| Fixed Aslsets : Freehold Property | 1,00,000 |
| (2) *Current Assets* | |
| Stock | 1,20,000 |
| Debtors | 80,000 |
| Balance at Bank | 2,20,000 |
| Total Assets | 5,20,000 |

At the annual general meeting held on 18th April, 2016 it was resolved:

(i) To declare dividend of 10% for the accounting year ended on 31st March, 2016,

(ii) To issue one bonus share for every 4 shares held out of Surplus Account.

(iii) To give existing shareholders the option to purchase for cash one share for ₹ 15 for every 4 shares held prior to the bonus distribution. This option was accepted by all the shareholders. (On this no bonus share will be given)

(iv) To redeem the debentures at a premium of 3%.

Assuming that the authorised share capital is enough and dividends have been paid in full, pass necessary Journal. Entries. Ignore dividend distribution tax.

**SOLUTION**

**JOURNAL ENTRIES**

| | | | ₹ | ₹ |
|---|---|---|---|---|
| (1) | Proposed Dividend A/c | Dr. | 20,000 | |
| | To Dividend Payable A/c | | | 20,000 |
| | (Being dividend declared) | | | |
| (2) | Dividend Bank A/c | Dr. | 20,000 | |
| | To Bank A/c | | | 20,000 |
| | (Being amount transferred to Dividend Bank Account) | | | |
| (3) | Dividend Payable A/c | Dr. | 20,000 | |
| | To Dividend Bank A/c | | | 20,000 |
| | (Being dividend paid) | | | |
| (4) | Surplus A/c | Dr. | 50,000 | |
| | To Bonus to Shareholders A/c | | | 50,000 |
| | (Being bonus declared for shareholders) | | | |
| (5) | Bonus to Shareholders A/c | Dr. | 50,000 | |
| | To Equity Share Capital A/c | | | 50,000 |
| | (Being 5,000 bonus shares allotted to shareholders) | | | |

| | | | | |
|---|---|---|---|---|
| (6) | Bank A/c Dr. | | 75,000 | |
| | To Equity Capital A/c | | | 50,000 |
| | To Securities Premium Reserve A/c | | | 25,000 |
| | (Being 5000 equity shares of ₹ 10 each issued at premium of ₹ 5 per share) | | | |
| (7) | Securities Premium Reserve A/c Dr. | | 3,600 | |
| | To Premium on Redemption of Debentures A/c | | | 3,600 |
| | (Being Premium on Redemption of debentures provided) | | | |
| (8) | 6% Debentures A/c | | | |
| | Premium on Redemption of Debentures A/c | | | |
| | To Bank A/c | | | |
| | (Being redemption of debentures) | | | |

**ILLUSTRATION 13.2 -** Following figures have been extracted from the books of ABC Ltd. as at 31-3-2016 :

| | ₹ |
|---|---|
| Authorised Capital: | |
| 50,00,000 Equity Shares off ₹ 10 each | 5,00,00,000 |
| Issued and Subscribed Capital: | |
| 45,00,000 Equity Shares off ₹10 each, fully paid up | 4,50,00,000 |
| Reserves and Surplus: | |
| General Reseve | 50,00,000 |
| Surplus Account | 1,10,00,000 |
| Capital Reserves | 30,00,000 |
| Securities Premium Reserve | 15,00,000 |
| 14% Partly Convertible Debentures of ₹ 100 each | 1,25,00,000 |

The company decided to capitalise its reserves by way of bonus issue at the rate of one share for every 4 shares held. Capital reserves include ₹ 20,00,000 profit on sale of fixed assets. It may be assumed that securities premium reserve has been realised in cash. 40% of 14% debentures are convertible into equity shares of ₹ 10 each fully paid on 30th September, 2016.

Show the necessary Journal Entries in the books of the company and prepare the extract of the Balance Sheet immediately after the bonus ‘issue but before conversion of debentures.

**SOLUTION**

**ACB Ltd.**
**JOURNAL ENTRIES**

| | | | ₹ | ₹ |
|---|---|---|---|---|
| | Capital Reserve Account Dr.<br>Securities Premium Reserve Account Dr.<br>General Reserve Account Dr.<br>Surplus Account Dr.<br>To Bonus to Shareholders Account<br>(Being bonus issue @ 1 share for every 4 shares held by utilising various reserves as per Board’s resolution dated.....) . | | 20,00,000<br>15,00,000<br>50,00.000<br>27,50,000 | <br><br><br><br>1,12,50,000 |
| | Bonus to Shareholders Account Dr<br>To Equity Share Capital Account<br>(Being issue of 11,25,000 bonus shares of ₹ 10 each fully paid up to be distributed in the ratio of 1 bonus share for every 4 shares held) | | 1,12,50,000 | <br>1,12,50,000 |

**BALANCE SHEET (EXTRACT)**

***as on........ (after Bonus Issue)***

| | ₹ |
|---|---|
| Authorised Capital | |
| 62,50,000 Equity Shares of ₹ 10 each | 6,25,00,000 |
| Issued and Subscribed Capital | |
| 56,25,000 Equity Shares of ₹ 10 each, fully paid up (Out of the above 11,25,000 equity shares of ₹ 10 each have been issued as fully paid bonus shares out of Capital Reserve Account ₹ 20,00,000, Securities Premium Reserve Account ₹ 15,00,000, General Reserve ₹ 50,00,000 and Surplus Account ₹ 27,50,000) | 5,62,50,000 |
| Reserves and Surplus : | |
| Capital Reserves | 10,00,000 |
| Surplus Account | 82,50,000 |
| Secured Loan: | |
| 14% Partly Convertible Debentures of ₹ 100 each | 1,25,00.000 |

Notes:

(1) It is assumed that the company will pass necessary resolution at its general body meeting for increasing the authorised capital. Figure of increased authorised capital may be as follows:

| | ₹ |
|---|---|
| Existing number of equity shares as authorised | 50,00,000 |
| Add : issue of bonus shares to equity shareholders | 11,25,000 |
| Number of bonus shares to be issued to debenlureholders for | |
| conversion $\frac{₹\ 1,25,00,000 \times 40\%}{4 \times ₹\ 10}$ | 1,25,000 |
| | 62,50,000 |

(2) Entries for bonus shares to be issued to debentureholders will be made when debentures will be converted. No. of shares to be issued to debenture holders is calculated as follows:

| | | ₹ |
|---|---|---|
| Partly convertible debentures | | 1,25,00,000 |
| Portion to be converted 40% | ₹ 1,25,00,000 × $\frac{40}{100}$ | 50,00,000 |
| Ratio of bonus issue 1 : 4 | ₹ 50,00,000 × $\frac{1}{4}$ | 12,50,000 |
| No. of bonus shares @ ₹10 each (₹12,50,000 ÷ 10) | | 1,25,000 |

## 13.9 SUMMARY

Some believe that company profits are best re-invested back into the company: research and development, capital investment, expansion, etc. Proponents of this view (and thus critics of dividends per se) suggest that an eagerness to return profits to shareholders may indicate the management having run out of good ideas for the future of the company. Some studies, however, have demonstrated that companies that pay dividends have higher earnings growth, suggesting that dividend payments may be evidence of confidence in earnings growth and sufficient profitability to fund future expansion.

Taxation of dividends is often used as justification for retaining earnings, or for performing a stock buyback, in which the company buys back stock, thereby increasing the value of the stock left outstanding.

When dividends are paid, individual shareholders in many countries suffer from double taxation of those dividends:

1. the company pays income tax to the government when it earns any income, and then
2. when the dividend is paid, the individual shareholder pays income tax on the dividend payment.

In many countries, the tax rate on dividend income is lower than for other forms of income to compensate for tax paid at the corporate level.

Capital gains should not be confused with dividends. Capital gains assumes an increase in a stock's value. Dividend is merely parsing out a share of the profits, and is taxed at the dividend tax rate. If there is an increase of value of stock, and a shareholder chooses to sell the stock, the shareholder will pay a tax on capital gains (often taxed at a lower rate than ordinary income). If a holder of the stock chooses to not participate in the buyback, the price of the holder's shares could rise (as well as it could fall), but the tax on these gains is delayed until the actual sale of the shares. Certain types of specialized investment companies (such as a REIT in the U.S.) allow the shareholder to partially or fully avoid double taxation of dividends.

Shareholders in companies that pay little or no cash dividends can reap the benefit of the company's profits when they sell their shareholding, or when a company is wound down and all assets liquidated and distributed amongst shareholders. This, in effect, delegates the dividend policy from the board to the individual shareholder. Payment of a dividend can increase the borrowing requirement, or leverage, of a company.

## 13.10 GLOSSARY

- **Dividend-** Part of profit distributed among shareholders
- **Interim dividend-** Dividend declared by company in between two annual general meeting
- **Contingent Liabilities-**These are the liabilities which may or may not occur and are shown as a foot note in the balance sheet**.**

## 13.11 SELF ASSESSMENT QUESTIONS

**Q.1 What do you mean by dividend?**

________________________________________________

________________________________________________

________________________________________________

________________________________________________

**Q.2 What is proposed dividend?**

______________________________________________________________

______________________________________________________________

______________________________________________________________

## 13.12 LESSON END EXERCISE

Q.1 What do you mean by dividend? How dividends are treated in the consolidated balance sheet?

Q.2 Discuss the treatment of proposed dividend and interim dividend in the consolidated balance sheet with suitable examples.

## 13.13 SUGGESTED READINGS


- M.C Shukla and Grewal, "Advanced Accounts-II", S.Chand, New Delhi.
- Jain, S.P and Narang, K.L. "Advanced Accounts-II", Kalyani Publisher, New Delhi
- Maheshwari, S.N "Advanced Accounts-II", Vikash Publisher, New Delhi


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# CONSOLIDATED FINANCIAL STATEMENTS

| M.Com II Sem. | Advanced Accounting | Unit-III |
|---|---|---|
| M.Com – C 250 | | Lesson No. 14 |

**STRUCTURE:**

## 14.1 INTRODUCTION

Goodwill has been said to be attraction force which brings in customers. Thus, to determine the nature of goodwill in a particular case, it is necessary to consider the types of business and the type of customers which such a business is inherently likely to attract as well as surrounding circumstances of each case. Goodwill of a business is a composite thing referable in part to its locality, in part of the way in which it is conducted and the personality of those who conduct and in part to the likelihood of competition. According to Braden and Allyn, "Goodwill is an intangible asset compounded from a variety of successful business quality and profitable product, efficient production methods, an outstanding reputation, plus the expectation that these ingredients, will continue to produce an about normal rate of return fro an indefinite period of time."

## 14.2 OBJECTIVES

After going through this lesson you, should be able to understand the treatment of goodwill already appearing in the balance sheet of subsidiary company, elimination of common transactions, treatment of fictitious assets, treatment of unrealised profit, treatment of contingent liabilities, treatment of bonus issue and revaluation of assets.

## 14.3 TREATMENT OF GOODWILL ALREADY APPEARING IN THE BOOKS OF THE SUBSIDIARY COMPANY

Goodwill appearing in the Balance Sheet of the subsidiary company will be shown alongwith goodwill (if any) of the holding company. In case there is capital reserve, it will be adjusted in capital reserve on consolidation.

**Illustration 14.1**- (Simple) From the balance sheets given below prepare a Consolidated Balance Sheet of A. Ltd. and its subsidiary company B. Ltd.

## BALANCE SHEETS

*as on 31st March, 2008*

| Liabilities | A. Ltd. Rs. | B. Ltd. Rs. | Assets | A. Ltd. Rs. | B. Ltd. Rs. |
|---|---|---|---|---|---|
| Share Capital : | | | Land & Building | 6,40,000 | 2,00,000 |
| Shares of Rs. 10 each | 25,00,000 | 6,00,000 | Machinery | 12,60,000 | 3,40,000 |
| General Reserve | 3,60,000 | 1,20,000 | Furniture | 1,40,000 | 60,000 |
| Profit and Loss A/c | 2,40,000 | 1,80,000 | 40,000 shares in B. Ltd. | 5,00,000 | |
| Trade Creditors | 3,50,000 | 1,00,000 | Stock in hand | 4,10,000 | 2,50,000 |
| | | | Debtors | 3,80,000 | 1,00,000 |
| | | | Bank Balance | 1,20,000 | 50,000 |
| | 34,50,000 | 10,00,000 | | 34,50,000 | 10,00,000 |

At the date of acquisition of A Ltd. of its holding of 40,000 shares in B. Ltd., the latter company had undistributed profits and reserves amounting to Rs. 1,00,000, none of which has been distributed since then.

**SOLUTION**

### CONSOLIDATED BALANCE SHEET OF A. LTD. AND ITS SUBSIDIARY B. LTD.

*as on 31st March, 2008*

| Liabilities | Rs. | Rs. | Assets | Rs. | Rs. |
|---|---|---|---|---|---|
| Share Capital : | | | Goodwill | (3) | 33,333 |
| 2,50,000 shares of Rs. 10 each | | | Land & Building : | | |
| fully called up and paid up | | 25,00,000 | A. Ltd. | 6,40,000 | |
| Minority Interest (4) | | 3,00,000 | B. Ltd. | 2,00,000 | |
| General Reserve | | 3,60,000 | | | 8,40,000 |
| Profit and Loss Account : | | | Machinery : | | |
| Balance as per A Ltd.'s | | | A. Ltd. | 12,60,000 | |
| Balance Sheet | 2,40,000 | | B. Ltd. | 3,40,000 | |
| *Add* : Profit of | | | | | 16,00,000 |
| B. Ltd. (2) | 1,33,333 | | | | |
| | | 3,73,333 | Furniture : | | |
| Trade Creditors : | | | A. Ltd. | 1,40,000 | |
| A. Ltd. | 3,50,000 | | B. Ltd. | 60,000 | |
| B. Ltd. | 1,00,000 | | | | 2,00,000 |
| | | 4,50,000 | Stock in Hand : | | |
| | | | A. Ltd. | 4,10,000 | |
| | | | B. Ltd. | 2,50,000 | |
| | | | | | 6,60,000 |
| | | | Debtors : | | |
| | | | A. Ltd. | 3,80,000 | |
| | | | B. Ltd. | 1,00,000 | |
| | | | | | 4,80,000 |
| | | | Bank Balance : | | |
| | | | A. Ltd. | 1,20,000 | |
| | | | B. Ltd. | 50,000 | |
| | | | | | 1,70,000 |
| | | 39,83,333 | | | 39,83,333 |

**Working Notes :**

| | Rs. |
|---|---|
| (1) ***Calculation of Capital (or Pre-acquisition) Profits*** | |
| Balance of General Reserve and Profits and Loss of B. Ltd. on the date of acquisition of shares by the holding company | 1,00,000 |

| | |
|---|---|
| Holding Company's share is 2/3 because 40,000 shares out of 60,000 shares of B. Ltd. have been acquired by it $\left(i.e., \text{Rs. } 1{,}00{,}000 \times \frac{2}{3}\right)$ | 66,667 |
| Outsiders' share is 1/3 because 20,000 shares out of 60,000 shares are held by them $\left(i.e., \text{Rs. } 1{,}00{,}000 \times \frac{1}{3}\right)$ | 33,333 |
| | 1,00,000 |

(2) ***Calculation of Revenue Profit (i.e., Profits after Acquisition of Shares)***

| | *General Reserve* Rs. | *P & L A/c* Rs. | *Total* Rs. |
|---|---|---|---|
| Balance as given in B Ltd.'s B/S | 1,20,000 | 1,80,000 | 3,00,000 |
| *Less* : Reserves on the date of the acquisition *of shares treated as capital profits* | 1,00,000 | — | 1,00,000 |
| | 20,000 | 1,80,000 | 2,00,000 |
| Holding Company's Share — 2/3 | 13,333 | 1,20,000 | 1,33,333 |
| Outsiders' Share—1/3 | 6,667 | 60,000 | 66,667 |

(3) ***Calculation of Goodwill or Cost of Control***

| | Rs. | Rs. |
|---|---|---|
| Amount paid for 40,000 shares in B. Ltd. | | 5,00,000 |
| *Less* : Face value of 40,000 shares of Rs. 10 each | 4,00,000 | |
| Holding Company's share of capital profits as calculated in (1) above | 66,667 | |
| | | 4,66,667 |
| Cost of Control or Goodwill | | 33,333 |

(4) ***Calculation of Minority Interest***

| | Rs. |
|---|---|
| Face value of 20,000 shares of Rs. 10 each held by outsiders | 2,00,000 |
| *Add* : 1/3 share of capital profit as calculated in (1) above | 33,333 |
| 1/3 share of revenue profits as calculated in (2) above | 66,667 |
| | 3,00,000 |

## 14.4 ELIMINATION OF COMMON TRANSACTIONS

While preparing Consolidated Balance Sheet, common transactions appearing in both the Balance Sheets of the holding company and the subsidiary company should be eliminated. Such transactions may be:

1. Goods sold on credit by the holding company to the subsidiary company or vice versa will appear as debtors in the Balance Sheet of the company selling goods and as creditors in the Balance Sheet of the company purchasing goods.
2. Bills drawn by one company and accepted by the other company are eliminated while preparing Consolidated Balance Sheet but bills discounted and endorsed

will continue to appear as a liability because the company, which has accepted such bills, will have to make the payment to an outsider (i.e., bank) on the due date.

3 Loans advanced by the holding company to the subsidiary company or vice versa appears as an asset in the Balance Sheet of the company which gives such loans and as a liability in the Balance Sheet of the company that takes these loans.

4. Debentures issued by one company and held by the other company.

## 14.5 TREATMENT OF FICTITIOUS ASSETS

In case if any fictitious assets (i.e. preliminary expenses, discount on issue of shares and debentures, underwriting commission etc.) are given on the assets side of the Balance Sheet of the subsidiary company, then these items must be deducted from the capital profits (or added to the capital loss) before distributing the same among the holding company and minority shareholders.

## 14.6 TREATMENT OF UNREALISED PROFIT

At the time when the goods are sold at a profit by the subsidiary company to the holding company or by the holding company to the subsidiary company remain unsold at the close of the financial year, the profit charged by the company on unsold goods remains unrealised. In such a case, it is not proper to credit the Profit and Loss Account with such unrealised profit. So, a stock reserve is created and, profit is reduced by the unrealised profit. For example, H Ltd. purchased from S Ltd. goods of the value of Rs. 50,000 on which S Ltd. has charged a profit of 25% on cost and goods worth Rs. 20,000 remained unsold at the end of the financial year. Unrealised profit in this case will be Rs. 4,000 (i.e.. 125 x Rs. 20,000). While preparing a Consolidated Balance Sheet, Stock Reserve of Rs. 4,000 will be deducted from stock on the assets side and the balance of Profit and Loss Account of the holding company will be reduced by Rs. 4,000 on the liabilities side.

**Illustration 14.2**- (Inter Company Owings, Stock Reserve & Fictitious Assets). From the Balance Sheet and information given below, prepare Consolidated Balance Sheet.

Additional Information:

**BALANCE SHEET**
*as at 31st March, 2008*

| | H. Ltd. | S. Ltd. | | H. Ltd. | S. Ltd. |
|---|---|---|---|---|---|
| | Rs. | Rs. | | Rs. | Rs. |
| Share Capital : | | | Fixed Assets | 4,00,000 | 60,000 |
| Shares of Rs. 10 | | | Stock | 3,00,000 | 1,20,000 |
| each fully paid | 5,00,000 | 1,00,000 | Debtors | 75,000 | 85,000 |
| Profit & Loss | 2,00,000 | 60,000 | Bills Receivable | 20,000 | — |
| Reserves | 60,000 | 40,000 | Shares in S Ltd. | | |
| Bills Payable | — | 15,000 | 7,500 at cost | 75,000 | — |
| Creditors | 1,10,000 | 60,000 | Preliminary Expenses | — | 10,000 |
| | 8,70,000 | 2,75,000 | | 8,70,000 | 2,75,000 |

(1) The bills accepted by S. Ltd. are all in favour of H Ltd.

(2) The stock of H Ltd. includes Rs. 25,000 bought from S Ltd. at a profit to the latter of 20% of sales.

(3) All the profit of S Ltd. has been earned since the shares were acquired by H Ltd. but there 'was already the reserve of Rs. 40,000 at that date.

**SOLUTION**

**CONSOLIDATED BALANCE SHEET OF H. LTD. & ITS SUBSIDIARY S. LTD.**
*as at 31st March, 2008*

| *Liabilities* | Rs. | Rs. | *Assets* | Rs. | Rs. |
|---|---|---|---|---|---|
| Share Capital : | | | Fixed Assets : | | |
| 50,000 shares of | | | H Ltd. | 4,00,000 | |
| Rs. 10 each fully | | | S Ltd. | 60,000 | |
| paid-up | | 5,00,000 | | | 4,60,000 |
| Minority Interest (4) | | 47,500 | | | |
| Capital Reserve (3) | | 22,500 | Stock : | | |
| Reserves | | 60,000 | H Ltd. | 3,00,000 | |
| Profit and Loss Account : | | | S Ltd. | 1,20,000 | |
| H Ltd. | 2,00,000 | | | 4,20,000 | |
| S. Ltd. | | | *Less* : Stock | | |
| $\left(\frac{75}{100} \times \text{Rs. } 60{,}000\right)$ | 45,000 | | Reserve (*i.e.*, | | |
| | 2,45,000 | | Unrealised | | |
| *Less* : Unrealised Profit | | | Profit | | |
| as per contra | 5,000 | | | | |
| | | 2,40,000 | $\left(\frac{20}{100} \times \text{Rs. } 25{,}000\right)$ | | |
| Bills Payable : | | | | 5,000 | |
| S Ltd. | 15,000 | | | | 4,15,000 |

| | | | | | |
|---|---|---|---|---|---|
| *Less* : Held by H Ltd. | 15,000 | Nil | Debtors : | | |
| Creditors : | | | H Ltd. | 75,000 | |
| H Ltd. | 1,10,000 | | S Ltd. | 85,000 | |
| S Ltd. | 60,000 | | | | 1,60,000 |
| | | 1,70,000 | Bills Receivable : | | |
| | | | H Ltd. | 20,000 | |
| | | | *Less* : Mutual Owing | 15,000 | |
| | | | | | 5,000 |
| | | 10,41,000 | | | 10,41,000 |

**Working Notes :**

| | Rs. |
|---|---|
| Total shares of the subsidiary company | 10,000 |
| Shares held by the holding company | 7,500 |
| Proportion of shares held by the holding company $\left(\frac{7,500}{10,000}\right)$ | $\frac{3}{4}$ |
| Shares held by the outsiders (10,000 – 7,500) | 2,500 |
| Proportion of shares held by the outsiders $\left(\frac{2,500}{10,000}\right)$ | $\frac{1}{4}$ |

(1) ***Analysis of Capital Profit***

| | Rs. |
|---|---|
| Balance of General Reserve on the date of acquisition | 40,000 |
| *Less* : Preliminary Expenses | 10,000 |
| | 30,000 |
| *Less* : Monority Interest (1/4) | 7,500 |
| Share of Holding Company | 22,500 |

(2) ***Analysis of Revenue Profit***

| | Rs. |
|---|---|
| Profit earned after acquisition | 60,000 |
| *Less:* Minority Interest (1/4) | 15,000 |
| Share of Holding Company | 45,000 |

(3) ***Calculation of Cost of Control or Capital Reserve***

| | Rs. | Rs. |
|---|---|---|
| Amount paid for 7,500 shares in S Ltd. | | 75,000 |
| *Less* : Paid-up value of 7,500 shares for Rs. 10 each | 75,000 | |
| 3/4 share of Rs. 30,000 Reserves of S Ltd. treated as capital profit because these existed on the date of purchase of shares in S Ltd. | 22,500 | |
| | | 97,500 |
| Capital Reserve | | 22,500 |

(4) ***Calculation of Minority Interest***

| | Rs. |
|---|---|
| Paid-up value of 2,500 shares held by the outsiders | 25,000 |
| *Add* : 1/4 share of Reserves of S Ltd. (*i.e.*, Rs. 30,000 × 1/4) | 7,500 |
| 1/4 share of Profit of S Ltd. (*i.e.*, Rs. 60,000 × 1/4) | 15,000 |
| Minority Interest | 47,500 |

**ILLUSTRATION 14.3** *(Loss in Profit & Loss A/c, Inter Company Owings & Stock Reserve).* The following Balance Sheets are presented to you as on 31st March, 2008.

| *Liabilities* | *H Ltd.* | *S Ltd.* | *Assets* | *H Ltd.* | *S Ltd.* |
|---|---|---|---|---|---|
| | Rs. | Rs. | | Rs. | Rs. |
| Share Capital : | | | Fixed Assets | 3,03,000 | 2,00,000 |
| Shares of Rs. 100 each | 5,00,000 | 2,00,000 | Stock | 90,000 | 40,000 |
| General Reserve | 1,00,000 | — | Debtors | 60,000 | 30,000 |
| Profit & Loss A/c | 80,000 | | 6% Debentures in | | |
| 6% Debentures | — | 1,00,000 | S Ltd. at par | 60,000 | — |
| Trade Creditors | 75,000 | 45,000 | Shares in S Ltd. | | |
| Loan from H Ltd. | | 50,000 | 1500 @ Rs. 80 | | |
| | | | purchased | 1,20,000 | — |
| | | | Bank | 75,000 | 25,000 |
| | | | Profit & Loss A/c | — | 1,00,000 |
| | | | Loan to S Ltd. | 47,000 | |
| | 7,55,000 | 3,95,000 | | 7,55,000 | 3,95,000 |

## SOLUTION

**Working Notes :**

| | | |
|---|---|---|
| Total shares of S Ltd. (Rs. 2,00,000 ÷ Rs. 100) | | 2,000 |
| Shares of S Ltd. held by H Ltd. | | 1,500 |

Therefore, $\frac{3}{4}\left(i.e.\ \frac{1,500}{2,000}\right)$ shares of S Ltd. are held by H Ltd. and $\frac{1}{4}\left(i.e.\ \frac{500}{2,000}\right)$ shares are held by minority interest.

**(1) *Calculation of Capital (i.e. Pre-acquisition) Loss***

| | | Rs. |
|---|---|---|
| Debit balance in Profit & Loss A/c on 1-4-2007 | | 1,50,000 |
| *Less* : Capital Profit (*i.e.* Pre-acquisition Profit) : | Rs. | |
| Accumulated Loss on 1-4-2007 | 1,50,000 | |
| *Less* : Accumulated Balance of Loss on 31-3-2008 | 1,00,000 | |
| Profit made during the year ending 31-3-2008 | 50,000 | |
| *Add* : Loss of stock by fire in June 2007 (Rs. 6,000 – Rs. 2,000) | 4,000 | |
| Adjusted Profit in 2007-08 | 54,000 | |
| Profit for pre-acquisition period of 1-4-2007 to 30-7-2007 | | |
| (4 months) Rs. 54,000 $\times \frac{4}{12}$ | 18,000 | |
| *Less* : Loss of stock by fire in June, 2007 (pre-acquisition period) | 4,000 | |
| | | 14,000 |
| Capital Loss | | 1,36,000 |
| Share of H Ltd. in Capital Loss $\left(\text{Rs. } 1,36,000 \times \frac{3}{4}\right)$ | | 1,02,000 |
| Share of Minority Interest in Capital Loss $\left(\text{Rs. } 1,36,000 \times \frac{1}{4}\right)$ | | 34,000 |

**(2) *Calculation of Revenue Profit (i.e., Post-acquisition Profit)***

| | Rs. |
|---|---|
| Total adjusted profit in 2007-08 | 54,000 |

| | | |
|---|---|---|
| ∴ Revenue profit for 8 months from 1-8-2007 to 31-3-2008 | | |
| (*i.e.* Post-acquisition Period) Rs. 54,000 $\times \frac{8}{12}$ | | 36,000 |
| Share of Revenue Profit of H Ltd. $\left(\text{Rs. } 36{,}000 \times \frac{3}{4}\right)$ | | 27,000 |
| Share of Revenue Profit of Minority Interest $\left(\text{Rs. } 36{,}000 \times \frac{1}{4}\right)$ | | 9,000 |

(3) ***Calculation of Cost of Acquiring Control or Goodwill***

| | | Rs. |
|---|---|---|
| Cost of acquiring shares in S Ltd. | | 1,20,000 |
| *Less* : Face value of 1,500 Shares of Rs. 100 each held | Rs. 1,50,000 | |
| *Less* : Share in Capital Loss | Rs. 1,02,000 | |
| | | 48,000 |
| Goodwill | | 72,000 |

(4) ***Calculation of Minority Interest***

| | | Rs. |
|---|---|---|
| Paid up value of 500 shares of Rs. 100 each held | | 50,000 |
| *Less* : Share of Capital Loss | Rs. 34,000 | |
| *Less* : Share of Revenue Profit | Rs. 9,000 | |
| | | 25,000 |
| Minority Interest | | 25,000 |

(5) ***Profit & Loss A/c of H Ltd.***

| | Rs. |
|---|---|
| H Ltd.'s Profit | 80,000 |
| Share of Revenue Profit in S Ltd. | 27,000 |
| Interest on Loan | 3,000 |
| | 1,10,000 |
| *Less* : Unrealised Profit | 1,000 |
| | 1,09,000 |

**CONSOLIDATED BALANCE SHEET OF H LTD. AND ITS SUBSIDIARY S LTD.**

*as at 31st March, 2008*

| *Liabilities* | | Rs. | *Assets* | Rs. | Rs. |
|---|---|---|---|---|---|
| *Share Capital :* | Rs. | | *Fixed Assets :* | | |
| 5,000 shares of Rs. 100 each | | 5,00,000 | Goodwill | (3) | 72,000 |
| Minority Interest | (4) | 25,000 | Others : H Ltd. | 3,03,000 | |
| *Reserves & Surplus :* | | | S Ltd. | 2,00,000 | |
| General Reserve | | 1,00,000 | | | 5,03,000 |
| Profit & Loss Account | (5) | 1,09,000 | *Current Assets :* | | |
| *Secured Loans :* | | | Stock : H Ltd. | 90,000 | |
| 6% Debentures | 1,00,000 | | S Ltd. | 40,000 | |
| *Less* : Held by H Ltd. | 60,000 | | *Less* : Unrealised | 1,30,000 | |
| | | 40,000 | Profit $\left(\frac{1}{2} \times \text{Rs. } 2{,}000\right)$ | 1,000 | |
| Creditors : H Ltd. | 75,000 | | | | |
| S Ltd. | 45,000 | | | | |
| | 1,20,000 | | | | 1,29,000 |
| *Less* : Mutual Owing | 20,000 | | Debtors : H Ltd. | 60,000 | |
| | | 1,00,000 | S Ltd. | 30,000 | |
| | | | | 90,000 | |

| | | | | |
|---|---|---|---|---|
| | | *Less* : Mutual Owing | 20,000 | |
| | | | | 70,000 |
| | | Bank : H Ltd. | 75,000 | |
| | | S Ltd. | 25,000 | |
| | | | | 1,00,000 |
| | 8,74,000 | | | 8,74,000 |

## 14.7 TREATMENT OF CONTINGENT LIABILITIES

Contingent liability is that liability which may or may not arise. Its payment depends on the occurrence of a future event which is not certain. Such a liability is shown by way of a footnote in the Balance Sheet. Examples of such liabilities can be

(1) Liability in respect of bills discounted not yet matured. It is possible that bills may be dishonoured on the due date and liability may arise.

(2) Amount uncalled on partly paid shares held.

(3) Arrears of dividend on cumulative preference shares.

(4) Claims against the company not acknowledged debt as yet.

While preparing a Consolidated Balance Sheet, the treatment of contingent liability depends on whether it is towards outsiders or it is internal between holding and subsidiary companies. The external contingent liability is shown by way of footnote in the Consolidated Balance Sheet and internal contingent liability is eliminated treating it as mutual owing and is not shown in the Consolidated Balance Sheet as a footnote.

## 14.8 REVALUATION OF ASSETS

If assets and liabilities of the subsidiary company are revalued at the time of acquisition of shares in the subsidiary company, profit or loss on account of such revaluation is treated as capital profit or capital loss and is divided among minority shareholders and holding company according to the proportions of the equity shares held by them. Holding company's share of such capital profit is transferred to capital reserve or deducted from cost of controlor goodwill and vice versa if there is loss on revaluation. Share of profit of minority shareholders is added to the minority interest and a deduction is made from the minority interest if there is a loss on revaluation. As the asset value increases or decrease because of revaluation at the time of acquisition, adjustment of depreciation must be made in the revenue profits of the subsidiary company. For appreciation on the value of assets depreciation charge could be increased proportionately and would be deducted from the revenue profits of subsidiary company. But if there is decrease in the value of asset, depreciation would be decreased proportionately and added to the revenue profits of the subsidiary company.

**Illustration 14.4 -** (Revaluation of Assets). The Balance Sheets of H Ltd. and S Ltd. on 31st March, 2008 were as follows

| *Liabilities* | *H. Ltd.* Rs. | *S. Ltd.* Rs. | *Assets* | *H. Ltd.* Rs. | *S. Ltd.* Rs. |
|---|---|---|---|---|---|
| Share Capital : | | | Land & Building | | |
| 10% Preference | | | at Cost | 3,10,000 | 1,60,000 |
| Shares of Rs. 100 each | — | 1,00,000 | Machinery less | | |
| Equity Shares of | | | 10% Depreciation | 2,70,000 | 1,35,000 |
| Rs. 100 each | 10,00,000 | 4,00,000 | 3,000 Shares in | | |
| General Reserve | 1,00,000 | 50,000 | S Ltd. | 4,50,000 | — |
| Profit & Loss A/c | | | Stock at cost | 2,20,000 | 1,50,000 |
| Balance on 1-4-2007 | 40,000 | 30,000 | Sundry Debtors | 1,55,000 | 90,000 |
| Profit for 2007-08 | 2,00,000 | 80,000 | Cash & Bank Balance | 85,000 | 1,95,000 |
| Creditors | 1,50,000 | 70,000 | | | |
| | 14,90,000 | 7,30,000 | | 14,90,000 | 7,30,000 |

H Ltd. acquired 3,000 Equity Shares in S Ltd. on 1st October 2007. As on the date of acquisition, H Ltd. found that the value of land and buildings and machinery of S Ltd. should be Rs. 1,50,000 and Rs. 1,92,500 respectively.

Prepare the Consolidated Balance Sheet of H Ltd. and its subsidiary S Ltd. as on 31st March, 2008 taking into consideration the fact that assets are to be taken at their proper values.

**CONSOLIDATED BALANCE SHEET OF H. LTD. & ITS SUBSIDIARY S LTD.**

*as on 31st March, 2008*

| *Liabilities* | Rs. | Rs. | *Assets* | | Rs. | Rs. |
|---|---|---|---|---|---|---|
| Share Capital : | | | Goodwill (3) | | | 33,750 |
| 10,000 shares of Rs. 100 | | | Land & Buildings at cost : | | | |
| each fully paid | | 10,00,000 | H Ltd. | | 3,10,000 | |
| Minority Interest | (4) | 2,56,875 | S Ltd. | | 1,50,000 | |
| General Reserve | | 1,00,000 | | | | 4,60,000 |
| Profit & Loss Account : | | | Machinery : | | | |
| Balance as per H Ltd.'s | | | H Ltd. | | 3,00,000 | |
| Balance Sheet | 2,40,000 | | *Less* : Depreciation | | 30,000 | |
| *Add* : Profit of | | | | Rs. | 2,70,000 | |
| S Ltd. (2) | 24,375 | | S Ltd. | 2,00,000 | | |
| | | 2,64,375 | (Rs. 1,50,000 + Rs. 50,000) | | | |
| Creditors : | | | *Less* : Depreciation | 17,500 | | |
| H Ltd. | 1,50,000 | | | | 1,82,500 | |
| S Ltd. | 70,000 | | | | | 4,52,500 |
| | | 2,20,000 | Stock at cost : | | | |
| | | | H Ltd. | | 2,20,000 | |
| | | | S Ltd. | | 1,50,000 | |
| | | | | | | 3,70,000 |
| | | | Sundry Debtors : | | | |
| | | | H Ltd. | | 1,55,000 | |
| | | | S Ltd. | | 90,000 | |
| | | | | | | 2,45,000 |
| | | | Cash and Bank Balance : | | | |
| | | | H Ltd. | | 85,000 | |
| | | | S Ltd. | | 1,95,000 | |
| | | | | | | 2,80,000 |
| | | 18,41,250 | | | | 18,41,250 |

**Working Notes :**

(1) ***Calculation of Capital Profits :***

| | Rs. | Rs. |
|---|---|---|
| General Reserve | | 50,000 |
| Profit & Loss Account Balance on 1-4-2007 | | 30,000 |
| Profits up to 30th September, 2007 : | | |
| Profit for the year ending 31-3-2008 | 80,000 | |
| *Less* : Preference Dividend $\left(\frac{10}{100} \times \text{Rs. } 1,00,000\right)$ | 10,000 | |
| | 70,000 | |
| Half of Rs. 70,000 | | 35,000 |
| *Add* : Increase in the value of machinery : | | |
| Book value on 31-3-2008 after 10% depreciation | 1,35,000 | |
| Book value on 1-4-2007 | | |
| $\left(\text{Rs. } 1,35,000 \times \frac{100}{90}\right)$ | 1,50,000 | |

| | | |
|---|---|---|
| *Less* : 10% depreciation for $\frac{1}{2}$ year | 7,500 | |
| | 1,42,500 | |
| Increased value | 1,92,500 | |
| | | 50,000 |
| | | 1,65,000 |
| *Less* : Reduction in the value of land and buildings (Rs. 1,60,000 – Rs. 1,50,000) | | 10,000 |
| Capital Profits | | 1,55,000 |
| *Less* : Holding Company's Share (3/4) | | 1,16,250 |
| Outsiders' Interest | | 38,750 |

(2) ***Calculation of Revenue Profits***

| | | |
|---|---|---|
| | | Rs. |
| Profits (after deduction of preference dividend) after 30th September, 2007 | | 35,000 |
| *Less* : Depreciation @ 10% for 6 months from October 1, 2007 to March 31, 2008 on the increase in the value of machinery $\left(\text{Rs. } 50{,}000 \times \frac{10}{100} \times \frac{1}{2}\right)$ | | 2,500 |
| Revenue Profits | | 32,500 |
| *Less* : Holding Company's Share (3/4) | | 24,375 |
| Outsiders' Interest | | 8,125 |

(3) ***Calculation of Goodwill or Cost of Control***

| | | |
|---|---|---|
| | | Rs. |
| Amount paid for shares acquired in S Ltd. | | 4,50,000 |
| *Less* : Face Value of 3,000 shares of Rs. 100 each | Rs. 3,00,000 | |
| Capital Profits | 1,16,250 | |
| | | 4,16,250 |
| Goodwill | | 33,750 |

(4) ***Calculation of Minority Interest***

| | | |
|---|---|---|
| | | Rs. |
| 10% Preference Share Capital | | 1,00,000 |
| *Add* : 10% Dividend for the year | | 10,000 |
| | | 1,10,000 |
| *Add* : | | |
| Equity Shareholders : | Rs. | |
| 1,000 Shares of Rs. 100 each | 1,00,000 | |
| Share of Capital Profits | 38,750 | |
| Share of Revenue Profits | 8,125 | |
| | | 1,46,875 |
| Total Minority Interest | | 2,56,875 |

## 14.9 TREATMENT OF BONUS SHARES

Treatment of issue of bonus shares by the subsidiary company will depend upon the, source - from which bonus shares are issued. Bonus shares may be issued out of pre-acquisition profits or reserves or post-acquisition profits or reserves of the subsidiary company.

(a) Treatment of Issue of Bonus Shares out of Pre-acquisition Profits. Issue of bonus shares out of pre-acquisition profits or reserves will have no effect on the Consolidated Balance Sheet. It is so because holding company's share in pre-acquisition profits is reduced on account of issue of bonus shares and on the other hand paid-up value of shares held by holding company increases. Therefore, cost of control or goodwill will remain the same as it was before the issue of bonus shares.

**Illustration 14.5 -** (Bonus shares from preacquisition profits and revaluation of assets). A Ltd. acquired 8,000 shares of Rs. 100 each in B Ltd. on 30th September 2007. The summarised Balance Sheets of the two companies as on 31st March, 2008 were as follows:

| | A Ltd. Rs. | B Ltd. Rs. | | A Ltd. Rs. | B Ltd. Rs. |
|---|---|---|---|---|---|
| Share Capital : | | | Fixed Assets | 15,00,000 | 14,47,000 |
| 30,000 Shares of | | | Investment in B Ltd. | | |
| Rs. 100 each | 30,00,000 | | at cost | 17,00,000 | — |
| 10,000 Shares of | | | Stock in hand | 4,00,000 | 2,00,000 |
| Rs. 100 each | | 10,00,000 | Loan to A Ltd. | — | 20,000 |
| Capital Reserve | — | 5,50,000 | Bills Receivable | | |
| General Reserve | 3,00,000 | 50,000 | (including Rs. 5,000 | | |
| Profit and Loss Account | 3,82,000 | 1,80,000 | from B Ltd.) | 12,000 | — |
| Loan from B Ltd. | 21,000 | — | Debtors | 2,50,000 | 1,80,000 |
| Bills Payable (including | | | Cash and Bank | | |
| Rs. 5,000 to A Ltd.) | — | 17,000 | Balance | 20,000 | 20,000 |
| Creditors | 1,79,000 | 70,000 | | | |
| Note : On the Balance Sheet of A Ltd. : There is a contingent liability for bills discounted of Rs. 6,000. | | | | | |
| | 38,82,000 | 18,67,000 | | 38,82,000 | 18,67,000 |

You are given the following information

1. B Ltd. made a bonus issue on 31st March, 2008 of one share for every two shares held, reducing the Capital Reserve equivalently but the accounting effect to this has not been given in the above Balance Sheet.

2. Interest receivable for the yaar (Re. 1,000) in respect of the loan due by A Ltd. to B Ltd. has not been credited in the books of B Ltd.

3. The credit balance in Profit and Loss Account of B Ltd. as on 1-4-2007 was Rs 21,000.

4. The directors decided on the date of the acquisitionthat the fixed assets of B Ltd. were over valued and should be written down by Rs. 50,000. Consequentiai adjustments on depreciation is to be ignored. Prepare the Consolidated Balance Sheet as at 31st March, 2008 showing your working.

## SOLUTION

**CONSOLIDATED BALANCE SHEET OF A LTD. AND ITS SUBSIDIARY B LTD.**

*as on 31st March, 2008*

| *Liabilities* | Rs. | Rs. | *Assets* | Rs. | Rs. |
|---|---|---|---|---|---|
| *Share Capital* | | | *Fixed Assets* | | |
| 30,000 shares of Rs. 100 each | | | Goodwill (3) | | 3,79,200 |
| fully paid up | | 30,00,000 | Fixed Assets : | | |
| Minority Interest (4) | | 3,46,200 | A Ltd. | 15,00,000 | |
| *Reserves & Surplus* | | | B Ltd. | 13,97,000 | |
| General Reserve | | 3,00,000 | | | 28,97,000 |
| Profit & Loss A/c | 3,82,000 | | *Current Assets* | | |
| *Add* : Share of Revenue | | | Stock in hand : | | |
| Profit in B Ltd. | | | A Ltd. | 4,00,000 | |
| | | | B Ltd. | 2,00,000 | |
| $\left(\text{Rs. } 80,000 \times \frac{4}{5}\right)$ | 64,000 | | | | 6,00,000 |
| | | 4,46,000 | Debtors : | | |
| *Current Liabilities* | | | A Ltd. | 2,50,000 | |
| Bills Payable | 17,000 | | B Ltd. | 1,80,000 | |
| *Less* : Mutual Owing | 5,000 | | | | 4,30,000 |
| | | 12,000 | Cash & Bank Balance : | | |
| Creditors : | | | A Ltd. | 20,000 | |
| A Ltd. | 1,79,000 | | B Ltd. | 20,000 | |
| B Ltd. | 70,000 | | | | 40,000 |
| | | 2,49,000 | *Loans & Advances* : | | |
| | | | Bills Receivable | 12,000 | |
| Contingent Liability for | | | *Less* : Mutual Debt | 5,000 | |
| Bills Discounted | Rs. 6,000 | | | | 7,000 |
| | | 43,53,200 | | | 43,53,200 |

Working Notes:

(1) After taking into consideration interest receivable on loan to A Ltd. Rs. 1,000, Profit and Loss balance of B Ltd. is Rs. 1,81,000 (i.e. Rs. 1,80,000 as reported + Rs. 1,000) and Loan to A Ltd. becomes Rs. 21,000 (i.e. Rs. 20,000 as given + Re. 1,000 interest receivable).

(2) Analysis of Reserve and Profit of B Ltd.

| | *Capital Profit* Rs. | *Revenue Profit* Rs. |
|---|---|---|
| Capital Reserve of B Ltd. | 5,50,000 | |
| *Less* : Utilised for bonus shares (Issue of 5,000 bonus shares of Rs. 100 each @ 1 bonus share for every 2 shares) | 5,00,000 | |
| | 50,000 | |
| *Add* : General Reserve | 50,000 | |
| | 1,00,000 | |
| Profit & Loss A/c : | | |
| Balance as on 1-4-2007 | 21,000 | |
| Profit during the year (Rs. 1,81,000 – Rs. 21,000) (Rs. 1,60,000 divided equally between pre-acquisition period and post acquisition period because pre-acquisition period 1-4-2007 to 30-9-2007 and post-acquisition period 1-10-2007 to 31-3-2008 are of equal duration) | 80,000 | 80,000 |
| | 2,01,000 | 80,000 |
| *Less* : Loss on fixed assets | 50,000 | |
| | 1,51,000 | |

(3) ***Calculation of Goodwill/Capital Reserve***

| | Rs. | Rs. |
|---|---|---|
| Cost of acquiring 8,000 shares of B Ltd. | | 17,00,000 |
| *Less* : Face value of 8,000 shares of Rs. 100 each | 8,00,000 | |
| Face value of 4,000 bonus shares of Rs. 100 each | 4,00,000 | |
| Share of Capital profit $\left(\frac{4}{5} \times \text{Rs. } 1,51,000\right)$ | 1,20,800 | |
| | | 13,20,800 |
| Goodwill | | 3,79,200 |

(4) ***Calculation of Minority Interest***

| | Rs. |
|---|---|
| Face value of 2,000 shares of Rs. 100 each | 2,00,000 |
| *Add* : Face value of 1,000 bonus shares of Rs. 100 each | 1,00,000 |
| 1/5 Share of capital profit $\left(\frac{1}{5} \times \text{Rs. } 1,51,000\right)$ | 30,200 |
| 1/5 Share of revenue profit $\left(\frac{1}{5} \times \text{Rs. } 80,000\right)$ | 16,000 |
| | 3,46,200 |

Treatment of Bonus Shares out of Post-acquisition Profits. Issue of bonus shares out of the post-acquisition profits will have effect on the Consolidated Balance Sheet in that share of the holding cor pany of revenue profit earned after the date of purchase of shares will be reduced and paid-up v ue of shares held by the holding company will increase because of issue of bonus shares. Increased paid-up value of shares held will reduce the cost of control or increase the capital profits as is clear from the following illustration.

**Illustration 14.6 -** (Bonus shares from post acquisition profits). H Ltd. acquired 20,000, (i.e., 4/5) equity shares of S Ltd. of Re. 100 each on 31st March, 2007. The summarised Balance Sheets of H Ltd. and S. Ltd. as 31st March, 2008 were as follows:

**BALANCE SHEETS**

| *Liabilities* | *H. Ltd.* | *S. Ltd.* | *Assets* | *H. Ltd.* | *S. Ltd.* |
|---|---|---|---|---|---|
| | Rs. | Rs. | | Rs. | Rs. |
| Share Capital in shares of Rs. 100 each | 80,00,000 | 25,00,000 | Fixed Assets | 70,00,000 | 25,00,000 |
| | | | Current Assets | 40,00,000 | 20,00,000 |
| Reserves | 30,00,000 | 5,00,000 | 20,000 shares in S Ltd. | 30,00,000 | — |
| Profit & Loss A/c | 10,00,000 | 10,00,000 | | | |
| Creditors | 20,00,000 | 5,00,000 | | | |
| | 1,40,00,000 | 45,00,000 | | 1,40,00,000 | 45,00,000 |

S Ltd. had the credit balance of Rs. 5,00,000 in the reserves and Rs. 2,00,000 in the Profit and Loss Account when H Ltd. acquired the shares in S Ltd. S Ltd. issued bonus shares @ 1 for every 5 shares held out of post-acquisition profits. This is not shown in the above balance sheet. Prepare Consolidated Balance Sheet.

**SO!!JTION**

**Working Notes :**

(1) ***Analysis of Capital Profit***

| | | Rs. |
|---|---|---|
| | Reserve Balance | 5,00,000 |
| | P/L A/c Balance | 2,00,000 |
| | | 7,00,000 |
| *Less* : | Minority Interest (1/5 share) | 1,40,000 |
| | Holding Company's Share | 5,60,000 |

(2) ***Analysis of Revenue Profit***

| | | Rs. |
|---|---|---|
| | Profit earned after purchase of shares by S. Ltd. (Rs. 10,00,000 – Rs. 2,00,000) | 8,00,000 |
| | *Less* : Profit utilised for issue of bonus shares $\left(\text{Rs. } 25{,}00{,}000 \times \frac{1}{5}\right)$ | 5,00,000 |
| | | 3,00,000 |
| *Less* : | Minority Interest (1/5) | 60,000 |
| | Holding Company's Share | 2,40,000 |

(3) ***Cost of Control after Issue of Bonus Shares***

| | Rs. | Rs. |
|---|---|---|
| Cost of acquiring 20,000 shares | | 30,00,000 |
| *Less* : Paid-up value of shares held : | | |
| Value of 20,000 shares of Rs. 100 each | | |

**BALANCE SHEETS**

| Liabilities | H. Ltd. | S. Ltd. | Assets | H. Ltd. | S. Ltd. |
|---|---|---|---|---|---|
| | Rs. | Rs. | | Rs. | Rs. |
| Share Capital in shares of Rs. 100 each | 80,00,000 | 25,00,000 | Fixed Assets | 70,00,000 | 25,00,000 |
| Reserves | 30,00,000 | 5,00,000 | Current Assets | 40,00,000 | 20,00,000 |
| Profit & Loss A/c | 10,00,000 | 10,00,000 | 20,000 shares in S Ltd. | 30,00,000 | — |
| Creditors | 20,00,000 | 5,00,000 | | | |
| | 1,40,00,000 | 45,00,000 | | 1,40,00,000 | 45,00,000 |

S Ltd. had the credit balance of Rs. 5,00,000 in the reserves and Rs. 2,00,000 in the Profit and Loss Account when H Ltd. acquired the shares in S Ltd. S Ltd. issued bonus shares @ 1 for every 5 shares held out of post-acquisition profits. This is not shown in the above balance sheet. Prepare Consolidated Balance Sheet.

**SOLUTION**

**Working Notes :**

(1) ***Analysis of Capital Profit***

| | | Rs. |
|---|---|---|
| Reserve Balance | | 5,00,000 |
| P/L A/c Balance | | 2,00,000 |
| | | 7,00,000 |
| *Less* : Minority Interest (1/5 share) | | 1,40,000 |
| Holding Company's Share | | 5,60,000 |

(2) ***Analysis of Revenue Profit***

| | | Rs. |
|---|---|---|
| Profit earned after purchase of shares by S. Ltd. (Rs. 10,00,000 – Rs. 2,00,000) | | 8,00,000 |
| *Less* : Profit utilised for issue of bonus shares $\left(\text{Rs. } 25{,}00{,}000 \times \frac{1}{5}\right)$ | | 5,00,000 |
| | | 3,00,000 |
| *Less* : Minority Interest (1/5) | | 60,000 |
| Holding Company's Share | | 2,40,000 |

(3) ***Cost of Control after Issue of Bonus Shares***

| | Rs. | Rs. |
|---|---|---|
| Cost of acquiring 20,000 shares | | 30,00,000 |
| *Less* : Paid-up value of shares held : | | |
| Value of 20,000 shares of Rs. 100 each | | |

## 14.10 SUMMARY

Goodwill appearing in the Balance Sheet of the subsidiary company will be shown alongwith goodwill (if any) of the holding company. In case there is capital reserve, it will be adjusted in capital reserve on consolidation. While preparing Consolidated Balance Sheet, common transactions appearing in both the Balance Sheets of the holding company and the subsidiary company should be eliminated. Such transactions may be:

1. Goods sold on credit by the holding company to the subsidiary company or vice versa will appear as debtors in the Balance Sheet of the company selling goods and as creditors in the Balance Sheet of the company purchasing goods.

2. Bills drawn by one company and accepted by the other company are eliminated while preparing Consolidated Balance Sheet but bills discounted and endorsed will continue to appear as a liability because the company, which has accepted such bills, will have to make the payment to an outsider (i.e., bank) on the due date.

3 Loans advanced by the holding company to the subsidiary company or vice versa appears as an asset in the Balance Sheet of the company which gives such loans and as a liability in the Balance Sheet of the company that takes these loans.

4. Debentures issued by one company and held by the other company.

In case if any fictitious assets (i.e. preliminary expenses, discount on issue of shares and debentures, underwriting commission etc.) are given on the assets side of the Balance Sheet of the subsidiary company, then these items must be deducted from the capital profits (or added to the capital loss) before distributing the same among the holding company and minority shareholders.

## 14.11 GLOSSARY

- **Goodwill-** Intangible assets
- **Fictitious Assets-** preliminary expenses, discount on issue of shares and debentures, underwriting of commission etc.
- **Bonus Issue-** Shares issued by the company to its existing employees for the purpose of raising capital of the company.
- **Contingent Liabilities-** these are the liabilities which are not included in the balance sheet total but are shown as a footnote.

## 14.12 SELF ASSESSMENT QUESTIONS

Q.1 How fictitious assets are treated in the consolidated balance sheet?

______________________________________________

______________________________________________

______________________________________________

Q.2 What do you mean by revaluation of assets?

## 14.13 LESSON END EXERCISE

Q.1 Discuss the treatment of goodwill already appearing in the consolidated balance sheet with suitable examples.

Q.2 Discuss the treatment of contingent liabilities and bonus share in the consolidated balance sheet with suitable examples.

## 14.14 SUGGESTED READINGS


- Damodaran, Aswath, “Corporate Finance”, john Willey and Sons, New York, 2nd edition, 2005.
- R.P. Rustogi, “Financial Analysis and Financial Management, Sultan Chand and Sons.
- R.K. Sharma, Shashi K Gupta, “Management Accounting”, Kalyani Publishers.
- M.C Shukla and Grewal, “Advanced Accounts-II”, S.Chand, New Delhi.
- Jain,S.P and Narang, K.L. “Advanced Accounts-II”, Kalyani Publisher, New Delhi
- Maheshwari,S.N “Advanced Accounts-II”, Vikash Publisher, New Delhi


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# CONSOLIDATED FINANCIAL STATEMENTS

| M.Com II Sem. | Advanced Accounting | Unit-III |
|---|---|---|
| M.Com – C 250 | | Lesson No. 15 |

**STRUCTURE:**



## 15.1 INTRODUCTION

One of the popular firms of business combination is by means of holding company or Parent Company. A holding company is one which directly or indirectly acquires either all or more than half the number of Equity shares in one or more companies so as to secure a controlling interest in such companies, which are then known as subsidiary companies. Holding companies are able to nominate the majority of the directors of subsidiary company and therefore control such companies. Holding company meet directly from such subsidiary company or it may acquired majority or shares in existing company. Such company also considered as subsidiary company in which holding company acquired majority shares. A subsidiary company, subsidiary, or sister company is a company that is completely or partly owned and partly or wholly controlled by another company that owns more than half of the subsidiary's stock. The subsidiary can be a company, corporation, or limited liability company. In some cases it is a government or state-owned enterprise. The controlling entity is called its parent company, parent, or holding company. An operating subsidiary is a business term constantly used within the United States railroad industry. In the case of a railroad, it refers to a company that is a subsidiary but operates with its own identity, locomotives and rolling stock. In contrast, a non-operating subsidiary would exist on paper only (i.e. stocks, bonds, articles of incorporation) and would use the identity and rolling stock of the parent company.

## 15.2 OBJECTIVES

After going through this lesson, you should be able

- to know about the holding company having number of subsidiaries
- to understand the concept of cross holding
- to learn about how, shares are purchased and sold in different dates.

## 15.3 HOLDING COMPANIES HAVING MORE THAN ONE SUBSIDIARY

So far we have assumed that a holding company has only one subsidiary but that is not the case because a holding company may have a number of subsidiaries. Preparation of the consolidated Balance Sheet of such a holding company presents no difficulty if there is no mutual holdings in between the subsidiaries. Capital profit, revenue profit, goodwill or cost of control, minority interest etc. will be calculated separately for each subsidiary as we have done in case of one subsidiary, and then the total of all these heads for all subsidiaries is taken up under each head. Other items such as unrealised profit on closing stock, mutual owings, dividend, bonus shares, profit or loss on revaluation of assets and liabilities of subsidiaries will be treated exactly in the same way as we have done in case of one subsidiary company. If the subsidiaries nave mutual holdings in between them (i.e., one subsidiary has acquired the shares of another subsidiary), capital profit, revenue profit, dividend, bonus shares etc. of the group should be adjusted keeping in view the total shares acquired by the holding company and the subsidiaries and only then .the share of minority shareholders is taken up in each company. E.g. Facebook has got more than one subsidiary e.g. Instagram, Whatsapp etc.

## 15.4 CROSS HOLDING

A situation in which a publicly-traded corporation owns stock in another publicly-traded company. So, technically, listed corporations own securities issued by other listed corporations. Cross holding can lead to double counting, whereby the equity of each company is counted twice when determining value. When double counting occurs, the security's value is counted twice, which can result in estimating the wrong value of the two companies.

Companies that have cross holdings are susceptible to confusion and management holdout in cases of company mergers and acquisitions, because one company might refuse consent to the other, and vice versa. Also, if Company A holds stocks or bonds in Company B, the value of this security might be counted twice, in error, because these securities would be counted when determining the value of the company issuing the security, and again when looking over the securities held by the other company.

A cross holding is a security issue by a publicly listed company that is held by another company on the same listing. If the cross holding is not accounted for when determining the values of companies on the exchange, the result can be a double counting of the security's value, which would obscure the true value of the companies involved. It is also important to consider the role of cross holdings in situations like corporate takeovers and ousters of management. A company that holds shares in another can vote just like any other shareholder. In the most simple example of a cross holding, Company X can hold stocks or bonds issued by Company Y. Company Y's value would be counted twice if the cross holding was not accounted for. It would be counted once when looking at the value of securities issued by the company, and again when considering the securities held by Company X. This would lead to having skewed information about the values of companies on the index. It is also possible for companies to hold shares in each other and to hold securities issued by multiple companies. A tangled web of cross holdings can be created on a securities index by companies making diverse investments in order to maximize the potential for returns. The more cross holdings there are, the more challenging it becomes to value companies accurately.

One corporation owning shares in another corporation. Cross-holdings are important when it comes down to accounting because without taking cross-holdings into consideration would mean double-counting. For example, if Corporation X and Corporation Y are both listed on the same index, Corporation X's cross-holdings in Corporation Y need to be accounted for in order to avoid Corporation Y's value from being double-counted.

## 15.5 PURCHASE AND SALE OF SHARES IN SUBSIDIARY COMPANY

A holding company may purchase shares of the subsidiary company in installments. In such circumstances division of profit between pre and post acquisition will depend upon the lots in which shares are purchased. However, if small purchases are made over the period of time then date of purchase of shares which results in acquiring in controlling interest may be taken as cut of line for division of profits between capital and Revenue.

When a holding company disposed off a part of its holding in the subsidiary company the relationship of holding and subsidiary company continues, as it holds majority of shares of subsidiary. Sale of shares by holding company may be treated as follows.

a) Profit or loss on sale of shares should be ascertained and it should be adjusted while ascertaining goodwill or capital reserve. In brief, such loss or gain on sale of share should be considered in cost of control.

b) The minority interest and cost of control should be ascertained on the basis of number of shares held by the holding company and the minority on the date of consolidated balance sheet.

## 15.6 PREPARATION OF CONSOLIDATED BALANCE SHEET AND PROFIT & LOSS ACCOUNT

A holding company is required to present to its shareholders consolidated balance sheet of holding company and its subsidiaries. Consolidated balance sheet is nothing but addicting of up or combining the balance sheet of holding and its subsidiary together. However assets and liabilities are straight forward, i.e. added line to line and combination of share capital, reserves, and accumulated losses are not directly added in consolidated balance sheet.

### PREPARATION OF CONSOLIDATED BALANCE SHEET.

The following points need special attention while preparing consolidated balance sheet.

1) Share of holding company and share of minority (outside shareholders).
2) Date of Balance sheet of holding company and that of various subsidiary companies must be same. If they are not so necessary adjustment must be made before consolidation.
3) Date of Acquisition of control in subsidiary companies.
4) Inter company owing.
5) Revaluation of fixed assets as on date of acquisition, depreciation, adjustment on revaluation amount etc. which are discussed here in after.

- **Consolidated Statement of Profit and loss**

Consolidated Balance Sheet is prepared to show the financial position of tbe group. Similarly, Consolidated Statement of Profit and Loss is prepared to show the profit of the group so that shareholders may he able to know the profits of the company in which they have made the investment. Apart from the usual items of income, losses and expenses which will be shown in the Statement of Profit and Loss of the holding and the subsidiary companies are am”rregated while preparing Consolidated Statement of Profit and Loss, some adjustments are made so that Consolidated Stat.ement of Profit and Loss may show the earnings of the group. Some of the important adjustments are as follows:

(a) Transfer of goods within the group should he eliminated; so Consolidated Statement of Profit and Loss eliminates purchases and sales within the group. Thus, if the subsidiary company bought goods worth ₹ 5,00,000 from the holding company ₹ 5,00,000 will be deducted from the purchases of the subsidiary company and the sales of the holding company.

(b) Similarly, common expenses and incomes are eliminated frorn the Consolidated Staternent of Profit and Loss.

(c) Reserve for unrealised profits on unsold goods sold by the subsidiary to the holding company (or vice versa should be created by debit to the Consolidated Surplus Account and credit to Stock Reserve Account.

(d) Interest on debentures and dividends received by the holding company from the subsidiary company (or vice versa) should be eliminated as inter company transactions from both sides of the Consolidated Statement of Profit and Loss. It may be noted that no adjustment is required for tax on dividends or on interest on debentures beeause the payment of tax is to he made to the outsiders.

(e) Holding company's share of profits of the suhsidiary company arising before the date of acquisition of shares should be debited to Surplus Account and credited to capital reserve or cost of control or goodwill as the case may be and vice versa in case of a loss.

(f) Minority shareholders' share of all profits of the subsidiary company should be credited to Minority Interest Account and debited to Consolidated Statement of Profit and Loss and vice versa in case of a loss.

(g) Holding company's share of the profit set aside for redemption of preference shares should be debited to Surplus Account and credited to Capit.al Redemption Reserve Account. Holding company's share will be in proportion to the value. of preference shares held.

**ILLUSTRATION 15.1 -** The Trial Balances of H Ltd. and S Ltd. are given below as on 31-11-2016:

| | *H Ltd* | *S Ltd* | | |
|---|---|---|---|---|
| | Dr. | Cr. | Dr. | Cr. |
| | ₹ | ₹ | ₹ | ₹ |
| Equity Share Capital (₹ 10) | | 1,00,000 | | 4,00,000 |
| 6% Preference Share Capital (₹ 10) | | | | 1,00,000 |
| Fixed Assets less Depreciation upto 31-3-2015 | 5,50,000 | | 3,50,000 | |
| Sales (including ₹ 2,00,000 sales by H Ltd. to S Ltd.) | | 12,00,000 | | 10,00,000 |
| Cost of Goods sold | 9,60,000 | | 8,00,000 | |
| Stock (31-3-2016) | 1,20,000 | | 90,000 | |
| Debtors and Creditors | 2,00,000 | 1,30,000 | 1,60,000 | 60,000 |
| General Expenses | 1,30,000 | | 1,20,000 | |
| 32,000 Shares in S Ltd. | 4,00,000 | | | |
| Interim Dividend Paid: | | | | |
| Preference | | 3,000 | | |
| Equity | | | 20,000 | |
| Dividend Received | | 16,000 | | |
| Surplus Account (31-3-2015) | | 76,000 | | 48,000 |
| Bank | 62,000 | | 65,000 | |
| | 24,22,000 | 24,22,000 | 16,08,000 | 16,08,000 |

(1) Shares were purchased on 1-4-2014.

(2) S Ltd. has paid and provided ₹ 20,000 dividend for 2018-2014 and ₹ 46.000 for 2014-2015. The net profit for 2014-2015 was ₹ 74,000.

(3) H Ltd. proposed ₹ 80,000 for 2015-16 and S Ltd. provided for final dividend of ₹ 3,000 as Preference Dividend and ₹ 20,000 Equity Dividend.

(4) Goods sold by H Ltd. to S Ltd. were at 20% profit. on sale price. Closing stock of S Ltd. includes ₹ 20,000 such stocks.

(5) Depreciation is charged @ 10% p.a. on reducing balance method. There is no addition in 2015-16. Fixed assets of S Ltd. were valued at ₹ 10,000 in excess, but no adjustment has been made in the books. Provision for additional depreciation is to be made only to the extent of holding of H Ltd.

Prepare Consolidated Statement of Profit and Loss for the year ended 31st March, 2016 and Consolidated Balance Sheet as at 31st March, 2016.

**SOLUTION**

**(For Consolidated Statement of Profit and Loss please see next page)**

**CONSOLIDATED BALANCE SHEET OF H LTD. AND ITS SUBSIDIARY S LTD.**

as at 31st March, 2016

| | | Note No | ₹ |
|---|---|---|---|
| I. Equity and Liabilities | | | |
| (1) Shareholders' Funds | | A | 10,00,000 |
| Share Capital Reserves and Surplus | | B | 99,880 |
| (2) Minority Interest | | | |
| | | | 10,99,880 |
| | (4) | | 1,96,400 |
| (3) Current Liabilities | | | |
| Trade Payables (Creditors) : | ₹ | | |
| H Ltd, | 1,30,000 | | |
| S Ltd. | 60,000 | | |
| | | | 1,90,000 |
| Short-term Provisions | | C | |

| | | |
|---|---|---|
| Total Equity and Liabilities (1) + (2) + (3) | | |
| **II. Assets** | | |
| (1) Fixed Assets: | | |
| Tangible Assets | D | 8,10,000 |
| Intangible Assets | E | 64,000 |
| (2) Current Assets | | |
| Inventories | F | 2,06,000 |
| Trade Receivables | G | 3,60,000 |
| Cash and Cash Equivalents | H | 1,27,000 |
| | | 6,93,000 |
| Total Assets (1) + (2) | | 15,67,000 |

## ACCOMPANYING NOTES TO THE CONSOLIDATED BALANCE SHEET

### A. Share Capital

| | |
|---|---|
| | ₹ |
| *Authorised Capital:* | ? |
| Issued, Subscribed and Paid-up Capital | |
| 1,00,000 Equity Shares of f 10 each fully paid up | 10,00,000 |

**CONSOLIDATED STATEMENT OF PROFIT AND LOSS OF H LTD.**
**AND ITS SUBSIDIARY S LTD.**
for the year ending 31st March 2016

| | *H Ltd.* | *S Ltd.* | *Adjustment* | *Total* |
|---|---|---|---|---|
| | ₹ | ₹ | ₹ | ₹ |
| I. Income from Operations (i.e. Sales) | 12,00,000 | 10,00,000 | 2,00,000 | 20,00,000 |
| II. Other Income | – | – | – | – |
| III. Total Revenue (I+II) | 12,00,000 | 10,00,000 | 2,00,000 | 20,00,000 |
| IV. Expenses : | | | | |
| Cost of Goods Sold | 9,60,000 | 8,00,000 | 2,00,000 | 15,60,000 |
| Depreciation (10%) | 55,000 | 35,000 | – | 90,000 |
| Other Expenses (i.e. General Expenses) | 1,30,000 | 1,20,000 | – | 2,50,000 |
| Total Expenses | 11,45,000 | 9,55,000 | 2,00,000 | 19,00,000 |
| V. Profit for the year (III-IV) | 55,000 | 45,000 | – | 1,00,000 |

**B. Reserves and Surplus**

| | | H Ltd. | S. Ltd. |
|---|---|---|---|
| | | ₹ | ₹ |
| Surplus A/c on 31-3-2015 | | 76,000 | 48,000 |
| Add: Profit for the year as per Statement of Profit and Loss | | 55,000 | 45,000 |
| | | 1,31,000 | 93,000 |
| *Less:* Extra Depreciation on Value Written Off (to the extent of Holding Co.'s share) $\left(\frac{10}{100} \times ₹\,9{,}000 \times \frac{80}{100}\right)$ | | 720 | |
| | | 1,30,280 | |
| *Less :* Interim Dividend paid by S Ltd. | ₹ | | |
| Preference | 3,000 | | |
| Equity | 20,000 | | |
| Proposed Dividend by S Ltd. | | | |
| Preference | 3,000 | | |
| Equity | 20,000 | | |
| | | | 46,000 |
| | | | 43,000 |
| *Less:* Minority Interest (20% of ₹ 47,000) | 9,400 | | |
| Capital Reserve (2) | 16,000 | | |
| | | | 25,400 |
| | | | 21,600 |
| Share of Surplus A/c (Revenue Profit) | | 21,600 | –21,600 |
| | | 1,51,880 | – |
| Less: Stock Reserve (i.e. Unrealised Profit ₹ 20,000 x $\frac{20}{100}$) | | 4,000 | |
| | | 1,47,880 | |

| | | ₹ | | |
|---|---|---|---|---|
| Add: Share of Dividend in S Ltd. | | | | |
| Interim | $\left(₹\,20{,}000 \times \frac{80}{100}\right) =$ | 16,000 | | |
| Proposed | $\left(₹\,20{,}000 \times \frac{80}{100}\right) =$ | 16,000 | | |
| | | | 32,000 | |
| | | | 1,79,880 | |
| Less: Proposed Dividend | | | 80,000 | |
| | | | 99,880 | |

**C. Short-term Provisions**

| | ₹ |
|---|---|
| Proposed Dividend | 80,000 |
| Provision for Depreciation on Excess Value of Fixed Asset Written off to the Extent of Holding of H Ltd $\left(₹\,9{,}000 \times \frac{10}{100} \times \frac{80}{100}\right)$ | 720 |
| | 80,720 |

**D. Tangible Assets**

| | ₹ | ₹ |
|---|---|---|
| Fixed Assets: | | |
| H Ltd. | 5,50,000 | |
| S Ltd. | 3,50,000 | |
| | 9,00,000 | |
| Less: 10% Depreciation | 90,000 | |
| | | 8,10,000 |

**E. Intangible Assets**

| | | ₹ |
|---|---|---|
| Goodwill | (3) | 64,000 |

**F. Inventories**

| | ₹ | ₹ |
|---|---|---|
| Stock (at cost) : H Ltd. | 1,20,000 | |
| S Ltd. | 90,000 | |

| | | |
|---|---|---|
| | 2,10,000 | |
| *Less :* Stock Reserve | 4,000 | |
| | | 2,06,000 |

**G. Trade Receivables**

| | ₹ | ₹ |
|---|---|---|
| Debtors: H Ltd. | 2,00,000 | |
| S Ltd. | 1,60,000 | |
| | | 3,60,000 |

**H. Cash and Cash Equivalents**

| | ₹ | ₹ |
|---|---|---|
| Bank Balance: H Ltd. | 62,000 | |
| S Ltd. | 65,000 | |
| | | 1,27,000 |

***Working Notes:***

**(1) Calculation of Extra Depreciation on Fixed Assets**

| | ₹ |
|---|---|
| Amount written up on 1-4-2014 | 10,000 |
| Less: 10% Depreciation $\left(₹\,10{,}000 \times \frac{10}{100}\right)$ | 1,000 |
| Book value on 1-4-2015 | 9,000 |
| 10% Depreciation for 2015-16 $\left(₹\,9{,}000 \times \frac{10}{100}\right)$ | 900 |
| Holding Company's Share of Depreciation (4/5 x ₹ 900) | 720 |

**(2) Calculation of Capital Reserve**

| | ₹ | ₹ |
|---|---|---|
| Surplus Account Balance of S Ltd. on 31-3-2015 | | 48,000 |
| Less: Profit of S. Ltd. for 2014-15 | 74,000 | |
| Less: Dividend for 2014-15 | 46,000 | |
| | | 28,000 |
| Surplus Account's Balance on 1-4-2014 | | 20,000 |
| Share of Holding Company (₹ 20,000 x 4/5) | | 16,000 |

**(3) Calculation of Goodwill**

| | ₹ | ₹ |
|---|---|---|
| Amount paid for acquiring shares of S Ltd. | | 4,00,000 |
| Less: Face value of 32.000 shares | 3,20,000 | |
| Capital Reserve | 16,000 | |
| | | 3,20,000 |
| | | 64,000 |

**(4) Calculation of Minority Interest**

| | ₹ | ₹ |
|---|---|---|
| Preference Share Capital | 1,00,000 | |
| Add: Proposed Dividend | 3,000 | |
| | | 1,03,000 |
| Equity Share Capital (₹ 4,00,000 – ₹ 3,20,000) | 80,000 | |
| Add: Proposed Dividend | 4,000 | |
| | | 84,000 |
| Share in Surplus Account (₹ 47,000 x 1/5) | | 9,400 |
| | | 1,96,400 |

## 15.7 SUMMARY

Subsidiaries are a common feature of business life, and all multinational corporations organize their operations in this way. Examples include holding companies such as Berkshire Hathaway, Time Warner, or Citigroup; as well as more focused companies such as IBM, or Xerox Corporation. These, and others, organize their businesses into national and functional subsidiaries, oftentimes with multiple levels of subsidiaries. A parent company does not have to be the larger or "more powerful" entity; it is possible for the parent company to be smaller than a subsidiary or the parent may be larger than some or all of its subsidiaries (if it has more than one). The parent and the subsidiary do not necessarily have to operate in the same locations, or operate the same businesses, but it is also possible that they could conceivably be competitors in the marketplace. Also, because a parent company and a subsidiary are separate entities, it is entirely possible for one of them to be involved in legal proceedings, bankruptcy, tax delinquency, indictment and/or under investigation, while the other is not. The most common way that control of a subsidiary is achieved, is through the ownership of shares in the subsidiary by the parent. These shares give the parent the necessary votes to determine the composition of the board of the subsidiary, and so exercise control. This gives rise to the common presumption that 50% plus one share is enough to create a subsidiary. There are, however, other ways that control can come about, and the exact rules both as to what control is needed, and how it is achieved, can be complex (see below). A subsidiary may itself have subsidiaries, and these, in turn, may have subsidiaries of their own. A parent and all its subsidiaries together are called a "group", although this term can also apply to cooperating companies and their subsidiaries with varying degrees of shared ownership.

Subsidiaries are separate, distinct legal entities for the purposes of taxation, regulation, and liability. For this reason, they differ from divisions, which are businesses fully integrated within the main company, and not legally or otherwise distinct from it.

In other words, a subsidiary can sue and be sued separately from its parent and its obligations will not normally be the obligations of its parent. However, creditors of an insolvent subsidiary may be able to obtain a judgment against the parent if they can pierce the corporate veil and prove that the parent and subsidiary are mere alter egos of one another.

In descriptions of larger corporate structures, the terms "first-tier subsidiary", "second-tier subsidiary", "third-tier subsidiary" etc. are often used to describe multiple levels of subsidiaries. A first-tier subsidiary means a subsidiary/daughter company of the ultimate parent company, while a second-tier subsidiary is a subsidiary of a first-tier subsidiary: a "granddaughter" of the main parent company. Consequently, a third-tier subsidiary is a subsidiary of a second-tier subsidiary: a "great-granddaughter" of the main parent company.

The ownership structure of the small British specialist company Ford Component Sales, which sells Ford components to specialist car manufacturers and OEM manufacturers, such as Morgan Motor Company , illustrates how multiple levels of subsidiaries are used in large corporations:

The word "control" used in the definition of "subsidiary" is generally taken to include both practical and theoretical control. Thus, reference to a body which "controls the composition" of another body's board is a reference to control in principle, while reference to being able to cast more than half of the votes at a general meeting, whether legally enforceable or not, refers to theoretical power. The fact that a company has a holding of less than 50% plus one share which, because the holdings of others are widely dispersed, gives effective control is not enough to give that company 'control' for the purpose of determining whether it is a subsidiary.

In Australia, for instance, the accounting standards defined the circumstances in which one entity controls another. In doing so, they largely abandoned the legal control concepts in favour of a definition that provides that 'control' is "the capacity of an entity to dominate decision-making, directly or indirectly, in relation to the financial and operating policies of another entity so as to enable that other entity to operate with it in pursuing the objectives of the controlling entity." This definition was adapted in the Australian Corporations Act 2001: s 50AA. And also it can be a very useful part of the company that allows every head of the company to apply new projects and latest rules.

## 15.8 GLOSSARY

- **Cross holding-** A cross holding is a security issue by a publicly listed company that is held by another company on the same listing.

- **Ford Motor Company-** the ultimate US parent company in Dearborn, Michigan
- **Ford International Capital LLC-** first-tier subsidiary (a US holding company located in Dearborn, Mi, but registered in Delaware
- **Blue Oval Holdings-** second-tier subsidiary (a British holding company, located at the Ford UK head office in Brentwood, Essex with five employees)
- **Ford Motor Company Limited-** third-tier subsidiary (the main British Ford company, with head office in Brentwood, with 10,500 employees)
- **Ford Component Sales Limited-** fourth-tier subsidiary (small British specialist component sales company at the UK Ford head office, with some 30 employees)

## 15.9 SELF ASSESSMENT QUESTIONS

Q.1 Write a short note on subsidiary company.

Q.2 What do you mean by a parent company?

## 15.10 LESSON END EXERCISE

Q.1 "A cross holding is a security issue by a publicly listed company that is held by another company on the same listing". Do you agree with this statement? Comment.

Q.2 Why intercompany purchases and sales are eliminated while preparing consolidated profit & loss, by the Holding Company?

## 15.11 SUGGESTED READINGS


- M.C Shukla and Grewal, "Advanced Accounts-II", S.Chand, New Delhi.
- Jain, S.P. and Narang, K.L. "Advanced Accounts-II", Kalyani Publisher, New Delhi.
- Maheshwari,S.N "Advanced Accounts-II", Vikash Publisher, New Delhi.


***

# FUNDS FLOW STATEMENT AND CASH FLOW STATEMENT

| | | |
|---|---|---|
| **M.Com II Sem.** | **Advanced Accounting** | **Unit-IV** |
| **M.COMC250** | | **Lesson No. 16** |

**STRUCTURE:**

## 16.1 INTRODUCTION

The basis of financial statements, i.e., the balance sheet and profit and loss account or income statement of business, reveal the net effect of the various transactions on the operational and financial position of the company. The balance sheet gives a summary of the assets and liabilities of an undertaking at a particular point of time. It reveals the financial status of the company. The assets side of a balance sheet shows the deployment of resources of an undertaking while the liabilities side indicates its obligations, i.e., the manner in which these resources were obtained. The profit and loss account reflects the results of the business operations for a period of time. It contains a summary of expenses incurred and the revenue realised in an accounting period. Both these statements provide the essential basic information on the financial activities of a business, but their usefulness is limited for analysis and planning purposes. The balance sheet gives a static view of the resources (liabilities) of a business and the uses (assets) to which these resources have been put at a certain point of time. It does not disclose the causes for changes in the assets and liabilities between two different points of time. The profit and loss account, in a general way, indicates the resources provided by operations. But there are many transactions that take place in an undertaking and which do not operate through profit and loss account. Thus, another statement has to be prepared to show the change in the assets and liabilities from the end of another period of time to the end another period of time. The statement is called a Statement of changes in Financial Position or a Funds Flow Statement.

The Funds Flow Statement is a statement which shows the movement of funds and is a report of the financial operations of the business undertaking. It indicates various means by which funds were obtained during a particular period and the ways in which these funds were employed. In simple words, it is a statement of sources and applications of funds. Another statement namely, cash flow statement, which is simply a financial statement that provides aggregate data regarding all cash inflows a company receives from its ongoing operations and external investment sources. It also includes all cash outflows that pay for business activities and investments during a given period.

## 16.2 OBJECTIVES

After going through this lesson you will be able to:

- Understand the basics of funds flow statement.
- Differentiate the funds flow statement and cash flow statement.
- Differentiate the funds flow statement, balance sheet and income statement.

## 16.3 BASICS OF FUNDS FLOW STATEMENT

The term 'funds' has been defined in a number of ways.

(a) **In a narrow sense**, it means cash only and a funds flow statement prepared on this basis is called a cash flow statement. Such a statement enumerates net effects of the various business transactions on cash and takes into account receipts and disbursements of cash.

(b) **In a broader sense**, the term 'funds' refers to money values in whatever form it may exist. Here `funds' means all financial resources, used in business whether in the form of men, material, money, machinery and others.

(c) **In a popular sense**, the term 'funds', means working capital, i.e., the excess of current over current liabilities. The working capital concept of funds has emerged due to the fact that total resources of a business are invested partly in fixed assets in the form of fixed capital and partly kept in form of liquid or near liquid form as working capital.

The narrower concept of 'funds', i.e., cash or working capital concept, fails to reveal the changes in the total financial resources of a business. Some significant items, such as purchase of building in exchange of shares or payment of bonus in the form of shares, which do not directly affect cash or working capital are not revealed from the analysis based on these concepts. However, the concept of funds as working capital is the most popular one and in this chapter we shall generally refer to 'funds' as working capital and a funds flow statement as a statement of sources and application of funds.

## 16.4 MEANING AND CONCEPT OF 'FLOW OF FUNDS'

The term 'flow' means movement and includes both 'inflow' and 'outflow'. The term 'flow of funds' means transfer of economic values from one asset of equity to another. Flow of funds is said to have taken place when any transaction makes changes in the amount of funds available before happening of the transaction. If the effect of transaction results in the increase of funds, it is called a source of funds and if it results in the decrease of funds, it is known as an application of funds. Further, in case the transaction does not change funds, it is said to have not resulted in the flow of funds. According to the working capital concept of funds, the term 'flow of funds' refers to the movement of funds in the working capital. If any transaction results in the increase in working capital, it is said to be a source or inflow of funds and if it results in the decrease of working capital, it is said to be an application or out-flow of funds.

**Rule**

The flow of funds occurs when a transaction changes on the one hand a non-current account and on the other a current account and vice-versa.

When a change in a non-current account e.g., fixed assets, long-term liabilities, reserves and surplus, fictitious assets, etc., is followed by a change in another non-current account, it does not amount to flow of funds. This is because of the fact that in such cases neither the working capital increases nor decreases.

Similarly, when a change in one current account results in a change in another current account, it does not affect fund. Funds move from non-current to current transactions or vice-versa only. In simple language funds move when a transaction affects (i) a current asset and a fixed asset, or (ii) a fixed and a current liability or (iii) a current asset and a fixed liability, or (iv) a fixed liability and current liability; and funds do not when the transaction affects fixed assets and fixed liability or current assets and current liabilities.

## 16.5 CURRENT AND NON-CURRENT ACCOUNTS

To understand flow of funds, it is essential to classify various accounts and balance sheet items into current and non-current categories.

Current Accounts can either be current assets or current liabilities. Current assets are those assets which in the ordinary course of business can be or will be converted into cash within a short period of normally one accounting year.

Current liabilities are those liabilities which are intended to be paid in the ordinary course of business within a short period of normally one accounting year out of the current assets or the income of the business.

The following is the list of Current or Working Capital Accounts:

LIST OF CURRENT OR WORKING CAPITAL ACCOUNTS

| Current Liabilities | Current Assets |
|---|---|
| 1.Bill Payable | 1.Cash in hand |
| 2. Sundry Creditors or Accounts Payable | 2.Cash at bank |
| 3. Accured or Outstanding Expenses | 3.Bills Receivable |
| 4. Dividends Payable | 4.Sundry Debtors or Accounts Receivable |
| 5.Bank Overdraft | 5.Short-term loans & advances |
| 6. Short term loans advances & deposits | 6.Temporary or Marketable Investments |
| 7. Provision against Current Assets | 7. Inventories or stocks such as |
| | (a) Raw materials |
| | (b) Work-in-process |
| 8.Provision for taxation, if it does not amount | (c) Stores and Spares |
| to appropriation of profits | (d) Finished Goods |
| 9.Proposed Dividend (May be a current or a | 8.Prepaid Expenses |
| Non- current liability | 9.Accrued Incomes |

LIST OF NON-CURRENT OR PERMANENT CAPITAL ACCOUNTS

| Non-Current or Permanent Liabilities | Non-Current or Permanent Assets |
|---|---|
| 1. Equity Share Capital | 1. Goodwill |
| 2. Preference Share Capital | 2. Land |
| 3. Redeemable Preference Share Capital. | 3. Building |
| 4. Debentures | 4. Plant and Machinery |
| 5. Long-term Loans | 5. Furniture and Fittings |
| 6. Share Premium Account | 6. Trade Marks |
| 7. Share Forfeited Account | 7. Patent Rights |
| 8. Profit and Loss Account (balance i.e.. credit balance) | 8. Long-term investment |
| 9. Capital Reserve | 9. Debit Balance of Profit and Loss account |
| | 10. Discount on Issue of Shares |
| 10. Capital Redemption Reserve | 11. Discount on Issue of Debentures |
| 11. Provision for depreciation against fixed assets. | |
| 12. Appropriation or Proms : | 12. Preliminiary Expenses. |
| (a) General Reserve | 13. Other Deferred Expenses. |
| (b) Dividend Equalisation Fund | |
| (c) Insurance Fund | |
| (d) Compensation Fund | |
| (e) Sinking Fund | |
| (f) Investment Fluctuation Fund | |
| (g) Provision for Taxation | |
| (h) Proposed Dividend | |

## 16. 6 PROCEDURE FOR KNOWING WHETHER A TRANSACTION RESULTS IN THE FLOW OF FUNDS OR NOT:

(1) Analyse the transaction and find out the two accounts involved.

(2) Make Journal Entry of the transaction.

(3) Determine whether the accounts involved in the transaction are current or

non-current.

(4) If both the accounts involved are current i.e., either current assets or current liabilities, it does not result in the flow of funds.

(5) If both the account involved are non-current, i.e., either permanent assets or permanent liabilities, it still does not result in the flow of funds.

(6) If the accounts involved are such that one is a current account while the other is a non-current account, i.e., current asset and permanent liability, or current asset and fixed asset, or current liability and fixed asset, or current liability and permanent liability then it results in the flow of funds.

***Examples***

***(A) Transactions which involve only the current accounts and hence do not result in the flow of the funds :***

1. Cash collected from debtors.
2. Bills receivables realised.
3. Cash paid to creditors.
4. Payment or discharge of bills payable.
5. Issued bills payable to trade creditors.
6. Received acceptances from customers.
7. Raising of short-term loans.
8. Sale of temporary or marketable investments.
9. Goods purchased for cash or credit.

Analysis of the above transactions

1. Cash collected from debtors ; the journal entry shall be :

Cash A/c ...Dr.

To Sundry Debtors A/c

Both Cash A/c and Sundry Debtors A/c are current accounts and hence do not affect funds. The transaction results in increase in cash but at the same time an equal decrease in debtors. The total current assets and current liabilities remain unchanged and consequentially the working capital remains the same.

In the same way, the following also do not result in the flow of funds.

2. Bills Receivable released:

| | | |
|---|---|---|
| Cash A/c | ...Dr. | (Current Asset) |
| To Bills Receivable A/c | | (Current Asset) |

3. Cash Paid to creditors :

| | | |
|---|---|---|
| Sundry creditors A/c. | ...Dr | (Current Liability) |
| To Cash A/c | | (Current Asset) |

The transaction results in decrease in creditors (current liabilities) on the one hand and at the same an equal decrease in cash (current assets) ; and hence the difference between the two (C.A.-C.L.) or working capital remain unchanged.

4. Payment or discharge of Bills Payable:

| | | |
|---|---|---|
| Bill Payable A/c | ...Dr. | (Current Liability) |
| To Cash A/c | | (Current Asset) |

5. Issued Bills Payable to trade creditors :

| | | |
|---|---|---|
| Sundry creditors A/c | ...Dr. | (Current Liability) |
| To Bills Payable A/c | | (Current Liability) |

6. Received acceptance from customers :

| | | |
|---|---|---|
| Bills Receivable A/c. | ...Dr. | (Current Asset) |
| To Short-term Loan A/c | | (Current Liability) |

7. Raising of Short-term loans :

| | | |
|---|---|---|
| Cash or Bank A/c | ...Dr. | (Current Asset) |
| To Short-term Loan A/c | | (Current Liability) |

8. Sale of Temporary or Marketable Investments :

| | | |
|---|---|---|
| Cash A/c | ...Dr. | (Current Asset) |
| To Temporary Investments A/c | | (Current Asset) |

9. Goods Purchased for Cash or Credit :

| | | |
|---|---|---|
| Purchases A/c | ...Dr. | (Current) |
| To Cash A/c | | (Current Asset) |
| Or To | | |
| To Sundry Creditors A/c | | (Current Liability) |

(B) Transactions which involve only non-current accounts and hence do not result in the flow of funds.

1. Purchase of one new machine in exchange of two old machines.
2. Purchase of building or furniture in exchange of land.
3. Conversion of debentures into shares.
4. Redemption of preference shares in exchange of debentures.
5. Transfers to general reserves, etc.
6. Payment of bonus in the form of shares.
7. Purchase of fixed assets in exchange of shares, debentures, bonds or long-term loans.
8. Writing off of ficititious assets.
9. Writing off of accumulated losses or discount on issue of shares, etc.

***Analysis of the above transactions:***

1. Purchases of one new machine in exchange of two old machines ; the journal entry shall be :

| | | |
|---|---|---|
| New Machinery A/c | ...Dr. | |
| To Old Machinery A/c | | |

Both New Machinery A/c and Old Machinery A/c are non-current accounts and hence the transaction does not affect funds. The current assets and current liabilities remain unchanged and consequentially the working capital also remains the same. Similarly, the following transactions do not result in the flow of funds:

2. Purchase of Building or Furniture in exchange of land :

| | | |
|---|---|---|
| Building/Furniture A/c | ...Dr. | (Non-Current) |
| To Land A/c | | (Non-Current) |

3. Conversion of Debentures into shares :

| | | |
|---|---|---|
| Debentures A/c | ...Dr. | (Non-Current) |
| To Share Capital A/c | | (Non-Current) |

4. Redemption of Preference Shares in exchange of debentures :

| | | |
|---|---|---|
| Preference Share Capital A/c | ...Dr. | (Non-Current) |
| To Debentures A/c | | (Non-Current) |

5. Transfer to General Reserves :

| | | |
|---|---|---|
| Profit and Loss (App.) A/c | ...Dr. | (Non-Current) |
| To General Reserves A/c | | (Non-Current) |

6. Payment of Bonus in the form of Shares :

| | | |
|---|---|---|
| Profit and Loss (App.) A/c | ...Dr. | (Non-Current) |
| To Share Capital A/c | | (Non-Current) |

7. Purchase of fixed assets against issue of Shares or debentures

| | | |
|---|---|---|
| Fixed Assets A/c | ...Dr. | (Non-Current) |
| To Share Capital A/c | | (Non-Current) |
| or | | |
| To Debentures A/c | | (Non-Current) |

8. Writing off of fictitious assets, say goodwill :

| | | |
|---|---|---|
| Profit and Loss A/c | ...Dr. | (Non-Current) |
| To Goodwill A/c | | (Non-Current) |

9. Writing off discount on issue of shares :

| | | |
|---|---|---|
| Profit and Loss A/c | ...Dr. | (Non-Current) |
| To Discount on Issue of Shares A/c | | (Non-Current) |

(C) Transactions which involve both current and non-current accounts and hence result in the flow of funds:

1. Issue of shares for cash.
2. Issue of debentures for cash.
3. Raising of long-term loans.
4. Sale of fixed assets on cash or credit.
5. Sale of trade investments.
6. Redemption of Preference shares.
7. Redemption of debentures.
8. Purchase of fixed assets on cash or credit.
9. Purchase of long-term/trade investments.
10. Payment of bonus in cash.
11. Repayment of long-term loans.

12. Issue of shares against purchase of stock-in-trade.

***Analysis of the above transactions***

1. Issue of shares for cash, the journal entry will be :

| | | |
|---|---|---|
| Cash/Bank A/c | ...Dr. | (Current Asset) |
| To Share Capital A/c | | (Non-Current Liability) |
| To Share Premium A/c | | (Non-Current Liability) |
| (If issued at premium) | | |

As one of the accounts involved is a current account and the other is a non-current account, the transaction results in the flow of funds. When Cash A/c is debited, the total of cash balance or current assets will increase while the current liabilities remain the same. It will amount to an increase in working capital or the funds: In the same way, the following transactions also involve the flow of funds :

2. Issue of debentures for cash :

| | | |
|---|---|---|
| Cash A/c | ...Dr. | (Current Asset) |
| To Debentures A/c | | (Non-Current Liability) |

3. Raising of Long-term Loans :

| | | |
|---|---|---|
| Cash/Bank A/c | ...Dr. | (Current Asset) |
| To Loan A/c | | (Non-Current Liability) |

4. Sale of fixed assets on Cash or Credit :

| | | |
|---|---|---|
| Cash or Debtors A/c | ...Dr. | (Current Asset) |
| To Fixed Assets A/c | | (Non-Current Liability) |

5. Sale of long-term/trade investments :

| | | |
|---|---|---|
| Cash A/c | ...Dr. | (Current Asset) |
| To Long-term Investment A/c | | (Non-Current Liability) |

6. Redemption of preference shares :

| | | |
|---|---|---|
| Redeemable Preference Share Capital A/c | ...Dr. | (Non-Current Liability) |
| To Bank A/c | | (Current Asset) |

7. Redemption of debentures :

| | | |
|---|---|---|
| Debentures A/c | ...Dr. | (Non-Current Liability) |
| To Bank A/c | | (Current Asset) |

8. Purchase of fixed assets on cash or credit :

| | | |
|---|---|---|
| Fixed Assets A/c | ...Dr. | (Non-Current Asset) |
| To Cash/Creditors A/c | | (Current-Asset/Liability) |

9. Purchase of long-term investments or trade investment :

| | | |
|---|---|---|
| Long-term Investment A/c | ...Dr. | (Non-Current Asset) |
| To Cash A/c | | (Current Asset) |

10. Payment of bonus in cash :

| | | |
|---|---|---|
| (i) Profit and Loss (App.) A/c | ...Dr. | |
| To Bonus to Shareholders A/c | | |
| (ii) Bonus to Shareholders A/c | ...Dr. | |
| To Cash/Bank A/c | | |
| (iii) Or say, Profit & Loss (App.) A/c | ...Dr. | (Non-Current Liability) |
| To Cash/Bank A/c | | (Current Asset) |

11. Repayment of Long-term Loans :

| | | |
|---|---|---|
| Loans A/c | ...Dr. | (Non-Current Liability) |
| To Cash A/c | | (Current Assets) |

12. Issue of shares against purchase of stock-in-trade :

Stock-in-trade A/c ...Dr. (Current Assets)

To Share Capital A/c (Non-Current Liability)

| Summary of Transactions Showing No Flow of Funds | | | | |
|---|---|---|---|---|
| *Transaction* 1 | *Journal Entry* 2 | *Category of Debit Account* 3 | *Category of Credit Account* 4 | *Result Flow of Funds or Not* 5 |
| 1. Cash collected from debtors | Cash A/c To Sundry Debtors A/c | ...Dr. Current | Current | No |
| 2. Bills receivable realised | Cash A/c To B/R A/c | ...Dr. Current | Current | No |
| 3. Cash paid to trade creditors | Sundry Creditors A/c To Cash A/c | ...Dr. Current | Current | No |
| 4. Payment or discharge of bills payable | B/P A/c To Cash A/c | ...Dr. Current | Current | No |
| 5. Issued bills payable to trade creditors | Sundry Creditors A/c To B/P A/c | ...Dr. Current | Current | No |
| 6. Received acceptances from customers | B/R A/c To Sundry Debtors A/c | ...Dr. Current | Current | No |
| 7. Raising of short-term loans | Cash/bank A/c To Short-term Loan A/c | Current ...Dr. Current | Current | No |
| 8. Sale of temporary or marketable investments | Cash A/c To Temporary Investments A/c | ...Dr. Current | Current | No |
| 9. Goods purchased for cash or credit | Purchases A/c To Cash/Creditors A/c | ...Dr. Non-Current | Current | No |

| | | | | |
|---|---|---|---|---|
| 10. Purchase of new machine in exchange of old machines | New Machinery A/c To Old Machinery A/c | ...Dr. Non-Current | Non-Current | No |
| 11. Purchase of buildings in consideration of land | Building A/c To Land A/c | ...Dr. Non-Current | Non-Current | No |
| 12. Conversion of | Debentures A/c To | ...Dr. Non- | Non-Current | No |

**Summary of Transactions Showing Flow of Funds**

| ***Transaction*** 1 | ***Journal Entry*** 2 | ***Category of Debit Account*** 3 | ***Category of Credit Account*** 4 | ***Result Flow of Funds or Not*** 5 |
|---|---|---|---|---|
| 1. Issue of shares at premium | Cash/Bank A/c To Share Capital A/c To Share Premium A/c | ...Dr. Current | Non-Current | Yes |
| 2. Issue of debentures | Cash/Bank A/c To Debentures A/c | ...Dr. Current | Non-Current | Yes |
| 3. Raising of long-term loans | Cash/Bank A/c To Loan A/c | ...Dr. Current | Non-Current | Yes |
| 4. Sale of fixed Assets on cash or credit | Cash A/c Debtors A/c To Fixed Assets A/c | ...Dr. Current | Non-Current | Yes |
| 5. Sale of long-term trade Investments | Cash A/c To Long-term Investments A/c | ...Dr. Current | Non-Current | Yes |
| 6. Redemption of preference shares | Redeemable Preference Share Capital A/c To Bank A/c | ...Dr. Non-Current | Current | Yes |
| 7. Redemption of debentures | Debentures A/c To Bank A/c | ...Dr. Non-Current | Current | Yes |

| | | | | |
|---|---|---|---|---|
| 8. Purchase of fixed assets on cash or credit | Fixed Assets A/c To Cash/Creditors A/c | ...Dr. Non-Current | Current | Yes |
| 9. Purchase of long-term trade investments | Long-term Investments A/c To Cash A/c | ...Dr. Non-Current | Current | Yes |
| 10. Payment of bonus in cash | Profit and Loss (App.) A/c To Cash A/c | ...Dr. Non-Current | Current | Yes |
| 11. Repayment of long-term loans. | Loans A/c To Cash A/c | ...Dr. Non-Current | Current | Yes |
| 12. Issue of shares against purchase of | Stock-in-trade A/c To Share Capital | ...Dr. Current | Non-Current | Yes |

## 16.7 FUNDS FLOW STATEMENT AND INCOME STATEMENT

Funds flow statement is not a substitute of an income statement, i.e., a profit and loss account, and a balance sheet. The Profit and Loss Account is a document which indicates the extent of success achieved by a business in earning profits. It reports the results of business activities and indicates the reasons for the profitability or lack thereof. The Profit and Loss Account does not highlight the changes in the financial position of a business. It does not reveal the inflows and outflows of funds in business during a particular period.

Hence, Funds flow statement is not competitive but complementary to financial statements. The funds statement provides additional information as regards changes in working capital, derived from financial statements at two points of time. It is a tool of management for financial analysis and helps in making decisions.

Income statements main objective is to ascertain the net profit earned or loss incurred by the company out of business operations at the end of particular period. Income statement is prepared on the basis of nominal accounts of particular accounting period. Income statement uses only income and expenditure transactions relating to trading operations of a particular period. Preparation of profit and loss account is a statutory obligation and should be prepared in accordance with the legal requirements.

An income statement can be prepared without the help of a funds flow statement.

Income statement is static inasmuch as it gives information on what has happened during the period covered by it. Income statement is prepared only at the end of accounting period for the period covered by it. Income statement is prepared on accrual basis of accounting and fails to present the factual history of firm's cash transactions. The determination of periodic income is necessarily based on number of estimates, judgment and allocations and is subject to manipulations of management.

**Difference Between Funds Flow Statement and Income Statement**

| Funds Flow Statement | Income Statement |
|---|---|
| (1) It highlights the changes in the financial position of a business and indicates the various means by which funds were obtained during a particular period and the ways to which these funds were employed. | (1) It does not reveal the inflows and outflows of funds but depicts the items of expenses and income arrive at the figure of profit or loss. |
| (2) It is complementary to income statement. Income statement helps the preparation of Funds Flow Statement. | (2) Income statement is not prepared from Funds Flow Statement. |
| (3) While preparing Funds Flow Statement both capital and revenue items are considered. | (3) Only revenue items are considered. |
| (4) There is no prescribed format for preparing a Funds Flow Statement. | (4) It is prepared in a prescribed format. |

## 16.8 FUNDS FLOW STATEMENT AND BALANCE SHEET

A balance sheet is a statement of financial position or status of a business on a given date. It is prepared at the end of accounting period. The balance sheet depicts various resources of an undertaking and the deployment of these resources in various assets on a particular date. As it indicates the financial condition on a particular date, it is static in nature; while funds flow statement is a dynamic one. Funds statement tells us many financial facts which a balance sheet cannot tell. Balance Sheet does not disclose the causes for changes in the assets and liabilities between two different points of time. Again, while balance sheet is the end result of all accounting operations for a period of time, funds flow statement is essentially a post balance sheet exercise. It is prepared (Funds Statements) to show various sources from which the funds came into business and various applications where they have been used.

The term balance sheet refers to a financial statement that reports a company's assets, liabilities, and shareholder equity at a specific point in time. Balance sheets provide the basis for computing rates of return for investors and evaluating a company's capital structure.

In short, the balance sheet is a financial statement that provides a snapshot of what a company owns and owes, as well as the amount invested by shareholders. Balance sheets can be used with other important financial statements to conduct fundamental analysis or calculate financial ratios.

The balance sheet provides an overview of the state of a company's finances at a moment in time. It cannot give a sense of the trends playing out over a longer period on its own. For this reason, the balance sheet should be compared with those of previous periods.

Investors can get a sense of a company's financial wellbeing by using a number of ratios that can be derived from a balance sheet, including the debt-to-equity ratio and the acid-test ratio, along with many others. The income statement and statement of cash flows also provide valuable context for assessing a company's finances, as do any notes or addenda in an earnings report that might refer back to the balance sheet.

**Difference Between Funds Flow Statement and Balance Sheet**

| Funds Flow Statement | Balance Sheet |
|---|---|
| (1) It is a statement of changes in financial position and hence is dynamic in nature. | (1) It is a statement of financial position on a particular date and hence is static in nature. |
| (2) It shows the sources and uses of funds in a particular period of time. | (2) It depicts the assets and liabilities at a particular point of time. |
| (3) It is a tool of management for financial analysis and helps in making decisions. | (3) It is not of much help to management in making decisions. |
| (4) Usually, Schedule of Changes in Working Capital has to be prepared before preparing Funds Flow Statement. | (4) No such schedule of Changes in Working Capital is required. Rather Profit and Loss Account is prepared. |

## 16.9 DIFFERENCE BETWEEN CASH FLOW STATEMENT AND FUND FLOW STATEMENT

The **Cash Flow Statement** shows the changes in the cash position (Inflows and outflows) of a firm. It is an analytical reconciliation statement that explains the reasons for the differences between the opening and closing cash balances over a period. On the other hand, the **Fund Flow Statement** is a statement that shows the ups and downs of the financial position or the changes in working capital of the entity between the two financial years. The following table elucidates the cash flow and fund flow difference clearly to clear the concept.

| **Basis of Comparison** | **Cash Flow Statement** | **Fund Flow Statement** |
|---|---|---|
| Meaning | It shows how a company spends its cash revenue by giving a record of all inflows and outflows. | It charts the financial standing of a company. Also the source of the cash fund and application of it. |
| What Is Measured? | The real cash or cash-like assets are calculated | Only funds and capital are calculated |
| What does it Display? | Inflows and Outflows of hard cash | The source and application of existing funds. |
| Purpose | To keep a record of cash from the initial stage to the end of a specific period | The transformation of the business, from last financial quarter to existing one |
| Reveals | The short-term position of a business | The long-term standing of a business |

| | | |
|---|---|---|
| Basis of Analysis | On the narrower concept of cash only | On the broader concept of working capital |
| Source | States the opening cash balance and closing cash balance | States the sources of funds generation |
| Usage | Computes short term spending details | In accessing long-range financial planning |
| Working Capital Change Schedule | It shows those changes through the cash flow statement itself | Changes in current liabilities and assets are shown through the movement of working capital |
| End Result | Portrays the reasons for changes in cash flows only | Portrays the reasons for the change in net capital |
| Accounting Principle | Follows cash basis of accounting | Follows accrual basis of accounting |

**Significant Differences Between Cash Flow Statement and Fund Flow Statement**

- The cash flow statement is one of four financial statements that every investor examines to evaluate a company's financial status. In contrast, the money flow statement is not a financial statement.
- The cash flow statement is generated so that the company's net cash flow may be determined at the end of a specific period. A money flow statement is created to show the sources and uses of funds over a specific period, as well

as how that "change in funds" affects the company's working capital.

- A cash basis of accounting is used to generate the cash flow statement. The fund flow statement, on the other hand, is generated using the accrual accounting method.
- The cash flow statement is used to budget for cash. For capital budgeting, a fund flow statement is employed.

## 16. 10 SUMMARY

So, the funds flow statement describes the sources from which additional funds were derived and the uses to which these funds were put. Roy A. Fouke defines fund flow statement as a statement of sources and application of funds is a technical device designed to analyse the changes in the financial condition of a business enterprise between two dates. Thus, the fund flow statement reveals the volume of financial transactions and explains the flow of funds taking place within a business during a particular period of time and its effect on the net working capital. It is not a substitute for either the Profit and Loss Account or the Balance Sheet, but it is an useful supplement to them. It describes the sources from which funds are obtained and the uses of these funds, in a condensed form.

With the help of a fund flow statement format, we can prepare the fund flow statement. The company prepares this statement to analyze the changes in working capital between two balance sheets. It is based on historical data. It helps the management make future decisions, but management cannot take the entire decision based on only the fund flow statement because it considers only fund-based items. Last, management should prepare this statement because it considers all sources, i.e., from where the funds are coming, and all applications, i.e., where the funds are going. This summarized statement helps management to move further.

## 16.11 GLOSSARY

- **Financial Statements-** Financial statements include the balance sheet and profit and loss account or income statement of business that reveal the net effect of the various transactions on the operational and financial position of the company.

- **Flow of Funds-** It means transfer of economic values from one asset of equity to another.
- **Fund Flow Statement-** It reveals the reasons for changes or anomalies in the financial position of a company between two balance sheets.
- **Current Assets-** Current assets are those assets which in the ordinary course of business can be or will be converted into cash within a short period of normally one accounting year.
- **Bank Overdraft-** An overdraft is a loan provided by a bank that allows a customer to pay for bills and other expenses when the account reaches zero.
- **Sinking Fund-** A sinking fund is a fund containing money set aside or saved to pay off a debt or bond.
- **Provision for Taxation:** Provision for taxation is the provision made out of current profits to meet the tax obligation.

## 16.12 SELF ASSESSMENT QUESTIONS

1. What is the need of preparing funds flow statement?

______________________________________________

______________________________________________

______________________________________________

______________________________________________

2. Explain the cash flow statement.

______________________________________________

______________________________________________

______________________________________________

______________________________________________

## 16.13 LESSON END EXERCISE

1. Explain the narrow and boarder meaning of funds.

2. Discuss the various current and non-current accounts.

3. Describe the procedure for knowing whether a transaction results in the flow of funds or not.

## 16.14 SUGGESTED READINGS


- Gupta, Sashi, K. (2015). Financial Management. Kalyani Publisher, New Delhi.
- Jain, S.P and Narang, K.L. (2014). Advanced Acountancy-Vol-II. Kalyani Publisher, New Delhi.
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# FUNDS FLOW STATEMENT AND CASH FLOW STATEMENT

| M.Com II Sem. | Advanced Accounting | Unit-IV |
|---|---|---|
| M.COMC250 | | Lesson No. 17 |

**STRUCTURE**



## 17.1 INTRODUCTION

There are Three Parts of Fund Flow Statement Format. First one is Statement of Changes in Working Capital. Working capital means the difference between the current assets and current liabilities. If there is an increase in working capital, then it will be an application of funds, and if there is a decrease in working capital, it will be a source of funds.

While preparing a funds flow statement, one has to analyze the given balance sheets. Items relating to current accounts, i.e., current assets and current liabilities have to be shown in the schedule of changes in working capital. But the non-current assets and non-current liabilities have to be further analyzed to find out the hidden information in regard to sale or purchase of non- current assets, issue or redemption of share capital, raising or repayment of long-term loans, transfers to reserves and provisions, etc.

## 17.2 OBJECTIVES

After going through this lesson, you will be able to

- Prepare the Schedule of change in working capital.
- Understand the purpose of preparing the Schedule of change in working capital.
- Learn about the items requiring special attention while preparing a statement of changes in working capital

## 17.3 PROCEDURE FOR PREPARING A FUNDS FLOW STATEMENT

Funds Flow statement is a method by which we study changes in the financial position of a business enterprise between beginning and ending financial statements dates. Hence, the funds flow statement is prepared by comparing two balance sheets and with the help of such other information derived from the accounts as may be needed.

Broadly speaking, the preparation of a funds flow statement consists of two parts:

1. Statement or Schedule of Charges in Working Capital.
2. Statement of Sources and Application of Funds.

### 1. Statement or Schedule of Changes in Working Capital

Working Capital means the excess of current assets over current liabilities. Statement of changes in working capital is prepared to show the changes in the working capital between the two balance sheet dates. This statement is prepared with the help of current assets and current liabilities derived from the two balance sheets.

As, Working Capital = Current Assets - Current Liabilities.

So, (i) An increase in current assets increases working capital.

(ii) A decrease in current assets decreases, working capital.

(iii) An increase in current liabilities decreases working capital ; and

(iv) A decrease in current liabilities increases working capital.

The change in the amount of any current asset or current liability in the current balance sheet as Compared to that of the previous balance sheet either results in increase or decrease in working capital. The difference is recorded for each individual current asset and current liability. In case a current asset in the current period is more than in the previous period, the effect is an increase in working capital and it is recorde4n the increase column. But if a current liability in the current period is more than in the previous recorded, the effect is decrease in working capital and it is recorded in the decrease column or vice versa. The total increase and the total decrease are compared and the difference shows the net increase or net decrease in working capital. It is worth noting that schedule of changes in working capital is prepared only from current assets and current liabilities and the other information is not of any use for preparing this statement.

A typical form of statement or schedule of changes in working capital is as follows:

| **Statement of Schedule of Changes in Working Capital** | | | | |
|---|---|---|---|---|
| | | | ***Effect on Working Capital*** | |
| ***Particulars*** | ***Previous Year*** | ***Current Year*** | ***Increase*** | ***Decrease*** |
| *Current Assets :* | | | | |
| Cash in hand | | | | |
| Cash at bank | | | | |
| Bills Receivable | | | | |
| Sundry Debtors | | | | |
| Temporary Investments | | | | |

| | | | | |
|---|---|---|---|---|
| Stocks/Inventories | | | | |
| Prepaid Expenses | | | | |
| Accrued Incomes | | | | |
| Total Current Assets | | | | |
| **Current Liabilities:** | | | | |
| Bills Payable | | | | |
| Sundry Creditors | | | | |
| Outstanding Expenses | | | | |
| Bank Overdraft | | | | |
| Short-term advances | | | | |
| Dividends Payable | | | | |
| Proposed dividends* | | | | |
| Provision for taxation* | | | | |
| Total Current Liabilities | | | | |
| Working Capital (CA-CL) | | | | |
| Net Increase or Decrease in Working Capital | | | | |

* May or may not be a current liability.

**Illustration 17.1** Prepare a Statement of changes in Working Capital from the following Balance Sheets of Manjit and company Limited.

| **Balance Sheets as at March 31** | | |
|---|---|---|
| Particulars | 2016 (₹) | 2015 (₹) |
| I. Equity and Liabilities | | |
| Shareholders' Funds : | | |
| Equity Share Capital | 5,00,000 | 5,00,000 |
| Non-current-Liabilities : | | |
| Debentures | 4,50,00 | 3,70,000 |
| Current Liabilities : | | |

| | | |
|---|---|---|
| Accounts Payable | 1,92,000 | 96,000 |
| Tax Payable | 43,000 | 77,000 |
| Interest Payable | 45,000 | 37,000 |
| Dividend Payable | 35,000 | 50,000 |
| Total | 12,65,000 | 11,30,000 |
| | | |
| **II. Assets** | | |
| Non-Current Assets : | | |
| Fixed Assets | 7,00,000 | 6,00,000 |
| Long-term Investments | 1,00,000 | 2,00,000 |
| Current Assets : | | |
| Stock-in-Trade | 2,25,000 | 1,50,000 |
| Accounts Receivable | 1,40,00 | 70,000 |
| Work-in-Progress | 90,000 | 80,000 |
| Cash | 10,000 | 30,000 |
| Total | 12,65,000 | 11,30,000 |

**Solution :**

**Statement of Changes in Working Capital**

| *Particulars* | *2015* ₹ | *2016* ₹ | *Effect on Working Capital* *Increase* ₹ | *Decrease* ₹ |
|---|---|---|---|---|
| *Current Assets :* | | | | |
| Cash | 30,000 | 10,000 | | 20,000 |
| Accounts Receivable | 70,000 | 1,40,000 | 70,000 | |
| Stock-in-trade | 1,50,000 | 2,25,000 | 75,000 | |
| Work-in-progress | 80,000 | 90,000 | 10,000 | |
| | 3,30,000 | 4,65,000 | | |
| *Current Liabilities:* | | | | |
| Tax Payable | 77,000 | 43,000 | 34,000 | |
| Accounts Payable | 96,000 | 1,92,000 | | 96,000 |
| Interest Payable | 37,000 | 45,000 | | 8,000 |
| Dividend Payable | 50,000 | 35,000 | 15,000 | |
| | 2,60,000 | 3,15,0000 | | |
| Working Capital (CA-CL) | 70,000 | 1,50,000 | | |
| Net Increase in Working Capital | 80,000 | – | | 80,000 |
| | 1,50,000 | 1,50,000 | 2,04,000 | 2,04,000 |

**Illustration 17.2** From the following balance sheets of Bharat Company prepare a statement showing changes in working capital.

| *Particulars* | *31st March, 2016* (₹) | *31st March, 2015* (₹) |
|---|---|---|
| **I. Equity and Liabilities** | | |
| *Shareholder's Funds* | | |
| Share Capital | 1,50,000 | 1,25,000 |
| Reserve and Surplus | | |
| –Profit and Loss Account | 75,00 | 60,000 |
| –Preliminary Expenses | (3,000) | (5,000) |
| *Non-current Liabilities* | – | – |
| *Current liabilities* | | |
| Short-term Borrowings | | |
| –Loans (Payable on demand) | 20,000 | – |
| Trade Payables | | |
| – Trade creditors | 45,000 | 50,000 |
| – Bills payable | 35,000 | 20,000 |
| | 3,22,000 | 2,50,000 |
| **II. Assets** | | |
| *Non-current Assets* | | |
| Tangible Fixed Assets | | |
| – Land | 27,000 | 15,000 |
| Intangible Assets | | |
| – Goodwill | 5,000 | 10,000 |
| Non-current Investments | 10,000 | 15,000 |
| Current Assets | | |
| – Inventories (Stock) | 1,20,00 | 87,000 |
| – Trade Receivables (Debtors) | 90,000 | 98,000 |
| – Cash and cash equivalents | 70,000 | 25,000 |
| | 3,22,000 | 2,50,000 |

**Solution :**

**Statement Showing Changes in Working Capital**

| *Particulars* | *31st Mar., 2015* ₹ | *31st Mar., 2016* ₹ | *Effect on Working Capital* *Increase* ₹ | *Decrease* ₹ |
|---|---|---|---|---|
| *Current Assets :* | | | | |
| Cash | 25,000 | 70,000 | 45,000 | |
| Debtors | 98,000 | 90,000 | | 8,000 |
| Closing Stock | 87,000 | 1,20,000 | 33,000 | |
| | 2,10,000 | 2,80,000 | | |
| *Current Liabilities:* | | | | |
| Trade Creditors | 50,000 | 45,000 | 5,000 | |
| Bills Payable | 20,000 | 35,000 | | 15,000 |
| Loans (Payable on demand) | | 20,000 | | 20,000 |
| | 70,000 | 1,00,000 | | |
| Working Capital (CA-CL) | 1,40,000 | 1,80,000 | | |
| Net increase in Working Capital | 40,000 | | | 40,000 |
| | 1,80,000 | 1,80,000 | 83,000 | 83,000 |

**Note.** Loans (payable on demand) is a current liability.

## 17.4 PURPOSE OF PREPARING THE STATEMENT

A statement of changes in working capital is prepared to measure the increase or decrease in the individual items of current assets and current liabilities. It also shows the net increase or decrease in the working capital during the accounting period. Changes in working capital is included in cash flow from operations because companies typically increase and decrease their current assets and current liabilities to fund their ongoing operations. When a company increases its current assets, it's a cash outflow: The company had to shell out money to buy the extra assets. Likewise, when a company increases its current liabilities, it's a cash inflow: The added liabilities, such as short-term debt, provide money. Changes in working capital simply shows the net affect on cash flows of this adding and subtracting from current assets and current liabilities. When changes in working capital is negative, the company is investing heavily in its current assets, or else drastically reducing its current liabilities. When changes in working capital is positive, the company is either selling off current assets or else raising its current liabilities.

For many growing companies, changes in working capital is a little like capital spending: It's money the company is investing-in things like inventory-in order to grow. To get a true picture of the cash a company is generating before investment, one can add back changes in working capital to cash flow from operations. Another point: A negative value for changes in working capital could mean the company is investing heavily in growth, or that something's gone wrong. If a company is having trouble selling its goods, inventories will balloon, and changes in working capital will turn sharply negative.

## 17.5 STEPS TO FOLLOW TO PREPARE A STATEMENT OF CHANGES IN WORKING CAPITAL

First, draw the pro forma. Then, identify and enter all current assets under the heading of current assets. In turn, enter the current assets for the base year and current year in the respective columns.

Now, ascertain the difference in the current assets between the two periods. Enter the difference in the increase or decrease column, depending on the situation.

In turn, identify current liabilities and enter them under the heading of current liabilities. Then, enter the amount of current liabilities for the base year and current year in the respective columns.

The next step is to determine the difference in the current liabilities between the two periods. Enter the difference in the increase or decrease column, depending on the situation.

Add up the current assets and current liabilities for the previous year and current year. Denote the total current assets by A and current liabilities by B.

Calculate working capital for both the current period and base period by subtracting current liabilities (B) from current assets (A).

As the next step, compare the difference between the amount of working capital for the current and the base year.

If the working capital of the current year is greater than the working capital of the previous year, enter the difference in working capital in the previous year. In the relevant column, enter the increase in working capital against the amount written.

If the working capital of the current year is less than the working capital of the previous year, enter the difference in working capital in the current year. In the relevant column, enter the decrease in working capital against the amount written.

Finally, add up both of the columns for the previous and current years.

## 17.6 ITEMS REQUIRING ADVANCE TREATMENT WHILE PREPARING A STATEMENT OF CHANGES IN WORKING CAPITAL

The following items require particular care while preparing a funds flow statement.

1. Digging out Hidden Information: While preparing a funds flow statement, one has to analyse the given balance sheets. Items relating to current accounts, i.e., current assets and current liabilities have to be shown in the schedule of changes in working capital. But the non-current assets and non-current liabilities have to be further analysed to find out the hidden information in regard to sale or purchase of non-current assets, issue or redemption of share capital, raising or repayment of long-term loans, transfers

to reserves and provisions, etc.

The hidden information can be dug out either by preparing working notes in the statement form or preparing concerned accounts of non-current assets and non-current liabilities. Both of these methods have been clarified in the following illustrations :

**Illustration 17.3** The following information has been extracted from the Balance Sheets of a company.

| | *31st March 2010* ₹ | *31st March 2011* ₹ |
|---|---|---|
| Machinery | 80,000 | 2,00,000 |
| Accumulated Depreciation | 30,000 | 35,000 |
| Profit and Loss Account | 25,000 | 40,000 |

The following additional information is also available:

*(i)* A machine costing ₹ 20,000 was purchased during the year by issue of equity shares.

*(ii)* On April 1, 2010, a machine costing ₹ 15,000 (with an accumulated depreciation of ₹ 5,000) was sold for ₹ 7,000.

Find out sources/application of funds.

**Solution :**

**Accumulated Depreciation A/c**

| | ₹ | | ₹ |
|---|---|---|---|
| To Machinery A/c | 5,000 | By Balance b/d | 30,000 |
| To Balance c/d | 35,000 | By Adjusted P/L A/c (balancing figure) | 10,000 |
| | 40,000 | | 40,000 |

**Machinery A/c**

| | ₹ | | ₹ |
|---|---|---|---|
| To Balance b/d | 80,000 | By Cash (sales) | 7,000 |
| To Share Capital | 20,000 | By Accumulated Depreciation | 5,000 |
| To Cash -Purchases (balancing figure) | 1,15,000 | By Adjusted P/L A/c (Loss on sale) | 3,000 |
| | | By Balance c/d | 2,00,000 |
| | 2,15,000 | | 2,15, 000 |

**Adjusted Profit and Loss A/c**

| | ₹ | | ₹ |
|---|---|---|---|
| To Accumulated Depreciation A/c | 10,000 | By Balance b/d | 25,000 |
| To Machinery A/c (Loss on sale) | 3,000 | By Funds from operations | |
| To Balance c/d | 40,000 | (balancing figure) | 28,000 |
| | 53,000 | | 53,000 |

*(i)* Purchase of machinery for ₹ 20,000 by issue of equity shares is neither a source nor an application of funds.

*(ii)* Sale of machinery for ₹ 7,000 is a source of funds.

*(iii)* Purchase of machinery for ₹ 1,15,000 for cash is an application of funds.

*(iv)* Funds from operations of ₹ 28,000 is a source of funds.

Alternatively

| | | | |
|---|---|---|---|
| **(1)** | **Calculations for purchase of machinery** | | ₹ |
| | Opening Balance (at cost) | | 80,000 |
| | *Add :* Purchase of machinery for issue of equity shares | | 20,000 |
| | | | 1,00,000 |
| | *Less :* Cost of machinery sold | | 15,000 |
| | | | 85,000 |
| | Machinery at the end of the year | | 2,00,000 |
| | Machinery purchased during the year for cash (Application) | | 1,15,000 |
| **(2)** | **Depreciation on machinery** | | |
| | Opening Balance of Accumulated Depreciation | | 30,000 |
| | *Less :* Depreciation on machinery sold | | 5,000 |
| | | | 25,000 |
| | Closing Balance | | 35,000 |
| | Depreciation provided during the year | | 10,000 |
| **(3)** | **Loss on sale of machinery** | | |
| | Cost of machinery sold | | 15,000 |
| | *Less :* Accumulated Depreciation | | 5,000 |
| | | | 10,000 |
| | Less : Sale value (source) | | 7,000 |
| | Loss on sale | | 3,000 |
| **(4)** | **Funds from operations** | | |
| | Closing Balance of P/L A/c : | | 40,000 |
| | *Add* : Non-fund and non-operating items which have been debited to P/L A/c : | ₹ | |
| | Depreciation | 10,000 | |
| | Loss on sale machinery | 3,000 | 13,000 |
| | | | 53,000 |
| | *Less* : Opening Balance of P/L A/c | | 25,000 |
| | Funds from operations (source) | | 28,000 |

**2. Investments:** The treatment of investments while preparing funds flow statement depends upon their nature, i.e., whether they are current assets or fixed (long-term) or non-current assets. If the investments represent surplus funds temporarily invested in marketable or short-term securities, they are to be treated as current assets. But if investments are long-term, permanent or trade investments, these should be treated as fixed assets.

**(a) Temporary Investments.** When the surplus funds are temporarily invested in marketable securities, they are treated as current assets and hence shown in the schedule of changes in Working Capital. Temporary investments do not require any further treatment while preparing funds flow statement like all other current assets.

**(b) Long-term, Permanent or Non-Current Investments.** If the investments are of non-current nature, these should not be shown in the schedule of changes in working capital because they are not current assets. However, in this case, an investment account should be prepared as it is prepared in the books of accounts to find out the cost of investments purchased or sold during the year and the profit or loss on sale of such investments, if any. Sometimes, the investments are purchased-cum-dividend and the pre-acquisition dividend received is credited to the investment account. If there is a loss on sale of such investments and it has been debited to P/L A/c, it should be added back while finding funds from operations or shown on the debit side of adjusted profit and loss account (depending upon which method is followed) for the reason that such loss is not an operating loss. However, for the same reason, if a profit on sale of such investments has been credited to profit and loss account, it should be deducted while finding funds from operations or shown on the credit side of adjusted profit and loss account, as the case may be.

The purchase of non-current or trade investments is an application of funds while the proceeds realised from the sale of such investments are a source of funds.

**Illustration 17.4.** The extracts of a balance sheet reveal that there is an opening balance of trade investments amounting to 20,000 and a closing balance of Z 30,000, 3,000 by way of dividends have been received during the year including 1,000 from pre-acquisition profits which have been credited to Investments Account. You are required to find out the cost of investments purchased during the year to be shown as application of funds.

**Solution :**

| Investment Account | | | |
|---|---|---|---|
| | ₹ | | ₹ |
| To Balance b/d (Opening balance) | 20,000 | By Dividend A/c (Pre-acquisition) | 1,000 |
| To Cash (Purchases during the year-balancing figure) | 11,000 | By Balance c/d (Closing balance) | 30,000 |
| | 31,000 | | 31,000 |

*Alternatively :*

*Calculation of Purchase of Investments*

| | ₹ |
|---|---|
| Opening Balance | 20,000 |
| Less : Dividend being pre-acquisition credited to Investments A/c | 1,000 |
| | 19,000 |
| Closing Balance | 30,000 |
| Purchase of Investments during the year (balancing figure) | 11,000 |

**3. Provision for Taxation:** There are two ways of dealing with provision for taxation:

(i) As a current liability

(ii) As an appropriation of profits.

**(i) As a current liability.** Provision for taxation may be treated as a current liability as it, generally, 7epresents an immediate obligation of the company to pay tax to the Government. When it is treated as a current liability, provision for taxation will appear in the schedule of changes in working capital like all other current liabilities and no further treatment is required while preparing the funds flow statement. In this case, there is no need to prepare the provision for Taxation Account and the payment of tax made .during the year shall not be shown as an application of funds because in that case both the accounts Involved for the payment of tax shall be current accounts, e.g., the entry for taxes paid during the year shall be :

| | |
|---|---|
| Provision for Taxation A/c Dr. | (already taken as Current Liability) |
| To Cash A/c | (Current Asset) |

It is clear from the above entry that only the current accounts are involved and hence there is no movement of funds (Working Capital).

(ii) As on appropriation of profits. When the provision for taxation is treated as an appropriation of profits and not as a current liability, then it shall not appear in the schedule of changes in working capital. Provision for taxation made during the year then shall be the appropriation of profits made during the year and will have to be added back while finding funds from operations being a non-fund item. If an adjusted profits and loss account is prepared, provision for taxation made during the year shall appear on the debit side for the same reasons. Moreover, the taxes paid during the year shall be an application of funds (not being a current liability) and will have to be shown in the funds flow statement on the application side.

A provision for taxation account may have also to be prepared in case of hidden information, i.e., when the provision for taxation made during the year or the taxes paid during the year are not given.

However, the students may note that it is preferable to assume provision for taxation as a current liability as generally it is an immediate obligation of the company to pay it and it rarely represents an appropriation of profits.

**Illustration 17.5.** The opening balance in the Provision for Taxation Account as on 1st April, 2010 was 30.000 and the closing balance on 31st March, 2011 was 40,000. The taxes paid during the year amounted to 25,000. How will you deal with this item in the funds flow statement ?

**(A) When provision for taxation is treated as a current liability.**

Provision for taxation shall simply be shown in the schedule of changes in working capital and it will have no further effect on the fiords flow statement:

**Schedule of Changes in Working Capital**

| | *1-4-2010* ₹ | *31-3-2011* ₹ | *Increase in Working Capital* ₹ | *Decrease in Working Capital* ₹ |
|---|---|---|---|---|
| *Current Liabilities* | | | | |
| Provision for Taxation | 30,000 | 40,000 | | 10,000 |

**(B) When provision for taxation is treated as an appropriation of profits:**

(1) It will not be shown in the schedule of changes in working capital.

(2) Taxes paid during the year i.e., `25,000 is an application of funds and will appear on the application side of funds flow statement.

**Funds Flow Statement**
**for the year ended 31-3-2011**

| *Sources* | ₹ | *Application* | ₹ |
|---|---|---|---|
| | | *Taxes Paid* | 25,000 |

(3) Provision for taxation made during the year *i.e.,* ₹ 35,000 shall have to be calculated as below and it will be added back (or shall be shown on the debit side of adjusted profit and loss account) while finding funds from operations.

*Calculation of Provision for taxation made during the year.*

| | ₹ |
|---|---|
| Opening balance of provision for tax on 1-4-2010 | 30,000 |
| *Less :* taxes paid during the year | 25,000 |
| | 5,000 |
| Closing balance of provision on 31-3-2011 | 40,000 |
| Provision made during the year | 35,000 |

**OR**

**Provision for Taxation A/c**

| | | | |
|---|---|---|---|
| To Cash (tax paid) | 25,000 | By Balance b/d | 30,000 |
| To Balance c/d | 40,000 | By Adjusted P/L A/c (Provision made-balancing figure) | 35,000 |
| | 65,000 | | 65,000 |

**4. Proposed Dividends:**

Proposed dividend though shown on the liabilities side of a Balance Sheet is not a liability in real sense until it is formally declared to be paid to the shareholders in the Annual General Meeting of the Company. Till such declaration of dividends, it simply represents an appropriation of profits and is like a reserve or surplus. But generally, declarations of dividends proposed by the directors are accepted in the shareholders meeting. In that case, proposed dividend cannot be said to be an appropriation of profits as these become payable within a short time after they are proposed. So there are two alternatives to deal with this item in the same way as that of provision for taxation:

(i) **As a current liability.** When proposed dividend is treated as a current liability it represents an obligation of the company which is payable in a short period. Hence, it is shown in the schedule of changes in working capital as a current liability and it requires no further treatment in the funds flow statement.

(ii) **As an appropriation of profits.** When proposed dividend is treated as an appropriation of profits it is not a current liability and hence will not be shown in the schedule of changes in working capital. In this case, dividends proposed during the year, being an appropriation, are added back (or shown on the debit side of adjusted profit and loss account) while finding funds from operations. Thus, dividends paid during the year represent an application of funds and have to be shown on the application side of funds flow statement. In the absence of any information, proposed dividend for the previous year may be assumed to be paid during the year and taken as an application of funds while the proposed dividend of the current year, being an appropriation, may be added while finding funds from operations.

In any case, the students may note that the treatment of proposed dividend is much similar to the provision for taxation and it is also preferable to treat proposed dividend as a current liability because generally the dividends proposed by the directors are accepted by the shareholders in the Annual General Meeting and these become payable within a short period.

5. **Interim Dividend:** The expression 'interim dividend' denotes a dividend paid to the members of the company during a financial year, before the finalisation of annual accounts. The dividend paid or declared in between the two Annual General Meetings, i.e., interim dividend, should be added back (or debited in adjusted profit and loss account) while calculating funds from operations. However, if the figure of profit is taken prior to the debit and has to appear on the application side of funds flow statement.

**Illustration 17.6.** Extracts from the Balance Sheets:

| | 31-3-2010 ₹ | 31-3-2011 ₹ |
|---|---|---|
| Proposed Dividend | 50,000 | 70,000 |
| Profit and Loss A/c (Cr.) | 2,00,000 | 3,00,000 |

*Additional Information :*

Dividend paid during the year is ₹ 50,000.

Find out sources and applications of funds.

**Solution :**

**Proposed Dividend A/c**

| | ₹ | | ₹ |
|---|---|---|---|
| To Cash-Dividend Paid | 50,000 | By Balance b/d | 50,000 |
| | | By Adjusted P/L A/c | 70,000 |
| To Balance c/d | 70,000 | (balancing figure) | |
| | 1,20,000 | | 1,20,000 |

**Adjusted P/L A/c /c**

| | ₹ | | ₹ |
|---|---|---|---|
| To Proposed Dividend | 70,000 | By Balance b/d | 2,00,000 |
| To Balance c/d | 3,00,000 | By Funds from Operations | 1,70,000 |
| | | (balancing figure) | |
| | 3,70,000 | | 3,70,000 |

(*i*) Dividend paid ₹ 50,000 is an application of funds.

(*ii*) Funds from operations of ₹ 1,70,000 is a source of funds.

**Note.** In case proposed dividend is taken as a current liability and shown in the schedule of changes in working capital, payment of dividend of ₹ 50,000 is not an application of funds and no adjustment is required to calculate funds from operations.

6. **Provision against Current Assets:** Provision against current assets, such as, provision for bad debts and doubtful debts, provision for loss on stock, etc. may be treated by any of the following methods:

(a) The opening and closing balance of provision against current assets should be deducted from the respective opening and closing balance of the concerned asset. The net amount of the current assets should then be shown in the schedule of changes in working capital. It does not require any further treatment in the funds flow statement.

(b) The amount of the opening and closing balance of the current assets may be taken as gross in the schedule of changes in working capital, i.e., without deducting the amount of provision. But, then, the opening and closing balance of the provision against current assets shall have to be taken as a current liability in the schedule of changes in working capital and it will not need any further treatment in the funds statement.

(c) If excess provision has been created, it may be treated as an appropriation of profits and should be added while calculating funds from operations. The amount of the excess provision will not be shown in the schedule of changes in working capital.

## 17.7 SUMMARY

With the help of a fund flow statement format, we can prepare the fund flow statement. The company prepares this statement to analyze the changes in working capital between two balance sheets. It is based on historical data. It helps the management make future decisions, but management cannot take the entire decision based on only the fund flow statement because it considers only fund-based items. Last, management should prepare this statement because it considers all sources, i.e., from where the funds are coming, and all applications, i.e., where the funds are going. This summarized statement helps management to move further.

The treatment of investments while preparing funds flow statement depends upon their nature, i.e., whether they are current assets or fixed (long-term) or non-current assets. If the investments represent surplus funds temporarily invested in marketable or short-term securities, they are to be treated as current assets. But if investments are long-term, permanent or trade investments, these should be treated as fixed assets.

Provision for taxation may be treated as a current liability as it, generally, represents an immediate obligation of the company to pay tax to the Government. When it is treated as a current liability, provision for taxation will appear in the schedule of changes in working capital like all other current liabilities and no further treatment is required while preparing the funds flow statement.

Proposed dividend though shown on the liabilities side of a Balance Sheet is not a liability in real sense until it is formally declared to be paid to the shareholders in the Annual General Meeting of the Company. Till such declaration of dividends, it simply represents an appropriation of profits and is like a reserve or surplus. But

generally, declarations of dividends proposed by the directors are accepted in the shareholders meeting.

The expression 'interim dividend' denotes a dividend paid to the members of the company during a financial year, before the finalization of annual accounts. The dividend paid or declared in between the two Annual General Meetings, i.e., interim dividend, should be added back (or debited in the adjusted profit and loss account) while calculating funds from operations. However, if the figure of profit is taken prior to the debit of interim dividend this adjustment is not required. The interim dividend is also an application of funds and has to appear on the application side of funds flow statement.

## 17.8 GLOSSARY

- **Working Capital:** Working capital means the excess of current assets over current liabilities.
- **Statement of Changes in Working Capital:** It is prepared to show the changes in the working capital between the two balance sheet dates.
- **Accrued Dividend:** It is also known as dividends payable-are dividends on a common stock that have been declared by a company but have not yet been paid to shareholders.
- **Interim dividend:** An interim dividend is a dividend payment made before a company's annual general meeting (AGM) and the release of final financial statements.
- **Proposed dividend:** Proposed dividend is the dividend recommended by the Board of directors of a company in relation to a certain financial year after the expiry of the financial year but before the approval of the concerned financial statements and is shown in the Balance sheet of the said financial year as a liability.

## 17.9 SELF ASSESSMENT QUESTIONS

1. What is a Statement of changes in Working Capital?

2. What is the purpose of preparing the Statement of Changes in Working Capital?

3. How will you treat proposed dividend and provision for taxation while preparing funds flow statement?

## 17.10 LESSON END EXERCISE

1. How Is The Statement Of Changes In Working Capital Calculated?

2. How Can I Use The Statement Of Changes In Working Capital To Improve My Business?

3. Prepare a schedule of changes in working capital and statements of funds of flow Balance sheet as on 31st March 2022

| Liabilities | 2020 | 2021 | Assets | 2020 | 2021 |
|---|---|---|---|---|---|
| Share capital | 150000 | 180000 | Land and building | 85000 | 85000 |
| Profit and loss a/c Loans | 35000 | 42000 | Plant and machinery | 54000 | 70000 |
| Loans | 2000 | 15000 | stock | 30500 | 50000 |
| Creditors | 17000 | 23000 | Debtors | 25500 | 45000 |
| Bills payable | 3000 | 1000 | Bills receivable | 5000 | 2000 |
| | | | Cash | 7000 | 9000 |
| | **207000** | **261000** | | **207000** | **261000** |

4. From the following Balance Sheet of Krishna Ltd., prepare a schedule of changes in working capital and a funds flow statement:

| *Liabilities* | *2013* ₹ | *2014* ₹ | *Assets* | *2013* ₹ | *2014* ₹ |
|---|---|---|---|---|---|
| Capital | 63,000 | 1,00,000 | Cash | 15,000 | 20,000 |
| Long-term Borrowings | 50,000 | 60,000 | Debtors | 30,000 | 28,000 |
| Trade Creditors | 42,000 | 39,000 | Stock-in-trade | 55,000 | 72,000 |
| Bank Overdraft | 35,000 | 25,000 | Land and Buildings | 80,000 | 1,00,000 |
| Outstanding Expenses | 5,000 | 6,000 | Furniture | 15,000 | 10,000 |
| | 1,95,000 | 2,30,000 | | 1,95,000 | 2,30,000 |

## 17.11 SUGGESTED READINGS


- Gupta, Sashi, K. (2015). Financial Management. Kalyani Publisher, New Delhi.
- Jain, S.P and Narang, K.L. (2014). Advanced Acountancy-Vol-II. Kalyani Publisher, New Delhi.
- Gupta, Sashi, K. (2015). Management Accounting. Kalyani Publisher, New Delhi.
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# FUNDS FLOW STATEMENT AND CASH FLOW STATEMENT

| M.Com II Sem. | Advanced Accounting | Unit-IV |
|---|---|---|
| M.COMC250 | | Lesson No. 18 |

**STRUCTURE:**



## 18.1 INTRODUCTION

The Second thing which is needed for Funds Flow Statement is Funds from Operations which reveals if the company earns a profit, it will be a source of funds, and if there is a loss, it will be an application of funds. Last one is Fund Flow Statement. After ensuring the above two requirements, the firm will prepare the fund flow statement, which will comprise all outflow and inflow of funds. Source of Fund is used to know where funds have been arranged for investment. The source of the fund can be in the form of the issue of shares, debentures, profit from operations, dividends received on investments, and proceeds from borrowings, etc. Application of fund is used to know where the arranged funds have been invested. Application of funds can be in the purchase of fixed assets, increased working capital, purchase of investments, the dividend paid, repayment of borrowings, interest paid, etc.

## 18.2 OBJECTIVES

After reading this lesson you will be able to:

- Prepare the funds flow statement.
- Calculate the funds from operations.
- Learn about the sources and applications of funds.

## 18.3 MEANING OF FUND FLOW STATEMENT

A company prepares a Profit and Loss (P&L) statement and balance sheet, then what is the need for funds flow statement? The P&L Statement and Balance sheet are two statements that portray the financial position for the past and current year. They do not explain why the financial position has changed. That's where the fund flow statement is required and its need for long and short-term funds. It also explains the following:

- Fund Sources or where the funds came in from with their sources.
- Fund application or where the long or short-term funds have been used.

**Example of fund flow statement:**

Companies have long-term funds in non-current assets like patents, other investments in various companies, plant and machinery, intellectual property rights, equipment, buildings etc. Thus, non-current assets are created in a financial year whose monetary value is not fully realised in that accounting and financial year. Due to this, two situations arise, such as:

- When the long-term funds finance the non-current assets: The fund flow statement will reflect these assets utilised from the long-term funds. These changes can be understood if the company is using only long-term funds to finance the non-current assets. It is deemed as a healthy organisational behaviour that is growing positively with the proper fund usage.

- When the short term funds finance the non-current assets: The changes in the fund flow statement reflect usage of short-term funds. This is undesirable as it indicates the dangerous use of short-term funds on a long-term investment which is risky. Especially when the company is likely to be cash strapped for its short-term needs and financial obligations since the investments are long-term and cannot be easily liquidated.

Thus, the fund flow analysis can pinpoint the change and application of working capital, be it long or short term funds, through its utilisation and is an index of its financial health. It is widely used to interpret the impact of changes in funds position and its uses in the interim period between two balance sheets through its proper interpretation.

## 18. 4 FUND FLOW STATEMENT BENEFITS

From the above discussion, one can easily enumerate the benefits of a fund flow statement as:

- An aid to fund managers in explaining the strain on working capital and liquidity of a company, though the P&L Statement may declare it to be profitable.

- It helps the fund managers explain the financial strengths of a company despite its operational losses.

- It helps the fund managers analyse the fund flow and risk level when misusing short-term funds to finance long-term assets. Usually, this is a grey area that is not reflected in either the company's balance sheet or P&L statement.

## 18. 5 SPECIMEN OF FUNDS FLOW STATEMENT

*(a)* Report Form

*(b)* T Form or An Account Form or Self Balancing Type.

**Specimen of Report From of Funds Flow Statement**

| | ₹ |
|---|---|
| *Sources of Funds :* | |
| Funds from Operations | |
| Issue of Share Capital | |
| Raising of long-term loans | |
| Receipts from partly paid shares, called up | |
| Sales of non current (fixed) assets | |
| Non-trading receipts, such as dividends received | |
| Sale of Investments (long-term) | |
| Decrease in Working Capital | |
| (as per schedule of changes in Working Capital) | |
| Total | |
| *Applications or Uses of Funds :* | |
| Funds Lost in Operations | |
| Redemption of Preference Share Capital | |
| Redemption of Debentures | |
| Repayment of long-term loans | |
| Purchase of non-current (fixed) assets | |
| Purchase of long-term Investments | |
| Non-trading payments | |
| Payments of dividends* | |
| Payment of tax* | |
| Increase in Working Capital | |
| (as per schedule of changes in working capital) | |
| Total | |

**T Form or An Account Form or Self Balancing Type**
**Funds Flow Statement**
**(For the year ended.......)**

| *Sources* | ₹ | *Applications* | ₹ |
|---|---|---|---|
| Funds from Operations | | Funds lost in Operations | |
| Issue of Share Capital | | Redemption of Preference Share Capital | |
| Issue of Debentures | | Redemption of Debentures | |
| Raising of long-term loans | | Repayment of long-term loans | |
| Receipts from partly paid shares, called up | | Purchase of non-current (fixed) assets | |
| Sale of non-current (fixed) assets | | Purchase of long-term investments | |
| Non-trading receipts such as dividends | | Non-trading payments | |
| Sale of long-term Investments | | Payment of Dividends* | |
| Net Decrease in Working Capital | | Payment of tax* | |
| | | Net Increase in Working Capital | |

* **Note.** Payment of dividend and tax will appear as an application of funds only when these items are appropriations of profits and not current liabilities.

## 18.6 SOURCES OF FUNDS

- The following are the sources from which funds generally flow (come), into the business:

**(1) Funds From Operations or Trading Profits.** Trading profits or the profits from operations of the business are the most important and major source of funds. Sales are the main source of inflow of funds into the business as they increase current assets (cash, debtors or bills receivable) but at the same time funds flow out of business for expenses and cost of goods sold. Thus, the net effect of operations will be a source of funds if inflow from sales exceeds the outflow for expenses and cost of goods sold and vice-versa. But it must be remembered that funds from operations do not necessarily mean the profit as shown by the profit and loss account of a firm, because there are many non-fund or non-operating items which may have been either debited or credited to profit and loss account. The examples of such items on the debit side of a profit and loss account are : Amortization of fictitious and intangible assets such as goodwill, Preliminary expenses and Discount on issue of shares and debentures written off ; Appropriation of Retained Earnings, such as Transfers to Reserves, etc., Depreciation and depletion ; Loss on sale of fixed assets ; Payment of dividend, etc. The non-fund items are those which may be operation al expenses but they do not affect funds of the business, e.g., for depreciation charged to profit and loss account_ funds really do not move out of business. Non-operating items are those which although may result in the outflow of funds but are not related to the trading operations of the business, such as loss on sale of machinery or payment of dividends. The methods of calculating funds from operations have been discussed in the following pages.

- Basically, there are two methods of calculating funds from operations :
- (a) The first method is to prepare the profit and loss account afresh by taking into consideration only fund and operational items which involve funds and are related to the normal operations of the business. The balancing figure in this case will be either funds generated from operations or funds lost in operations depending upon whether the income or credit side of profit and loss account exceeds the expense or debit side of profit and loss account or vice-versa.

- (b) The second method (which is generally used) is to proceed from the figure of net profit or net loss as arrived at from the profit and loss account already prepared. Funds from operations by this method can be calculated as under :

| *(a)* **Calculation of Funds from Operation** | |
|---|---|
| Closing Balance of P & L A/c or Retained Earnings (as given in the balance sheet) | ₹ |
| *Add* : Non-fund and Non-operating items which have been already debited to P & L A/c : | |
| *(i)* Depreciation and Depletion | |
| *(ii)* Amortization of fictitious and Intangible Assets such as : | |
| *(a)* Goodwill | |
| *(b)* Patents | |
| *(c)* Trade Marks | |
| *(d)* Preliminary Expenses | |
| *(e)* Discount on Issue of Shares, etc. | |
| *(iii)* Appropriation of Retained Earnings, such as : | |
| *(a)* Transfer to General Reserve | |
| *(b)* Dividend Equialisation Fund | |
| *(c)* Transfer to Sinking Fund | |
| *(d)* Contingency Reserve, etc. | |
| *(iv)* Loss on Sale of any non-current (fixed) assets such as : | |
| *(a)* Loss on sale of land and building | |
| *(b)* Loss on sale of machinery | |
| *(c)* Loss on sale of furniture | |
| *(d)* Loss on sale of long-term investments, etc. | |
| *(v)* Dividends including : | |
| *(a)* Interim Dividend | |
| *(b)* Proposed Dividend (if it is an appropriation of profits and not taken as current liability) | |
| *(vi)* Provision for Taxation (if it is not taken as current liability) | |
| *(vii)* Any other non-fund/non-operating items which have been debited to P/L A/c | |
| Total (A) | |
| *Less* Non-fund or Non-operating items which have already been credited to P & L A/c | |
| *(i)* Profit or Gain from the sale of non-current (fixed) assets such as : | |
| *(a)* Profit on sale of land and building | |
| *(b)* Profit on sale of plant & machinery | |
| *(c)* Profit on sale of long-term investments, etc. | |
| *(ii)* Appreciation in the value of fixed assets, such as increase in the value of land if it has been credited to P/L A/c | |
| *(iii)* Dividends Received | |
| *(iv)* Excess Provision retransferred to P/L A/c or written off | |
| *(v)* Any other non-operating item which has been credited to P/L A/c | |
| *(vi)* Opening balance of P & L A/c or Retained Earnings (as given in the balance sheet) | |
| Total (B) | |
| Total (A) – Total (B) = Funds generated by operations | |

*(b)* **Funds from operations can also be calculated by preparing Adjusted Profit and Loss Account as follows:**

**Adjusted Profit and Loss Account**

| | ₹ | | ₹ |
|---|---|---|---|
| To Depreciation & Depletion or amortization | | By Opening Balance (of P & L A/c) | |
| By Transfers from excess provisions | | | |
| By Appreciation in the value of fixed assets | | | |
| By Dividends received | | | |
| By Interest on investments | | | |
| By Profit on sale of fixed or non-current assets | | | |
| By *Funds from Operations* (balancing figure in case debit side exceeds credit side) | | | |
| To Dividends (including interim dividend) | | | |
| To Proposed Dividend (if not taken as a current liability) | | | |
| To Provision for taxation (if not taken as a current liability) | | | |
| To Closing balance (of P & L A/c) | | | |
| To *Funds lost in Operations* (balancing figure, in case credit side exceeds the debit side) | | | |

**lustration 18.1.** B.M Traders present the following information and you are required to calculate the funds from operations:

**Profit and Loss Account**

| | ₹ | | ₹ |
|---|---|---|---|
| To Expenses : | | By Gross Profit | 2,00,000 |
| Operation | 1,00,000 | By Gain on Sale of Plant | 20,000 |
| Depreciation | 40,000 | | |
| To Loss on Sale of building | 10,000 | | |
| To Advertisement Suspense A/c | 5,000 | | |
| To Discount (allowed to customers) | 500 | | |
| To Discount on Issue of Shares written off | 500 | | |
| To Goodwill | 12,000 | | |
| To Net Profit | 52,000 | | |
| | 2,20,000 | | 2,20,000 |

**Solution:**

**Calculation of Funds from Operations**

| | | ₹ |
|---|---|---|
| Net Profit (as given) | | 52,000 |
| *Add:* Non-fund or non-operating items which have been debited to P/L A/c : | ₹ | |
| Depreciation | 40,000 | |
| Loss on sale of building | 10,000 | |
| Advertisement written off | 5,000 | |
| Discount on issue of shares written off | 500 | |
| Goodwill written off | 12,000 | 67,500 |
| | | 1,19,500 |
| *Less :* Non-fund or non-operating items which have been credited to P/L A/c : Gain on sale of Plant | 20,000 | |
| | | 20,000 |
| Funds from Operations | | 99,500 |

**Alternatively :**

**Adjusted Profit and Loss Account**

| | ₹ | | ₹ |
|---|---|---|---|
| To Depreciation | 40,000 | By Opening balance | — |
| To Loss on sale of building | 10,000 | By Gain on sale of plant | 20,000 |
| To Advertisement Suspense A/c | 5,000 | By Funds from Operations | |
| To Discount on issue of shares | 500 | (balancing figure) | 99,500 |
| To Goodwill | 12,000 | | |
| To Closing balance | 52,000 | | |
| | 1,19,500 | | 1,19,500 |

**Illustration 18.2.** Calculate 'Funds from Operations' from the information given below as on 31st March 2013:

(i) Net profit for the year ended 31st March 2013, ₹6,50,000.

*(ii)* Gain on the sale of building ₹ 35,500.

*(iii)* Goodwill appears in the books at ₹ 1,80,000 out of that 10 per cent has been written off during the year.

*(iv)* Old machinery worth ₹ 8,000 has been sold for ₹ 6,500 during the year.

*(v)* ₹ 1,25,000 have been transferred to the General Reserve Fund.

*(vi)* Depreciation has been provided during the year on machinery and furniture at 20% whose total cost is ₹ 6,50,000.

**Solution :**

**Calculation of Funds from Operations**

| | | ₹ | ₹ |
|---|---|---|---|
| | Net profit for the year (as given) | | 6,50,000 |
| *Add :* | Non-fund and non-operating items which have been debited to P/L A/c : | | |
| | | ₹ | |
| | Goodwill written off | 18,000 | |
| | Los on sale of machinery (₹ 8,000–6,500) | 1,500 | |
| | Transfer to General Reserve Fund | 1,25,000 | |
| | Depreciation @ 20% on 6,50,000 | 1,30,000 | 2,74,500 |
| *Less :* | Non-fund and non-operating items which have been credited to P/L A/c : | | 9,24,500 |
| | Gain on sale of building | 35,500 | 35,000 |
| | Funds from Operations | | 8,89,000 |

**Alternatively :**

**Adjusted Profit and Loss Account**

| | ₹ | | ₹ |
|---|---|---|---|
| To Goodwill | 18,000 | By Opening balance | — |
| To Loss on sale of machinery | 1,500 | By Gain on sale of building | 35,500 |
| To Transfer to General Reserve Fund | 1,25,000 | By Funds from operations (balancing figure) | 8,89,000 |
| To Depreciation | 1,30,000 | | |
| To Closing balance | 6,50,000 | | |
| | 9,24,500 | | 9,24,500 |

**Illustartion 18.3.** From the following balance sheets and additional information given, you are required to calculate funds from operations for the year ended 31st March, 2016.

| Particulars | Note No. | 31.3.2016 ₹ | 31.3.2015 ₹ |
|---|---|---|---|
| **Shareholder's Funds :** | | | |
| **I. Equity and Liabilities** | | | |
| **1. Shareholder's Funds :** | | | |
| (a) Share Capital | | 1,50,000 | 1,00,000 |
| (b) Reserves and Surplus | 1 | 52,000 | 50,000 |
| **2. Non-Current Liabilities :** | | | |
| Long - term Borrowings | 2 | 80,000 | 80,000 |
| Long - term Provisions | 3 | 10,000 | 5,000 |
| **3. Current Liabilities :** | | | |
| Trade Payables (Creditors) | | 58,000 | 65,000 |
| TOTAL | | 3,50,000 | 3,00,000 |
| **II. Assets** | | | |
| **1. Non-Current Assets** | | | |
| (a) Fixed Assets : | | | |
| (i) Tangible | 4 | 1,85,000 | 1,80,000 |
| (ii) Intangible | 5 | 10,000 | 20,000 |
| (b) Non-Current Investments | | 10,000 | - |
| **2. Current Assets** | | | |
| (a) Inventories | | 1,10,000 | 70,000 |
| (b) Trade Receivables | | 25,000 | 20,000 |
| (c) Cash and Cash Equivalents | | 10,000 | 10,000 |
| TOTAL | | 3,50,000 | 3,00,000 |

**Notes :**

| | 31.3.2016 ₹ | 31.3.2015 ₹ |
|---|---|---|
| **1. Reserves and Surplus :** | | |
| General Reserve | 30,000 | 30,000 |
| Balance of Profit & Loss | 22,000 | 20,000 |
| | 52,000 | 50,000 |
| **2. Long-term Borrowings :** | | |
| 6% Debentures | 80,000 | 80,000 |
| **3. Long-term Provisions :** | | |
| Provision for Employee Benefits | 10,000 | 5,000 |
| **4. Fixed Assets (Tangible) :** | | |
| Land and Building | 95,000 | 1,00,000 |
| Plant and Machinery | 90,000 | 80,000 |
| | 1,85,000 | 1,80,000 |
| **5. Intangible Fixed Assets :** | | |
| Goodwill | 10,000 | 20,000 |

**Additional Information :**

1. During the year ended 31-3-2016, dividends of ₹ 15,000 were paid.
2. Depreciation written off plant and machinery amounted to ₹ 6,000 and no depreciation has been charged on land and buildings.
3. Provision for employee benefits made during the year ₹ 5,000.
4. Profit on sale of machinery ₹ 2,000.

**Solution :**

**Calculation of Funds from Operations**

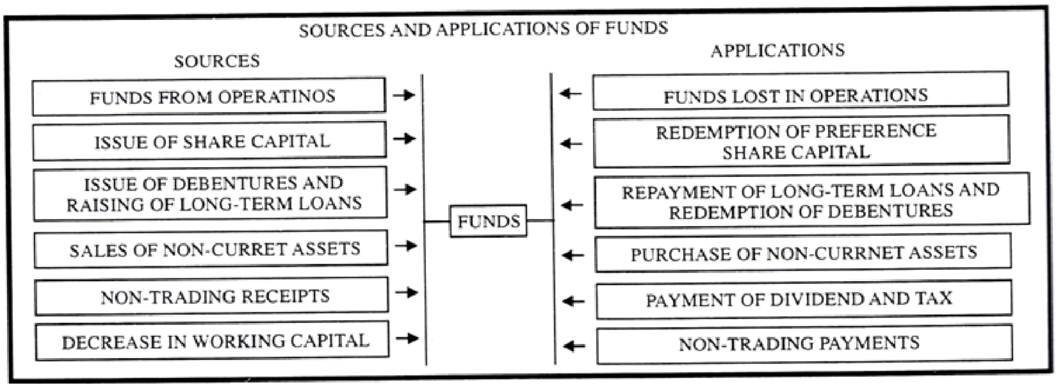
| | | ₹ |
|---|---|---|
| Closing balance of P/L A/c given in the B/S | | 22,000 |
| *Add :* Non-fund or non-operating items already debited to P/L A/c : | | |
| Depreciation | 6,000 | |
| Dividends | 15,000 | |
| Provision for employee benefits[1] | 5,000 | |
| Goodwill[2] | 10,000 | 36,000 |
| | | 58,000 |
| *Less :* Non-fund or non-operating items already credited to P/L A/c : | | |
| Profit on sale of machinery | 2,000 | |
| Opening balance of P/L A/c (given in B/S) | 20,000 | 22,000 |
| Funds from Operations | | 36,000 |

1. Provision for employee benefits has been treated as a non-current liability.
2. Goodwill written off during the year is : ₹ 20,000–₹ 10,000 = ₹ 10,000

**Alternatively**

**Adjusted Profit and Loss Account**

| | ₹ | | ₹ |
|---|---|---|---|
| To Depreciation | 6,000 | By Opening balance | 20,000 |
| To Dividends | 15,000 | By Profit on sale of machinery | 2,000 |
| To Provision for employee benefits | 5,000 | By Funds from operations | 36,000 |
| To Goodwill | 10,000 | (balancing figure) | |
| To Closing balance | 22,000 | | |
| | 58,000 | | 58,000 |




## 2. Issue of Share Capital.

If during the year there is any increase in the share capital, whether preference or equity, it means capital has been raised during the year. Issue of shares is a source of funds as it constitutes inflow of funds. Even the calls received from partly paid shares constitutes an inflow of funds. It should also be remembered that it is the net proceeds from the issue of share capital which amounts to a source of funds and hence in case shares are issued at premium, even the amount of premium collected shall become a source of funds. The same is true when shares are issued at discount ; it will not be the nominal value of shares but the actual realisation after deducting discount that shall amount tr inflow of funds. But sometimes shares are issued otherwise than in cash, the following rules must be followed : (i) Issue of shares or making of partly paid shares as fully paid out of accumulated profits in the form of bonus shares is not a source of funds. (ii) Issues of shares for consideration other than current assets such as against purchase of land_ machines, etc. does not amount to inflow of funds. (iii) Conversion of debentures or loans into shares also does not amount to inflow of funds. In all the three cases mentioned above, both the amounts involved are non-current and do not involN any current assets or funds.

(3) **Issue of Debentures and Raising of Loans, etc.** Issue of debentures or raising of loans (long-term), whether secured or unsecured results in the flow of funds into the business. The inflow of funds the actual proceeds from the issue of such debentures or raising of loans, i.e., including the amount of premium or excluding discount, if any. However, loans raised for consideration other than a current assets such as for purchase of building, will not constitute inflow of funds because in that case the accounts involved are only fixed or non-current.

(4) **Sale of Fixed (non-current)** Assets and Long-term or Trade investments. When any fixed er non-current asset like land, building, plant and machinery, furniture, long-term investments, etc. are sold it generates funds and becomes a source of funds. However, it must be remembered that if one fixed asset is exchanged for another fixed asset, it does not constitute an inflow of funds because no current assets are involved.

(5) **Non-Trading Receipts.** Any non-trading receipt like dividend received, refund of tax, rem received, etc. also increases funds and is treated as a sources of funds because such an income is nor included in the funds from operations.

(6) **Decrease in Working Capital.** If the working capital decreases during the

current periodcompared to the previous period, it means that there has been a release of funds from working capital and it constitutes a source of funds.

## 18.7 APPLICATION OR USES OF FUNDS

**(1) Funds lost in operations.** Sometimes the result of trading in a certain year is a loss and some funds are lost during that period in trading operations 1 Such loss of funds in trading amounts to an outflow of funds and is treated as an application of funds.

**(2) Redemption of preference share capital.** If during the year any preference shares are redeemed. it will result in the outflow of funds and is taken as an application of funds. When the shares are redeemed at premium or discount, it is the net amount paid (including premium or excluding discount, as the case may be). However, if shares are redeemed in exchanges of some other type of shares or debentures, it does not constitute an outflow of funds as no current account is involved in that case.

**(3) Repayment of loans or redemption of debentures, etc.** In the same way as redemption of preference share capital, redemption of debentures or repayment of loans also constitute an application of funds.

**(4) Purchase of any non-current or fixed asset:** When any fixed or non-current asset like land, building, plant and machinery, furniture, long-term investments, etc. are purchased, funds outflow from the business. However, if fixed assets are purchased for a consideration of issue of shares or debentures or if some fixed asset is exchanged for another, it does not involve any funds and hence not an application of funds.

**(5) Payments of dividends and tax.** Payments of dividends and tax are also applications of funds. It is the actual payment of dividend (may be interim dividend) and tax which should be taken as an outflow of funds and not the mere declaration of dividend or creating of a provision for taxation.

**(6) Any other non-trading payment.** Any payment or expense not related to the trading operations of the business amounts to outflow of funds and is taken as an application of funds. The examples could be drawings in case of sole trader or partnership firms, loss of cash, etc.

## 18.8 SUMMARY

With the help of a fund flow statement format, we can prepare the fund flow statement. The company prepares this statement to analyze the changes in working capital between two balance sheets. It is based on historical data. It helps the management make future decisions, but management cannot take the entire decision based on only the fund flow statement because it considers only fund-based items. Last, management should prepare this statement because it considers all sources, i.e., from where the funds are coming, and all applications, i.e., where the funds are going. **This summarized statement helps management to move further.**

## 18.9 GLOSSARY

- **Fund Sources:** It refers to the origin of the particular funds or any other monetary instrument which are the subject of the transaction between a Financial Institution and the customer.
- **Fund application:** Application of funds refers to use of cash or funds by the company during a financial year on various activities of the company.
- **Funds from Operations:** In simple terms, funds from operations are the cash flows generated by a company through its business operations.

## 18.10 SELF-ASSESSMENT QUESTIONS

1. Discuss the concept of funds from operations?

2. Elaborate the T-form specimen of Funds Flow Statement?

## 18.11 LESSON ENDED EXERCISE

1. Explain the various sources and application of funds?

2. From the following profit and loss account compute the funds from operations.

**Profit and Loss Account**

| | ₹ | | ₹ |
|---|---|---|---|
| To Salaries | 5,000 | By Gross profit b/d | 1,000 |
| To Rent | 2,000 | By Discount | 5,000 |
| To Depreciation | 1,000 | By Interest on investment | 4,000 |
| To Preliminary expenses | 2,000 | By Net loss | 5,000 |
| To Loss on sale of land | 5,000 | | |
| | 15,000 | | 15,000 |

## 18.12 SUGGESTED READINGS


- Gupta, Sashi, K. (2015). Financial Management. Kalyani Publisher, New Delhi.
- Jain, S.P and Narang, K.L. (2014). Advanced Acountancy-Vol-II. Kalyani Publisher, New Delhi.
- Gupta, Sashi, K. (2015). Management Accounting. Kalyani Publisher, New Delhi.
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# FUNDS FLOW STATEMENT AND CASH FLOW STATEMENT

| M.Com II Sem. | Advanced Accounting | Unit-IV |
|---|---|---|
| M.COMC250 | | Lesson No. 19 |

**STRUCTURE:**



## 19.1 INTRODUCTION

Till now you have learnt about the financial statements being primarily inclusive of Position Statement (showing the financial position of an enterprise as on a particular date) and Income Statement (showing the result of the operational activities of an enterprise over a particular period). There is also a third important financial statement known as Cash flow statement, which shows inflows and outflows of the cash and cash equivalents. This statement is usually prepared by the companies which come as a tool in the hands of users of financial information to know about the sources and uses of cash and cash equivalents of an enterprise over a period of time from various activities of an enterprise. It has gained substantial importance in the last decade because of its practical utility to the users of financial information. Financial Statements of companies are prepared following the accounting standards prescribed in the companies Act, 2013. Accounting Standards are notified under section 133 of the Companies Act, 2013 vide Accounting Standards Rules, 2006 and are mandatory in nature. Companies Act, 2013 also specifies that if the accounting standards are not followed, financial statements will not be true and fair, which is a quality of financial statement. Financial Statements are defined in Companies Act, 2013 (Section 2 (40)] and includes Cash Flow Statement prepared in accordance with Indian Accounting Standard- (IAS-7)- Cash Flow Statement. Ind AS 7 prescribes principles and guidance on preparation and presentation of cash flows of an entity from operating activities, investing activities and financing activities for a reporting period.

The objective of Ind AS 7 is to provide information about the historical changes in cash and cash equivalents of an entity during the reporting period from its operating, investing and financing activities.

Cash flows are inflows and outflows of cash and cash equivalents. Cash comprises cash on hand and demand deposits. Cash equivalents are short term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. Cash and cash equivalents include demand deposits, certain short-term investments and in some cases, bank overdrafts.

## 19.2 OBJECTIVES

After going through this lesson, you will be able to

- Understand the basics of cash flow statement.
- Learn about the items requiring special attention while preparing a cash flow statement.

## 19.3 BASICS OF CASH FLOW STATEMENT

*Cash* comprises cash on hand and demand deposits.

*Cash equivalents* are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

*Cash flows* are inflows and outflows of cash and cash equivalents.

*Operating activities* are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.

*Investing activities* are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

*Financing activities* are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

**Cash and cash equivalents**

Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents, for example in the case of preference shares acquired within a short period of their maturity and with a specified redemption date.

Bank borrowings are generally considered to be financing activities. However, where bank overdrafts which are repayable on demand form an integral part of an entity's cash management, bank overdrafts are included as a component of cash and cash equivalents. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn.

Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an entity rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.

**Components of cash and cash equivalents**

1. An entity shall disclose the components of cash and cash equivalents and shall present a reconciliation of the amounts in its statement of cash flows with the equivalent items reported in the balance sheet.

2. In view of the variety of cash management practices and banking arrangements around the world and in order to comply with Ind AS 1, Presentation of Financial Statements, an entity discloses the policy which it adopts in determining the composition of cash and cash equivalents.

3. The effect of any change in the policy for determining components of cash and cash equivalents, for example, a change in the classification of financial instruments previously considered to be part of an entity's investment portfolio, is reported in accordance with Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors.

## 19.4 CASH AND RELEVANT TERMS AS PER AS-3 (REVISED)

As per AS-3 (revised) issued by the Accounting Standards Board

1. (a) Cash fund :

    (i) Cash in hand

    (ii) Demand deposits with banks, and

    (iii) cash equivalents.

convertible into cash and which are subject to insignificant risk of changes in values.

2. Cash Flows are inflows and outflows of cash and cash equivalents.

The statement of cash flow shows three main categories of cash inflows and cash outflows, namely : operating, investing and financing activities.

(a) **Operating activities** are the principal revenue generating activities of the enterprise.

(b) **Investing activities** include the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

(c) **Financing activities** are activities that result in change in the size and composition of the owner's capital (including Preference share capital in the case of a company) and borrowings of the enterprise.

Cash Inflows from operating activities

- cash receipts from sale of goods and the rendering of services.
- cash receipts from royalties, fees, commissions and other revenues.

Cash Outflows from operating activities

- Cash payments to suppliers for goods and services.
- Cash payments to and on behalf of the employees.
- Cash payments to an insurance enterprise for premiums and claims, annuities, and other policy benefits.
- Cash payments of income taxes unless they can be specifically identified with financing and investing activities.

The net position is shown in case of operating cash flows. An enterprise may hold securities and loans for dealing or for trading purposes. In either case they represent Inventory specifically held for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by financial enterprises are usually classified as operating activities since they relate to main activity of that enterprise.

**Cash from Investing Activities**

As per AS-3, investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. Investing activities relate to purchase and sale of long-term assets or fixed assets such as machinery, furniture, land and building, etc. Transactions related to long term investment are also investing activities. Separate disclosure of cash flows from investing activities is important because they represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Examples of cash flows arising from investing activities are:

As per AS-3, investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. Investing activities relate to purchase and sale of long-term assets or fixed assets such as machinery, furniture, land and building, etc. Transactions related to long term investment are also investing activities. Separate disclosure of cash flows from investing activities is important because they represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Examples of cash flows arising from investing activities are:

**Cash Outflows from investing activities**

- Cash payments to acquire fixed assets including intangibles and capitalised research and development.
- Cash payments to acquire shares, warrants or debt instruments of other enterprises other than the instruments those held for trading purposes.
- Cash advances and loans made to third party (other than advances and loans made by a financial enterprise wherein it is operating activities).

**Cash Inflows from Investing Activities**

- Cash receipt from disposal of fixed assets including intangibles.
- Cash receipt from the repayment of advances or loans made to third parties (except in case of financial enterprise).
- Cash receipt from disposal of shares, warrants or debt instruments of other enterprises except those held for trading purposes. Interest received in cash from loans and advances. Dividend received from investments in other enterprises.

**Cash from Financing Activities**

As the name suggests, financing activities relate to long-term funds or capital of an enterprise, e.g., cash proceeds from issue of equity shares, debentures, raising long-term bank loans, repayment of bank loan, etc. As per AS-3, financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in case of a company) and borrowings of the enterprise. Separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise. Examples of financing activities are:

**Cash Inflows from financing activities**

- Cash proceeds from issuing shares (equity or/and preference).
- Cash proceeds from issuing debentures, loans, bonds and other short/ long-term borrowings.
- Cash repayments of amounts borrowed.
- Interest paid on debentures and long-term loans and advances.
- Dividends paid on equity and preference capital.

It is important to mention here that a transaction may include cash flows that are classified differently. For example, when the instalment paid in respect of a fixed asset acquired on deferred payment basis includes both interest and loan, the interest element is classified under financing activities and the loan element is classified under investing activities. Moreover, same activity may be classified differently for different enterprises. For example, purchase of shares is an operating activity for a share brokerage firm while it is investing activity in case of other enterprises.

## 19.5 ADVANCE TREATMENT OF EXTRA ORDINARY ITEMS

Extraordinary items are not the regular phenomenon, e.g., loss due to theft or earthquake or flood. Extraordinary items are non-recurring in nature and hence cash flows associated with extraordinary items should be classified and disclosed separately as arising from operating, investing or financing activities. This is done to enable users to understand their nature and effect on the present and future cash flows of an enterprise.

**Interest and dividends**

1. Cash flows from interest and dividends received and paid shall each be disclosed separately. Cash flows arising from interest paid and interest and dividends received in the case of a financial institution should be classified as cash flows arising from operating activities. In the case of other entities, cash flows arising from interest paid should be classified as cash flows from financing activities while interest and dividends received should be classified as cash flows from investing activities. Dividends paid should be classified as cash flows from financing activities.

2. The total amount of interest paid during a period is disclosed in the statement of cash flows whether it has been recognised as an expense in profit or loss or capitalised in accordance with Ind AS 23, Borrowing Costs.

3. Interest paid and interest and dividends received are usually classified as operating cash flows for a financial institution. However, there is no consensus on the classification of these cash flows for other entities. Some argue that interest paid and interest and dividends received may be classified as operating cash flows because they enter into the determination of profit or loss. However, it is more appropriate that interest paid and interest and dividends received are classified as financing cash flows and investing cash flows respectively, because they are costs of obtaining financial resources or returns on investments.

Some argue that dividends paid may be classified as a component of cash flows from operating activities in order to assist users to determine the ability of an entity to pay dividends out of operating cash flows. However, it is considered more appropriate that dividends paid should be classified as cash flows from financing activities because they are cost of obtaining financial resources.

**Taxes on income**

1. Cash flows arising from taxes on income shall be separately disclosed and

shall be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

4. Taxes on income arise on transactions that give rise to cash flows that are classified as operating, investing or financing activities in a statement of cash flows. While tax expense may be readily identifiable with investing or financing activities, the related tax cash flows are often impracticable to identify and may arise in a different period from the cash flows of the underlying transaction. Therefore, taxes paid are usually classified as cash flows from operating activities. However, when it is practicable to identify the tax cash flow with an individual transaction that gives rise to cash flows that are classified as investing or financing activities the tax cash flow is classified as an investing or financing activity as appropriate. When tax cash flows are allocated over more than one class of activity, the total amount of taxes paid is disclosed.

**Acquisition and Disposal of Subsidiaries and Other Business Units**

**i. Investments in subsidiaries, associates and joint ventures**

1. When accounting for an investment in an associate, a joint venture or a subsidiary accounted for by use of the equity or cost method, an investor restricts its reporting in the statement of cash flows to the cash flows between itself and the investee, for example, to dividends and advances.

2. An entity that reports its interest in an associate or a joint venture using the equity method includes in its statement of cash flows the cash flows in respect of its investments in the associate or joint venture, and distributions and other payments or receipts between it and the associate or joint venture.

**ii. Changes in ownership interests in subsidiaries and other businesses**

The aggregate cash flows arising from obtaining or losing control of subsidiaries or other businesses shall be presented separately and classified as investing activities.

An entity shall disclose, in aggregate, in respect of both obtaining and losing control of subsidiaries or other businesses during the period each of the following:

(a) the total consideration paid or received;

(b) the portion of the consideration consisting of cash and cash equivalents;

(c) the amount of cash and cash equivalents in the subsidiaries or other businesses over which control is obtained or lost; and

(d) the amount of the assets and liabilities other than cash or cash equivalents in the subsidiaries or other businesses over which control is obtained or lost, summarised by each major category.

An investment entity, as defined in Ind AS 110, Consolidated Financial Statements, need not apply paragraphs 40(c) or 40(d) to an investment in a subsidiary that is required to be measured at fair value through profit or loss.

1. The separate presentation of the cash flow effects of obtaining or losing control of subsidiaries or other businesses as single line items, together with the separate disclosure of the amounts of assets and liabilities acquired or disposed of, helps to distinguish those cash flows from the cash flows arising from the other operating, investing and financing activities. The cash flow effects of losing control are not deducted from those of obtaining control.

2. The aggregate amount of the cash paid or received as consideration for obtaining or losing control of subsidiaries or other businesses is reported in the statement of cash flows net of cash and cash equivalents acquired or disposed of as part of such transactions, events or changes in circumstances.

3. Cash flows arising from changes in ownership interests in a subsidiary that do not result in a loss of control shall be classified as cash flows from financing activities , unless the subsidiary is held by an investment entity, as defined in Ind AS 110, and is required to be measured at fair value through profit or loss.

4. Changes in ownership interests in a subsidiary that do not result in a loss of control, such as the subsequent purchase or sale by a parent of a subsidiary's equity instruments, are accounted for as equity transactions (see Ind AS 110), unless the subsidiary is held by an investment entity and is required to be measured at fair value through profit or loss. Accordingly, the resulting cash flows are classified in the same way as other transactions with owners described in paragraph 17.

**Foreign currency cash flows**

1. Cash flows arising from transactions in a foreign currency shall be recorded in an entity's functional currency by applying to the foreign currency amount the exchange rate between the functional currency and the foreign currency at the date of the cash flow.

2. The cash flows of a foreign subsidiary shall be translated at the exchange rates between the functional currency and the foreign currency at the dates of the cash flows.

3. Cash flows denominated in a foreign currency are reported in a manner consistent with Ind AS 21, The Effects of Changes in Foreign Exchange Rates. This permits the use of an exchange rate that approximates the actual rate. For example, a weighted average exchange rate for a period may be used for recording foreign currency transactions or the translation of the cash flows of a foreign subsidiary. However, Ind AS 21 does not permit use of the exchange rate at the end of the reporting period when translating the cash flows of a foreign subsidiary.

4. Unrealised gains and losses arising from changes in foreign currency exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the statement of cash flows in order to reconcile cash and cash equivalents at the beginning and the end of the period. This amount is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at end of period exchange rates.

**Non-cash transactions**

1. Investing and financing transactions that do not require the use of cash or cash equivalents shall be excluded from a statement of cash flows. Such transactions shall be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

2. Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of an entity. The exclusion of non cash transactions from the statement of cash flows is consistent with the objective of a statement of cash flows as these items do not involve cash flows in the current period.

Examples of non-cash transactions are:

(a) the acquisition of assets either by assuming directly related liabilities or by means of a finance lease;

(b) the acquisition of an entity by means of an equity issue; and

(c) the conversion of debt to equity.

Examples of these types of cash receipts and payments are advances made for, and the repayment of:

(a) principal amounts relating to credit card customers;

(b) the purchase and sale of investments; and

(c) other short-term borrowings, for example, those which have a maturity period of three months or less.

1. Cash flows arising from each of the following activities of a financial institution may be reported on a net basis:

(a) cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date;

(b) the placement of deposits with and withdrawal of deposits from other financial institutions; and

(c) cash advances and loans made to customers and the repayment of those advances and loans.

## 19.6 SUMMARY

A cash flow statement is a financial statement that provides aggregate data regarding all cash inflows a company receives from its ongoing operations and external investment sources. It also includes all cash outflows that pay for business activities and investments during a given period.

A company's financial statements offer investors and analysts a portrait of all the transactions that go through the business, where every transaction contributes to its success. The cash flow statement is believed to be the most intuitive of all the financial statements because it follows the cash made by the business in three main ways-through operations, investment, and financing. The sum of these three segments is called net cash flow.

These three different sections of the cash flow statement can help investors determine the value of a company's stock or the company as a whole.

Every company that sells and offers its stock to the public must file financial reports and statements with the Securities and Exchange Commission (SEC).1 The three main financial statements are the balance sheet, income statement, and cash flow statement. The cash flow statement is an important document that helps interested parties gain insight into all the transactions that go through a company.

There are two different branches of accounting-accrual and cash. Most public companies use accrual accounting, which means the income statement is not the same as the company's cash position. The cash flow statement, though, is focused on cash accounting.

Profitable companies can fail to adequately manage cash flow, which is why the cash flow statement is a critical tool for companies, analysts, and investors. The cash flow statement is broken down into three different business activities: operations, investing, and financing.

Cash flow associated with extraordinary items are disclosed separately as arising from operating, investing or financing activities in the Cash Flow Statement in order to enable the users to understand their nature and effect on the present and future cash flows of a firm. These disclosures are in addition to the separate disclosures of the nature and amount of extraordinary items, required by AS 5, Net Profit or Loss for the period, Prior Period Items, and Changes in Accounting Policy.

## 19.7 GLOSSARY

- **Cash Flows-** cash flow refers to the net amount of cash and cash equivalents being transferred in and out of a company. Cash received represents inflows, while money spent represents outflows.
- **Cash Flow Statement-** A cash flow statement is a financial statement that provides aggregate data regarding all cash inflows a company receives from its ongoing operations and external investment sources.
- **Extra ordinary Items-** The Cash flow associated with extra ordinary items should be classified as arising from operating, investing and financing activities. For example, the amount received from Insurance Company on account of Loss of Stock or loss from earthquake should be reported as cash flow from operating activities.
- **Dividend-** A dividend is a distribution of profits by a corporation to its shareholders. When a corporation earns a profit or surplus, it is able to pay a proportion of the profit as a dividend to shareholders.
- **Interest-** In finance and economics, interest is payment from a borrower or deposit-taking financial institution to a lender or depositor of an amount above repayment of the principal sum, at a particular rate.

## 19.8 SELF ASSESSMENT QUESTIONS

1. What is the need of preparing Cash flow statement?

______________________________________________

______________________________________________

______________________________________________

2. Explain the cash flow statement?

______________________________________________

______________________________________________

______________________________________________

## 19.9 LESSON END EXERCISE

1. Explain the narrow and boarder meaning of cash inflows and cash outflows?

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2. Discuss the various cash flows from investing, operating and financing activities?

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3. Describe the procedure for the treatment of extraordinary items while preparing cash flow statement?

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## 19.10 SUGGESTED READINGS


- Gupta, Sashi, K. (2015). Financial Management. Kalyani Publisher, New Delhi.
- Jain, S.P and Narang, K.L. (2014). Advanced Acountancy-Vol-II. Kalyani Publisher, New Delhi.
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# FUNDS FLOW STATEMENT AND CASH FLOW STATEMENT

| M.Com II Sem. | Advanced Accounting | Unit-IV |
|---|---|---|
| M.COMC250 | | Lesson No. 20 |

**STRUCTURE:**



## 20.1 INTRODUCTION

Cash plays a very important role in the economic life of a business. A firm needs cash to make payment to its suppliers, to incur day-to-day expenses and to pay salaries, wages, interest and dividends etc. In fact, what blood is to a human body, cash is to a business enterprise. Thus, it is very essential for a business to maintain an adequate balance of cash. For example, a concern operates profitably but it does not have sufficient cash balance to pay dividends, what message does it convey to the shareholders and public in general. Thus, management of cash is very essential. There should be focus on movement of cash and its equivalents. Cash means, cash in hand and demand deposits with the bank. Cash equivalent consists of bank overdraft, cash credit, short term deposits and marketable securities.

Cash Flow Statement deals with flow of cash which includes cash equivalents as well as cash. This statement is additional information to the users of Financial Statements. The statement shows the incoming and outgoing of cash. The statement assesses the capability of the enterprise to generate cash and utilize it. Thus a Cash-Flow statement may be defined as a summary of receipts and disbursements of cash for a particular period of time. It also explains reasons for the changes in cash position of the firm. Cash flows are cash inflows and outflows. Transactions which increase the cash position of the entity are called as inflows of cash and those which decrease the cash position as outflows of cash. Cash flow Statement traces the various sources which bring in cash such as cash from operating activities, sale of current and fixed assets, issue of share capital and debentures etc. and applications which cause outflow of cash such as loss from operations, purchase of current and fixed assets, redemption of debentures, preference shares and other long-term debt for cash. In short, a cash flow statement shows the cash receipts and disbursements during a certain period. The statement of cash flow serves a number of objectives which are as follows:

- Cash flow statement aims at highlighting the cash generated from operating activities.
- Cash flow statement helps in planning the schedule for repayment of loan schedule and replacement of fixed assets, etc.
- Cash is the centre of all financial decisions. It is used as the basis for the projection of future investing and financing plans of the enterprise.
- Cash flow statement helps to ascertain the liquid position of the firm in a better manner. Banks and financial institutions mostly prefer cash flow statement to analyse liquidity of the borrowing firm.

- Cash flow Statement helps in efficient and effective management of cash.
- The management generally looks into cash flow statements to understand the internally generated cash which is best utilised for payment of dividends.
- Cash Flow Statement based on AS-3 (revised) presents separately cash generated and used in operating, investing and financing activities.
- It is very useful in the evaluation of cash position of a firm.

## 20.2 OBJECTIVES

After going through this lesson, you will be able to

- Prepare the Cash flow statement.
- Understand the cash flows from various operating, investing and financing activities.

## 20.3 METHOD OF PREPARING CASH FLOW STATEMENT

The statement of cash flows shall report cash flows during the period classified by operating, investing and financing activities.

An entity presents its cash flows from operating, investing and financing activities in a manner which is most appropriate to its business. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the entity and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities.

A single transaction may include cash flows that are classified differently. For example, when the installment paid in respect of an item of Property, Plant and Equipment acquired on deferred payment basis includes interest, the interest element is classified under financing activities and the loan element is classified under investing activities.

### Operating activities

The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the entity have generated sufficient cash flows to repay loans, maintain the operating capability of the entity, pay dividends and make new investments without recourse to external sources of financing. Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.

Cash flows from operating activities are primarily derived from the principal revenue producing activities of the entity. Therefore, they generally result from the transactions and other events that enter into the determination of profit or loss. Examples of cash flows from operating activities are:

(a) cash receipts from the sale of goods and the rendering of services;

(b) cash receipts from royalties, fees, commissions and other revenue;

(c) cash payments to suppliers for goods and services;

(d) cash payments to and on behalf of employees;

(e) cash receipts and cash payments of an insurance entity for premiums and claims, annuities and other policy benefits;

(f) cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and

(g) cash receipts and payments from contracts held for dealing or trading purposes.

Some transactions, such as the sale of an item of plant, may give rise to a gain or loss that is included in recognised profit or loss. The cash flows relating to such transactions are cash flows from investing activities. However, cash payments to manufacture or acquire assets held for rental to others and subsequently held for sale as described in paragraph 68A of Ind AS 16, Property, Plant and Equipment, are cash flows from operating activities. The cash receipts from rents and subsequent sales of such assets are also cash flows from operating activities.

An entity may hold securities and loans for dealing or trading purposes, in which case they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by financial institutions are usually classified as operating activities since they relate to the main revenue-producing activity of that entity.

**Investing activities**

The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Only expenditures that result in a recognized asset in the balance sheet are eligible for classification as investing activities. Examples of cash flows arising from investing activities are:

(a) cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to capitalised development costs and self constructed property, plant and equipment;

(b) cash receipts from sales of property, plant and equipment, intangibles and other long-term assets;

(c) cash payments to acquire equity or debt instruments of other entities and interests in joint ventures (other than payments for those instruments considered to be cash equivalents or those held for dealing or trading purposes);

(d) cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(e) cash advances and loans made to other parties (other than advances and loans made by a financial institution);

(f) cash receipts from the repayment of advances and loans made to other parties (other than advances and loans of a financial institution);

(g) cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

(h) cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

When a contract is accounted for as a hedge of an identifiable position the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

**Financing activities**

The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of capital to the entity. Examples of cash flows arising from financing activities are:

(a) cash proceeds from issuing shares or other equity instruments;

(b) cash payments to owners to acquire or redeem the entity's shares;

(c) cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short-term or long-term borrowings;

(d) cash repayments of amounts borrowed; and

(e) cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease.

## 20.4 REPORTING CASH FLOWS FROM OPERATING ACTIVITIES

**An entity shall report cash flows from operating activities using either:**

(a) the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or

(b) the indirect method, whereby profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future

Entities are encouraged to report cash flows from operating activities using the direct method. The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method. Under the direct method, information about major classes of gross cash receipts and gross cash payments may be obtained either:

(a) from the accounting records of the entity; or

(b) by adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial institution) and other items in the statement of profit and loss for:

(i) changes during the period in inventories and operating receivables and payables;

(ii) other non-cash items; and

(iii) other items for which the cash effects are investing or financing cash flows.

20 Under the indirect method, the net cash flow from operating activities is determined by adjusting profit or loss for the effects of:

(a) changes during the period in inventories and operating receivables and payables;

(b) non-cash items such as depreciation, provisions, deferred taxes, unrealised foreign currency gains and losses, and undistributed profits of associates; and

(c) all other items for which the cash effects are investing or financing cash flows.

Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the revenues and expenses disclosed in the statement of profit and loss and the changes during the period in inventories and operating receivables and payables.

## 20.5 REPORTING CASH FLOWS FROM INVESTING AND FINANCING ACTIVITIES

An entity shall report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except to the extent that cash flows described in the below paragraphs are reported on a net basis.

1. Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:

(a) cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the entity; and

Examples of these cash receipts and payments are:

i. the acceptance and repayment of demand deposits of a bank;

ii. funds held for customers by an investment entity; and

iii. rents collected on behalf of, and paid over to, the owners of properties.

(b) cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.

## 20.6 PREPARATION OF CASH FLOW STATEMENT AS PER IND AS 7

There are two methods of preparing the Cash Flow Statement. Both methods give the same results in respect of the final total as well as sub-totals of the three sections - operating, investing and the financing. They differ only in the manner the information regarding cash flow from operating activities is presented.

With these three classifications, Cash Flow Statement is shown in following Exhibit.

**Cash Flow Statement (Main heads only)**

| | |
|---|---|
| (A) Cash flows from operating activities | XXX |
| (B) Cash flows from investing activities | XXX |
| (C) Cash flows from financing activities | XXX |
| Net increase (decrease) in cash and cash equivalents (A + B + C) + Cash and cash equivalents at the beginning | XXX |
| = Cash and cash equivalents at the end | XXX |

Indirect Method

Format of Cash Flow Statement

for the year ended ................

As per Accounting Standard - 3 (Revised)

| Particulars | ` | |
|---|---|---|
| (i) Cash flows from operating Activities<br>Net Profit as per Statement of Profit and Loss or difference between closing balance and opening balance of Statement of Profit and Loss | XXX | XXX |
| Add : Transfer to reserve | XXX | |
| Proposed dividend for current year | XXX | |
| Interim dividend paid during the year | XXX | |
| Provision for tax made during the current year | XXX | |
| Extraordinary items, if any, shown in statement of Profit and Loss | XXX | XXX |
| | XXX | XXX |
| Less : Extraordinary Items, if any, shown in statement of Profit and Loss | XXX | |
| Refund of Tax credited to be shown in statement Profit and Loss | XXX | XXX |
| A. Net profit before taxation and Extra ordinary items | | |
| Adjustment for Non-Cash and Non-Operating Items. | XXX | XXX |
| B. Add : | | |
| – Depreciation | XXX | |
| – Preliminary expenses written off | XXX | |
| – Discount on issue of shares and debentures written off | XXX | |
| – Interest on borrowings and debentures | XXX | |
| – Loss on sale of fixed assets | XXX | |
| C. Less : | | |

| | | |
|---|---|---|
| – Interest income/received | XXX | |
| – Dividend income received | XXX | |
| – Rental income received | XXX | |
| – Profit on sale of fixed assets | XXX | XXX |
| | | XXX |
| D. Operating profit before working capital changes (A + B – C) | XXX | |
| | | XXX |
| E. Add : Decrease in current assets and increase in current liabilities | | XXX |
| F. Less : Increase in current assets and decrease in current liabilities | XXX | |
| G. Cash generated from operations (D + E – F) | | XXX |
| H. Less : Income tax paid (Net tax refund received) | | XXX |
| I. Cash flow from operating activities before extraordinary items xxx Adjusted extraordinary items (+/–) | | XXX |
| J. Net cash from operating activities | | XXX |
| (ii) Cash from Investing Activities | | |
| Add : | | |
| – Proceeds from sale of fixed assets | | XXX |
| – Proceeds from sale of investments | | XXX |
| – Proceeds from sale of intangible assets | | XXX |
| - Interest and dividend received xxx | | XXX |
| — Rental Income | | XXX |
| | | |
| Less : | | |
| – Purchase of fixed assets | XXX | |
| -Purchase of investment | XXX | |
| – Purchase of intangible assets like goodwill | XXX | XXX |
| | | XXX |
| Adjusted extraordinary items (+/–) | | XXX |
| Net cash from (or used in) investing activities | | XXX |
| | | |
| iii) Cash flows from financing activities | | |

| | | |
|---|---|---|
| Add : | | |
| Proceeds from issue of shares and debentures | XXX | |
| Proceeds from other long term borrowings | XXX | |
| | XXX | |
| Less : | | |
| Final dividend paid | XXX | |
| Interim dividend paid | XXX | |

## 20.7 PRACTICAL PROBLEMS

### Illustration 20.1

The net Income reported in the Income Statement for the year was ` 110,000 and depreciation on fixed assets for the year was ` 44000. The balances of the current assets and current liabilities at the beginning and at the end of the year were as follows. Calculate cash from operating activities.

| *Current Items* | *End of the year Amount (₹)* | *Beginning of the year Amount (₹)* |
|---|---|---|
| Cash | 130,000 | 140,000 |
| Debtors | 200,000 | 180,000 |
| Inventories | 290,000 | 300,000 |
| Prepaid expenses | 15,000 | 16,000 |
| Account payables | 102,000 | 1,16,000 |

**Solution :**

## Cash from Operating Activities

| *Details* | | | *Amount (₹)* |
|---|---|---|---|
| Net Income | | | 1,10,000 |
| Adjustment for non cash and Non-operating items | | | |
| Add Depreciation | | | 44,000 |
| Operating Profit before working capital changes | | | 154,000 |
| Current Assets : | | | |
| ***Add :*** | (a) Decrease in inventories | 10,000 | |
| | (b) Decrease in prepaid expenses | 1000 | 11000 |
| | | | 1,65,000 |
| ***Deduct :*** | (a) Increase in Debtors Current Liabilities | (20,000) | |
| | (b) Decrease in Account payables | (14,000) | 34,000 |
| Net Cash flow from operating Activities | | | 1,31,000 |

### Illustration 20.2

From the following information calculate the cash flow from investing activities

| *Particulars* | *Opening (₹)* | *Closing (₹)* |
|---|---|---|
| Machinery (at cost) | 4,00,000 | 4,20,000 |
| Accumulated Depreciation | 1,00,000 | 1,10,000 |
| Patents | 2,80,000 | 1,60,000 |

**Additional Information :**

(i) During the year a machine costing ₹40,000 with this accumulated depreciation ₹24000 was sold for ₹20,000

(ii) Patents were written off to the extent of ₹40,000 and some patents were sold at a profit of ₹20,000

**Solution :**

**Cash Flow from Investing Activities**

| *Particulars* | *(₹)* |
|---|---|
| Inflow from sale of machinery | 20,000 |
| Inflow from sale of patent (2) | 1,00,000 |
| | 1,20,000 |
| Outflow on purchase of machinery (1) | (60,000) |
| Net cash flow from investing activities | 60,000 |

**Working Notes :**

**Machinery A/c**

| | | | |
|---|---|---|---|
| Balance b/d | 4,00,000 | Bank (Inflow) | 20,000 |
| Statement of Profit and Loss (Profit on sale of machine) | 4,000 | Accumulated depreciation (Depreciation on machinery sold) | 24,000 |
| Bank A/c | 60000 | Balance c/d | 420000 |
| | 464000 | | 464000 |

**Patent A/c**

| | | | |
|---|---|---|---|
| Balance b/d | 2,80,000 | Bank A/c (Inflow) Bal. Fig. | 1,00,000 |
| Statement of Profit and Loss | 20,000 | Statement of Profit and Loss | 40,000 |
| (Profit) | | Balance c/d | 1,60,000 |
| | 3,00,000 | | 300000 |

**Illustration 20.3**

From the following information. Calculate the Cash from financing activities:

| ***Particulars*** | ***31.12.2020 (₹)*** | ***31.12.2021 (₹)*** |
|---|---|---|
| Equity share capital | 4,00,000 | 5,00,000 |
| 10% debentures | 1,50,000 | 1,00,000 |
| Securities premium | 40,000 | 50,000 |

**Additional Information :** Interest paid on debentures ` 10000.

**Solution :**

Calculation of Cash from financing activities

| ***Particulars*** | | ***(₹)*** |
|---|---|---|
| Cash proceeds from the issue of shares | | 1,10,000 |
| (Including premium) | | |
| Interest paid on debentures | 10,000 | |
| Redemption of debentures | 50,000 | 60,000 |
| | | 50,000 |

**Illustration 20.4**

The comparative balance sheets of Bansal Private Limited at two different dates provide the following information.

| *Assets* | *March 31, 2020 Amount (₹)* | *March 31, 2021 Amount (₹)* |
|---|---|---|
| Plant and machinery | 13,50,000 | 14,40,000 |

It is informed that depreciation amounting to ` 60,000 has been provided during the year. Find the changes that have taken place in the asset and also state their effect on cash flows.

**Solution :**

In order to identify the transactions affecting the asset account, the proper procedure is to prepare the plant and machinery account as shown below:

**Plant and Machinery Account**

| *Particulars* | *Amount* | *Particulars* | *Amount* |
|---|---|---|---|
| Balance b/d | 13,50,000 | Depreciation (given) | 60,000 |
| Bank A/c (New machine purchased) | 1,50,000 | Balance c/d | 14,40,000 |
| | 15,00,000 | | 15,00,000 |

**Note**

- In the absence of specific information, it may be presumed that the additional machinery was purchased for `1,50,000.
- The amount spent on the plant and machinery represents a reduction in the cash and its equivalent. It is, therefore, an example of outflow of cash.

**Illustration 20.5**

In the comparative balance sheet of Wilson & Sons Ltd., the position of Building Account is given as under.

| *Liabilities* | *March 31, 2020 Amount* ` | *March 31, 2021 Amount* ` | *Assets* | *March 31, 2020 Amount* ` | *March 31, 2021 Amount* ` |
|---|---|---|---|---|---|
| Accumulated depreciation (Building) | 7,00,000 | 7,90,000 | Building | 3,84,0000 | 3,91,0000 |

**Additional Information**

A part of the building of ₹74,000 was sold for ₹60,000. The accumulated depreciation on building sold was `20,000 Analyse the transaction.

**Solution**

The different transactions affecting the building account are to be identified by preparing the following accounts :

**Building Account**

| *Particulars* | ₹ | *Particulars* | ₹ |
|---|---|---|---|
| Balance b/d | 38,40,000 | Cash (Inflow) | 60,000 |
| Statement of Profit and loss (gain on sale) | 6,000 | Accumulated Depreciation A/c | 20,000 |
| Bank A/c | | | |
| Purchase (outflow) | 1,44,000 | Balance c/d | 39,10,000 |
| | 39,90,000 | | 39,90,000 |

**Accumulated Depreciation A/c**

| *Particulars* | ₹ | *Particulars* | ₹ |
|---|---|---|---|
| Building A/c | 20,000 | Balance b/d | 7,00,000 |
| Balance c/d | 7,90,000 | Statement of Profit and Loss | 1,10,000 |
| | 8,10,000 | | 8,10,000 |

**Note**

- The gain on sale of building (i.e. ₹6000) would be deducted from the reported Income (or profit)
- Purchase of building for ₹144,000 is identified from the balancing figure in the Building account as an outflow of cash.
- ₹110,000 a charge to Profit and Loss Account is non-cash expense and would be added back to the reported net income (profit)

**Illustration 20.6**

From the summarised cash account of ABC Limited prepare cash flow statement for the year ended 31st December 2021 in accordance with AS-3 (Revised) using the direct method and indirect method. The company does not have any cash equivalents

**Summarised Cash A/c**

| *Particulars* | *Amount (₹000)* | *Particulars* | *Amount (₹ 000)* |
|---|---|---|---|
| Balance on 1.1.2021 | 50 | Payment to Suppliers | 2,000 |
| Issue of equity shares | 300 | Purchase of fixed assets | 200 |
| Receipts from customers | 2,800 | Overhead expenses | 200 |
| Sale of fixed assets | 100 | Wages and salaries | 100 |
| | | Taxation | 250 |
| | | Dividend | 50 |
| | | Repayment of Bank Loan | 300 |
| | | Balance on 31.12.2013 | 150 |
| | 3,250 | | 3,250 |

***Additional Information :*** Net profit before tax for the year 2021 was ` 500000.

**Solution :**

**Cash Flow Statement of ABC Ltd**
**for the year ended 31st December 2021 (Indirect method)**

| | ***₹000*** | ***₹000*** |
|---|---|---|
| A. Cash flow from operating activities | | |
| Net profit before tax | 500 | |
| Income tax paid | (250) | |
| Net cash from operating activities | | 250 |
| B. Cash flow from investing activities | | |
| Purchase of fixed assets | (200) | |
| Sale of fixed assets | 100 | |
| Net cash used in investing activities | | (100) |
| C. Cash flow from financing activities : | | |
| Issue of equity shares | 300 | |
| Repayment of bank loan | (300) | |
| Dividend paid | (50) | |
| Net cash used in financing activities | | (50) |
| Net increase in cash (A+B+C) | | 100 |
| (Net cash inflow from activities) | | |
| ***Add :*** Opening balance of cash | | 50 |
| Closing balance of cash | | 150 |

**Illustration 20.7**

Following are the Balance Sheets of X Ltd. Prepare a Cash Flow Statement

| *Particulars* | *Note No.* | *31st March, 2020 (₹)* | *31st March, 2021 (₹)* |
|---|---|---|---|
| **I. EQUITY AND LIABILITIES** | | | |
| **1. Shareholders' Funds** | | | |
| (a) Share Capital | | 25,00,000 | 20,00,000 |
| (b) Reserves and Surplus | 1 | 2,30,000 | 1,00,000 |
| **2. Current Liabilities** | | | |
| Trade Payables | | 4,50,000 | 7,00,000 |
| **Total** | | **31,80,000** | **28,00,000** |
| **II. ASSETS** | | | |
| **1. Non-Current Assets** | | | |
| *Fixed Assets* - Tangible Assets (Land) | | 6,60,000 | 5,00,000 |
| **2. Current Assets** | | | |
| (a) Inventories | | 9,00,000 | 8,00,000 |
| (b) Trade Receivables | | 11,50,000 | 12,00,000 |
| (c) Cash and Cash Equivalents | | 4,70,000 | 3,00,000 |
| **Total** | | **31,80,000** | **28,00,000** |

## Note to Accounts

| *Particulars* | *31st March, 2020 (₹)* | *31st March, 2021 (₹)* |
|---|---|---|
| **1. Reserves and Surplus** | | |
| Surplus, *i.e.,* Balance in Statement of Profit & Loss | 2,30,000 | 1,00,000 |

**Solution :**

**X Ltd.**
**Cash Flow Statement**
***for the year ended 31st March, 2021***

| *Particulars* | | ₹ | ₹ |
|---|---|---|---|
| **Cash Flow from Operating Activities** | | | |
| Profit for the Year (Difference between Closing and Opening Surplus, *i.e.,* Balance in Statement of Profit and Loss) (` 2,30,000 - ` 1,00,000) | | 1,30,000 | |
| ***Add :*** *Decrease in Current Asset and Increase* | | | |
| *in Current Liabilities :* | | | |
| Decrease in Trade Receivables | | 50,000 | |
| | | 1,80,000 | |
| *Less : Increase in Current Asset and Decrease* | | | |
| *in Current Liabilities :* | | | |
| Increase in Inventories | (1,00,000) | | |
| Decrease in Trade Payables | (2,50,000) | (3,50,000) | |
| *Cash Used in Operating Activities* | | | (1,70,000) |
| **Cash Flow from Investing Activities** | | | |
| Cash Payment for Land Purchased | | (1,60,000) | |
| *Cash Used in Investing Activities* | | | (1,60,000) |
| **Cash Flow from Financing Activities** | | | |
| Cash Proceeds from Issue of Shares | | 5,00,000 | |
| *Cash Flow from Financing Activities* | | | 5,00,000 |
| **Net Increase in Cash and Cash Equivalents** | | | 1,70,000 |
| ***Add:*** Cash and Cash Equivalents in the Beginning | | | 3,00,000 |
| **Cash and Cash Equivalents at the End** | | | 4,70,000 |

## 20.8 SUMMARY

Information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation. The Standard deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise by means of a cash flow statement which classifies cash flows during the period from operating, investing and financing activities. This statement provides relevant information in assessing a company's liquidity, quality of earnings and solvency. Information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation. The Standard deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise by means of a cash flow statement which classifies cash flows during the period from operating, investing and financing activities. This statement provides relevant information in assessing a company's liquidity, quality of earnings and solvency. Information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation. The Standard deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise by means of a cash flow statement which classifies cash flows during the period from operating, investing and financing activities. This statement provides relevant information in assessing a company's liquidity, quality of earnings and solvency. Cash flow statement deals with flow of cash which includes cash equivalent as well as cash. Cash flow statement is a summary of cash receipts and disbursements during a certain period. Cash flow statement is prepared as per AS-3

(Revised). Cash flow statement shows three categories of cash inflows and outflows i.e. (i) Operating activities (ii) Investing activities (iii) Financing activities. Operating activities are the revenue generating activities of the enterprise. Investing activities constitute the acquisition and disposal of long term assets and other investments not included in cash and equivalents. Financing activities are activities that result in change in the size and composition of the share capital and borrowings of the enterprise. The cash flows from extraordinary items are to be stated separately as arising from operating, investing and financing activities.

## 20.9 GLOSSARY

- **Cash flow items-** These are as (a) Cash flow from operating activities (b) Cash flow from investing activities (c) Cash flow from financing activities.
- **Investing Activities-** Investing activities relate to the long-term use of cash, such as buying or selling a property or piece of equipment, or gains and losses from investments in financial markets and operating subsidiaries. It reveals the reasons for changes or anomalies in the financial position of a company between two balance sheets.
- **Operating Activities-** Operating activities is a classification of cash flows within the statement of cash flows. Items classified within this area are an entity's primary revenue-producing activity, so cash flows are generally associated with revenues and expenses.
- **Financing Activities-** The financing activity in the cash flow statement focuses on how a firm raises capital and pays it back to investors through capital markets.

## 20.10 SELF ASSESSMENT QUESTIONS

1. What do you mean by Cash Flow Statement? State main objectives of cash flow statement.

2. Define cash as per AS-3 (revised). How the various activities are classified as per AS-3 revised while preparing cash flow statement.

3. Give three examples of operating activities and investing activities.

## 20.11 LESSON END EXERCISE

1. Give three examples of operating activities and investing activities.

2. From the following Balance Sheets of X Ltd., prepare Cash Flow Statement:

| *Particulars* | *Note No.* | *31st March, 2020 (₹)* | *31st March, 2021(₹)* |
|---|---|---|---|
| **I. EQUITY AND LIABILITIES** | | | |
| **1. Shareholders' Funds** | | | |
| (a) Share Capital | 1 | 2,00,000 | 1,80,000 |
| (b) Reserves and Surplus | 2 | 6,400 | 6,000 |
| **2. Non-Current Liabilities** | | | |
| *Long-term Borrowings :* | | | |
| 10% Debentures | | 14,000 | 12,000 |
| **3. Current Liabilities** | | | |
| (a) Short-term Borrowing | | | |
| (Bank Overdraft) | | 13,600 | 25,000 |
| (b) Trade Payables (Creditors) | | 22,000 | 24,000 |
| (c) Short-term Provisions | 3 | 20,000 | 16,000 |
| **Total** | | **2,76,000** | **2,63,000** |
| **II. ASSETS** | | | |
| **1. Non-Current Assets** | | | |
| Fixed Assets | 4 | 1,50,000 | 1,60,000 |
| **2. Current Assets** | | | |
| (a) Trade Receivables | | 48,000 | 40,000 |
| (b) Inventories | | 71,000 | 60,600 |
| (c) Cash and Cash Equivalents | | 7,000 | 2,400 |
| **Total** | | **2,76,000** | **2,63,000** |

**Notes to Accounts**

| *Particulars* | *31 March, 2020 (₹)* | *31 March, 2021 (₹)* |
|---|---|---|
| **1. Share Capital** | | |
| Share Capital | 1,80,000 | 1,55,000 |
| 10% Preference Share Capital | 20,000 | 25,000 |
| | 2,00,000 | 1,80,000 |
| 2. Reserves and Surplus<br>General Reserve<br>Surplus i.e., Balance in Statement of Profit & Loss | 4,000<br>2,400 | 4,000<br>2,000 |
| | 6,400 | 6,000 |
| 3. Short-term Provisions | | |
| Provision for tax | 8,000 | 5,000 |
| Proposed Dividend | 12,000 | 11,000 |
| | 20,000 | 16,000 |
| 4. Fixed Assets | | |
| Cost | 1,80,000 | 1,82,000 |
| Less : Accumulated Depreciation | 30,000 | 22,000 |
| | 1,50,000 | 1,60,000 |

## 20.12 SUGGESTED READINGS


- Gupta, Sashi, K. (2015). Financial Management. Kalyani Publisher, New Delhi.
- Jain, S.P and Narang, K.L. (2014). Advanced Acountancy-Vol-II. Kalyani Publisher, New Delhi.
- Gupta, Sashi, K. (2015). Management Accounting. Kalyani Publisher, New Delhi.
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