DIRECTORATE OF DISTANCE EDUCATION

UNIVERSITY OF JAMMU

JAMMU

SELF LEARNING MATERIAL
FOR
B. COM SEMESTER - III

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

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

Course Co-ordinator

Rohini Gupta Suri

(M) 9419186716

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B. COM SEMESTER - III

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UNIVERSITY OF JAMMU

B.COM. THIRD SEMESTER

CORPORATE ACCOUNTING

C.No. BCG-301 — **Max Marks = 100**
Internal assessment = 20
External Exam. = 80

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

UNIT-I: PROFIT PRIOR TO INCORPORATION

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

Computation of profit prior to incorporation as per prescribed form.

UNIT- II: BANKING COMPANIES

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

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

UNIT-III: ACCOUNTS OF INSURANCE COMPANIES

Meaning of insurance types of insurance, statutory and subsidiary books, important terms in insurance.
Preparation of revenue account & balance sheet of life insurance companies as per prescribed form.

UNIT — IV: ACCOUNTS OF HOLDING COMPANIES

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

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

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

Interaction with persons/officials concerned with LIC business.

Comment upon the consolidated financial statement of any holding co.

Create deep understanding of all concepts specified in the syllabus.

BOOKS RECOMMENDED

1. Jain & Narang :Corporate Accounting, Kalyani Publishers, New Delhi.

2 Gupta R.L. and Radha Swamy : Advanced Company Accounts, Sultan Chand & Son, New Delhi

3 Maheshwari S.N. : Corporate Accountancy, Vikas Publishing House, New Delhi

4 Monga J.R. Ahuja, : Financial Accounting, Mayur Paper Books, Noida Girish and Sehagl Ashok

5 Shukia, M.C. Grewal : Advanced Accounts, S. Chand and Co. New Delhi T.S. and Gupta SC

6 Moore C.L. and Managerial Accounting, South Western Publishing Co., Jaedicke R.K. Cinnannati, Ohia

6. Tulsain, P.C: Corporate Accounting, S. Chand Publication, New Delhi.

NOTE FOR PAPER SETTER

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

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

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

MODEL QUESTION PAPER
CORPORATE ACCOUNTING

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

Section A (20 Marks)

Attempt all the questions. Each question carries 5 marks.

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

Section B (60 Marks)

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

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

	Rs.		Rs.
To commission	2625	By Gross profit	98000
To Advertisement	5250	By Bad debts recovered	500
To Managing director's remuneration	9000		
To Depreciation	2800		
To Salaries	18000		
To Insurance	600		
To Preliminary exp.	700		
To Rent and rates	3000		
To Discount	350		
To Bad debts	1250		
To Net profit	54925		
	98500		98500

The following details are available:

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

4. Advertisement expenses were directly proportionate to the sales.

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

OR

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

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

	Rs. ('000)
Interest on loan	250
Interest on savings A/C	150
Interest on cash credits	160
Interest on fixed deposits	190
Interest on overdrafts	70
Payments to employees	150
Discount on bill discounted	40
Rent and rates	5
Commission and brokerage	15
Auditors fees	10
Directors fee and expenses	20

OR

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

	Rs.('000)
Payment to employees	74
12,500 shares of Rs. 100 each	1250
Statutory reserve	600
Current a/c and deposits a/c	7732
Interest paid	27
Govt. securities	600
Other securities	825
Shares and stock	637
Dep. on Premises	22
Interest, discount and commission	245
Cash in hand with Reserve Bank of India	20
Money at call and short notice	274
Bills discounted	379
Loans and advances	4665
Bank Premises and Furniture	480
Non Banking Assets	337

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

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

a. Dividend from investment Rs. 4,80, 000.

b. Income tax on above Rs. 48,000.

c. Bonus in reduction of Premium Rs. 8,77,500 (not taken as expense).

d. Claims covered under re-insurance Rs. 4,23,000.

e. Claims intimated, but not accepted by the company Rs. 7,62,000.

Ascertain correct balance of the fund.

OR

a. Explain the meaning and types of Life Insurance?

b. Prepare (with imaginary figures) the Balance sheet of a Life Insurance Company.

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

OR

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

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

The profit and loss account of S Ltd. had a credit balance of Rs. 3,000 on 1st April,2011. Prepare Consolidated Balance Sheet as on 31st March, 2012.

CONCEPT OF PROFIT PRIOR TO INCORPORATION, PROCEDURE OF ASCERTAINING PROFIT PRIOR TO INCORRPORATION, BASIS OF ALLOCATION OF EXPENSES AND INCOMES

STRUCTURE:

1.1 INTRODUCTION

Sometimes a company purchases a running business from a date prior to its incorporation, e.g., a company incorporated on 1st April, 2011 may purchase a business from 1st January, 2011, the date on which the accounting year of the vendor starts. Generally the business is purchased from vendor on the last date of the balance sheet so that assets and liabilities are taken over on the basis of the figures given in the balance sheet. If the company has earned any profit from the date of purchase to the date of incorporation such profit is called as profit prior to incorporation. Such profit cannot be said to have been earned by the company as it is not available for distribution as dividend to the shareholders. Such profit is treated as capital profit and is transferred to Capital Reserve Account. If there is any loss prior to incorporation such loss is in the nature of capital loss and can be dealt in different ways discussed afterwards. It should be noted carefully that it is the date of incorporation and not the date of commencement of business which is taken into consideration for calculating profits or loss pior to incorporation. When a running business is taken over from a date prior to its incorporation/commencement, the profit earned up to the date of incorporation/commencement (incorporation, in case of private company; and commencement, in case of public company) is known as 'Pre-incorporation profit'. The same is to be treated as capital profit since these are profits which have been earned before the company came into existence. In short, the profit earned after the date of purchase of business is called 'Post-incorporation or Post-acquisition profit' and the profit earned before the date of purchase of business is termed as 'Pre-incorporation profit'.

1.2 OBJECTIVES

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

- Concept and meaning of profit prior to incorporation.
- Procedure of ascertaining profit prior to incorporation.
- Computation of profit prior to incorporation.
- Computation of different types of ratios, expenses and incomes.

1.3 MEANING AND CONCEPT OF PROFIT PRIOR TO INCORPORATION.

Meaning of Profit Prior to Incorporation

"The profits earned b/w the date of acquisition and the date of incorporation are called profits prior to incorporation. These profits are of capital nature and these are not available for distribution among shareholders and transferred to capital reserve account. If there is any loss prior to incorporation, it is capital loss and debited to goodwill account. Under company's act 1956, pre incorporation profits are capital profits and hence not available has the declaration of the dividend. A company comes into existence only when it receives the certificate of incorporation from the registrar of companies. Sometimes a newly incorporated company acquires a running business from a date prior to its incorporation. In such a case, the amount of profit earned by the company from the date of purchase to the date of incorporation is called as "profit prior to incorporation."

Purpose of profit and loss prior to incorporation

1. How many profits before incorporation or after incorporation of business. The profit before incorporation is called capital profit and after incorporation profits are called net profit or revenue profit.

2. A separate profit and loss account is prepared for the pre incorporation period as distinguished from profit and loss account for post incorporation period which shows profits separately.

3. In the books of the new company, acquisition entries are passed on the same date after taking into considerations the assets and liabilities on the date of incorporation, which thus would include the results up to the date.

4. For calculating net profit and loss of respective period after deducting apportioned expenses and acquisition entries are passed at the end of the accounting year.

5. For the adjusted loss prior to incorporation of business, these losses would be adjusted as follows:

   (a) Debited to goodwill account.

   (b) Debited to capital reserve account arising from acquisition of business.

   (c) Debited to a suspense account which can be written off later as a fictitious asset.

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

The profits prior to incorporation can be calculated by following procedure:

1. **Prepare trading account.** In order to ascertain the amount of gross profit, the trading a/c, for the whole period should be prepared. The whole period means the period starting from the date of incorporation to the last date of closing of accounts.

2. **Calculation of time ratio.** Calculate time ratio by taking into consideration the time falling from the date of purchase of business to the date of incorporation and the period b/w the date of incorporation to the last date of preparing final accounts.

3. **Calculate sales ratio**. It may be calculated as under:- sales ratio = sales of pre incorporation period : sales of post incorporation period.

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

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

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

The Certificate of Incorporation (Requirements)

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

- **Business purpose -** It would describe the incorporated tasks a company has to do or provide. At present, only two types of business purpose clauses are used. They are:
  1. General - General purpose clauses are accepted by some and not all states. It indicates that the budding company has been formed to carry out "all lawful business" in the region.
  2. Specific - Alternatively, some states have made it mandatory for the business owners to furnish a more detailed explanation of the products and/or services to be offered by their companies.
- **Corporate name -** A chosen name must be added to the Certificate of Incorporation. This should be followed with the corporate identifier like "Corporation", "Incorporated", "Company", or one of the abbreviations like "Inc". A preliminary name availability search is advisable, prior to the submission of the Articles of Incorporation. In case of online incorporation, the state will have final say with regards to the name chosen for the company and that the name shouldn't deceive or mislead the consumers.
- **Registered agent -** Almost all the states require every corporation to have a registered agent of their own in the state of incorporation. Registered agents will receive all the important legal as well as tax documents on behalf of the corporation. A typical registered agent will need a physical address (P.O box nos.) in the state of incorporation and should be accessible during normal business hours.
- **Incorporator -** An incorporator is the person who prepares and files the Certificate of Incorporation with the concerned state.
- **Share par value -** It refers to the stated minimum value, and generally doesn't correspond to the actual value. Usually, $0.01, $1.00 or no par are some of the

common par values. In reality, the value of a share is based on its fair market value, or whatever amount a buyer is willing to pay for the same.

- **Number of authorized shares of stock -** An incorporation needs to stipulate the exact number of shares they as a company are willing to authorize. Moreover, it is mandatory for every corporation, be it small or large, to have stock. A stock represents ownership in the corporation.

- **Directors -** A lot of states need the name and addresses of the initial directors of the corporation in the incorporation papers. They are responsible for the corporation's daily affairs and oversee major corporate decisions. Directors hold an elected office as chosen by the shareholders' mandate and will be responsible to appoint officers.

- **Preferred shares -** If a company/corporation is willing to permit both preferred as well as common shares of stock, then this should have a mention in the Articles of Incorporation, along with the voting rights information. Generally, preferred shares provide its shareholders preferential payments of distribution of assets or dividends, in case the company shuts down its operations. A lot of small business owners only allow shares of common stock.

- **Officers -** Officers include president, vice president, secretary and treasurer have the responsibility towards the daily activities of the corporation. Certain states require that officer information be included, while others have kept it optional.

- **Legal address of the company/corporation -** In many states, it is optional to provide the legal or principal business address. But in some states it is mandatory.

Legal benefits

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

- **Transferable ownership**. Ownership in a corporation or LLC is easily transferable to others, either in whole or in part. Some state laws are particularly corporate-friendly. For example, the transfer of ownership in a corporation incorporated in Delaware is not required to be filed or recorded.
- **Retirement funds**. Retirement funds and qualified retirements plans, such as a 401(k), may be established more easily.
- **Taxation**. In the United States, corporations are taxed at a lower rate than individuals are. Also, they can own shares in other corporations and receive corporate dividends 80% tax-free. There are no limits on the amount of losses a corporation may carry forward to subsequent tax years. A sole proprietorship, on the other hand, cannot claim a capital loss greater than $3,000 unless the owner has offsetting capital gains.
- **Raising funds through sale of stock**. A corporation can easily raise capital from investors through the sale of stock.
- **Durability**. A corporation is capable of continuing indefinitely. Its existence is not affected by the death of shareholders, directors, or officers of the corporation.
- **Credit rating**. Regardless of an owner's personal credit scores, a corporation can acquire its own credit rating, and build a separate credit history by applying for and using corporate credit.

1.4 PROCEDURE FOR ASCERTAINING P/L PRIOR TO INCORPORATION.

Profit and loss of a business for the period prior to the date company into existence is referred to as Pre-Incorporation profit and losses. In simple words prior period item are those item which is done before incorporation of the company. Profit and loss of prior period and post period is divided separately because the prior period profit and loss is always credit and charged from capital reserve A/c. Post period profit and loss are credited and charged from Profit & Loss A/c.

Methods of computing profit and loss prior incorporation:-

Methods 1st : One is to close of old books and open new books with the assets and liabilities as the existed at the date of incorporation. In this way, automatically the result to that will be adjusted.

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

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

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

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

1. Some expenses which are treated as always pre-Incorporation period like promoters remuneration, survey report and expenses regarding articles of association and memorandum of association.

2. Some expenses which are treated as always post-Incorporation period like directors fees and debenture interest.

A company taking over a running business may also agree to collect its debts as an agent for the vendor and may further undertake to pay the creditors on behalf of the vendors ins such a case, the debtors and creditors of a vendors will be include in the accounts for the company by debit or credit separate total accounts in the general ledger to distinguish them from the debtors and creditors of the business and contra entries will be made in corresponding suspense account. Also details of debtors and creditors balance will be kept in separate ledger.

The vendor is treated as a creditors for the cash received by the purchasing company in respect of the debts due to the vendor, just as if he has himself collected cash from his debtors and remitted the proceeds to the purchasing company.

The vendor is considered a debtors in respect of cash paid to his creditors by the purchasing company. The balance of cash collected , less paid, will represent the amount due to or by the vendor, arising from debtors and creditors balances which have been taken over, subject to any collection expenses.

The balance in the suspense account will always equal to the amount of debtor and creditors taken over remaining unadjusted at any time.

All the common expenses and incomes are divided in the following appropriate ratio.

1. In sales ratio. Expenses related to sales are apportioned in this ratio like, advertisement, packing expenses, cartrage outward, commission to selling agent, discount allowed, variable expenses etc.
2. In time ratio. Expenses such as rent, depreciation salaries, electricity, telephone, interest, audit fees and other office and admn expenses.
3. In vendor ratio. Interest to vendor will be allocated in this ratio.
4. Post of incorporation. Like directors fees, interest to vendors, preliminary expenses (if written off) are recorded in post to incorporation period. If there is profit in the first column, such profit is known as profit prior to incorporation.

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

1. To write off the capital losses and expenditure.
2. To write off goodwill account. Profit or loss prior to incorporation, can be calculated by adopting the following steps

   Step1. Calculation of time ratio. This ratio will be calculated by taking into consideration the period b/w the date of purchase of the business to the date of incorporation of business and this period b/w the date of incorporation to the last date of preparing the final account.

Step2. Calculation of sales ratio. This ratio will be calculated as, sales of pre-increperation period: sales of post incorporation period.

Step3. Calculation of vendor ratio. This is another time ratio which is to be calculated by taking into consideration the period b/w the date of purchase of business to the date of incorporation and the period b/w the date of incorporation to the date payment of interest to the vendor.

Step4. Calculation of gross profit. For this purpose we have to prepare trading account for the whole period i.e. period starting from the date of purchase of business to the last date of purchase of business to the last date of closing of accounts.

Step5. Preparation of profit and loss account. Profit and loss account will be prepared in the columnar form i.e. one column for pre incorporation form and other for post incorporation items. Common expenses are to be divided b/w pre incorporation and post incorporation as under:

In sales ratio: Expenses related to sales and gross profit should be allocated on the basis of sales ratio e.g. advertisement, packing expenses, cartrage outward, commission to agents, discount allowed, bad debts, entertainment expenses, any variable expenses, travelling expenses etc. In time ratio: In this ratio expenses are to be allocated e.g. salary, interest (excluding interest to vendor and debenture interest), rent, depreciation, fixed expenses, electricity, telephone, audit fee, other office and administration expenses etc. Vendor ratio: Interest to vendor will be allocated in this ratio. Post to corporation: These expenses are to be recorded in post period column, these are incurred by the company after incorporation e..g .director fee, preliminary expenses, or formation expenses, debentures interest, any provisions created by the company etc. If there is profit prior to incorporation, then it will be treated as capital profit. If there is loss prior to incorporation then it will be treated as goodwill. Profit or loss for the post incorporation period will be treated as revenue profit or loss. When a running business is taken over from a date prior to its incorporation/ commencement, the profit earned up to the date of incorporation/commencement (incorporation, in case of private company; and commencement, in case of public company) is known as 'Pre- incorporation profit'. The same is to be treated as capital profit since these are profits which have been earned before the company came into existence. In short, the profit earned after the date of purchase of business is called 'Post-incorporation or Post-acquisition profit' and the profit earned before the date of purchase of business is termed as 'Pre-incorporation profit'. For example, X Ltd. was incorporated on 1st April 2006, took over a running business, Y Ltd., from 1st January 2006 and it closed its accounts on 31st December 2006. Now, the company X Ltd. is entitled not only to the profit/loss made by Y Ltd. from 1st April to 31st December 2006 but also to the profit/loss made by Y Ltd. from 1st January 2006 to 31st March 2006. **Method of Computation of Profits/ Loss Prior to Incorporation:**

In order to ascertain the profit prior to incorporation a Profit and Loss Account is to be prepared at the date of incorporation. But in practice, the same set of books of accounts is maintained throughout the accounting year.

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

(i) From the date of purchase to the date of incorporation or pre-incorporation period;

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

Application/Accounting Treatment of Profit/Loss Prior to Incorporation:

(a) Pre-incorporation Profit:

Since "Profit prior to Incorporation" is a Capital Profit the same should be written off against:

(i) Preliminary Expenses Account

(ii) Formation Expenses Account

(iii) Liquidation Expenses Account

(iv) Write down the value of Fixed Assets, if any

(v) Goodwill Account

(vi) Balance, if any, transferred to Capital Reserve.

(b) Pre-incorporation Loss:

Since "Pre-incorporation Loss" is a Capital Loss the same is adjusted against

(i) Any Capital Profit

(ii) Debited to Goodwill Account

(iii) Writing-off Fictitious Assets

(iv) Capital Reserve.

Special points in respect of certain items

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

Illustration

Trial Balance of Soma Ltd. as on 31st March, 1997 [extract]

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

Adjustments :

(i) The income tax assessment for 1995-96 completed during the year showed gross tax demand of Rs. 2,40,000 but no effect has been given for this in the account.

(ii) Provision for income tax is to be made for Rs. 2,10,000 for 1996-97.

Show Journal Entries and relevant extract in the Final Account.

Solution :

Journal Entries of soma Limited.

Date(1997)	*Particulars*		*Dr.(Rs.)*	*Cr.(Rs.)*
31.3	Profit & Loss A/c	Dr.	2,10,000	
	To Provision for Income-tax A/c			2,10,000
	(Being the amount of provision for Income-tax for the year 1996 - 97 charged to P/L Account)			
31.3	Profit & Loss Appropriation A/c	Dr.	40,000	
	To Provision for Income-tax A/c			40,000
	(Being the amount of less provision for Income-tax for 1995-96 charged to P/L A/c of this year 1996-97)			
31.3	Provision for Income-tax A/c	Dr.	2,20,000	
	To Advance Income-tax A/c			2,20,000
	(Being the amount of advance income-tax for earlier year 1995-96 adjusted with provision for tax.)			

Profit & Loss Account for the year ended 31.3.97 (Extract)

Dr. *Particulars*	*Rs.*	Cr. *Particulars*	*Rs.*
To Provision for Tax (1996–97)	2,10,000	By Gross Profit b/d	?
To Net Profit c/d	?		
To Provision for Tax (*Less:* Provision for 1995-96)	40,000	By Balance b/d	?
		By Net Profit during the year	?

SOMA Limited

Balance Sheet *as on 31.03.1997 (Extract)*

Liabilities	*Rs.*	*Assets*	*Rs.*
Share Capital	?	Fixed Assets	?
Reserves & Surplus	?	Current Assets, Loan and Advances	?
Current Liabilities & Provisions		Current Assets	?
Provision for Tax		Loans & Advances	
1995 – 96	20,000	Advance Income Tax for 1996-97	2,30,000
1996 – 97	2,10,000		
	?		?

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

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

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

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

(c) debts considered doubtful or bad.

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

(a) Bank balance with Scheduled Banks, and

(b) Bank balance with others.

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

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

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

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

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

Method of Accounting:

Steps to find out the profit or loss before and after incorporation are as follows:

1. Prepare one trading account for the whole period. Do not consider the date of incorporation. Thus, one figure of gross profit for the entire period is arrived at.
2. The gross profit is apportioned between the two periods, prior to incorporation and post-incorporation, on the basis of sales in the two periods.
3. The various expenses, which are shown in the profit and Loss Account, should be divided between pre and post incorporation periods on some logical and appropriate basis.

They are given below:

	Particulars	**Basis of Apportionment**
1.	Gross Profit or Loss	Sales Ratio
2.	Expenses of fixed nature, such as salaries, Rent Rates, Taxes, Insurance, Depreciation, Office, Expenses, Printing and stationary, Administrative Expenses, Postage, Audit Fees, Repairs etc.	Time Ratio
3.	Expenses of variable type, Such as, Carriage Out, Packaging, Commission, Advertisement, Discount, Bad Debits, Selling Expenses, Salesmen Salary, All types of expenses directly varying with turnover etc.	Sales Ratio

4.	All expenses relating to Pre-incorporation period, such as, interest to Vendor, Paid before incorp-oration and all other expenses during the period, i.e. Prior to incorportion.	No allocation. The Complete expenditure relating to pre-incorporation period.
5.	All expenses relating to Post - incorporation period. Such as, Preliminary Expenses, Dirctors's fee, Interest on Debentures, under-writing Comm-ission, Subscription to Political parties, Donations given by company etc.	No allocation. Wholly to Post incorporation period.

Sales Ratio:

In simple problems, where the sales is evenly spread over the whole period, the sales are apportioned between pre and post-incorporation periods in the proportion of their time periods. But in many cases, the sales are fluctuating from time to time. Therefore, the Sales Ratio is found out by considering pre and post-incorporation periods on the basis of their respective turnover. (Turnover-cum-time basis.)

Treatment of Pre Incorporation Results:

Profit or loss from the date of purchase of business till the date of incorporation belongs to the company. Such profit should not be regarded as trading profit. The profit made before incorporation is not available for distribution as dividends to the shareholders of the purchasing company because it is treated as capital profit.

The treatment of pre-incorporation results is given below:

(A) Profit Prior to Incorporation:

1. The profit is in the nature of capital profit.
2. Capital profit should not be used for payment of dividend.
3. It can be used for writing down goodwill or capital losses.
4. The unutilised portion of the profit can be transferred to Capital reserve.

(B) Loss Prior to Incorporation:

1. It can be treated as goodwill and added to goodwill account.

2. It can also be treated as deferred revenue expenditure and written off against profits, over a number of years.

3. It may be debited to a separate account – Loss Prior to Incorporation Account.

Profit prior to incorporation is that profit which a company gets between the period of date of buying and date of incorporation. Suppose, A company buys XYZ company on 1st Jan. 2010 and it has to incorporate at 1st April 2010. Then profit between 1st Jan. 2010 and 1st April 2010 will be profit prior to incorporation. This profit cannot be used for paying dividend to shareholders. Because current shareholder's capital is not involved for this profit, so this will be capitalized profit and it will be transferred to capital reserve account. If company gets loss prior to incorporation, it will be transferred to goodwill account.

Ascertainment of Profit or Loss Prior to Incorporation

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

1st Step : Make Trading Account of Whole Period

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

2nd Step : Calculate Time Ratio and Sale Ratio

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

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

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

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

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

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

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

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

(i) From the date of purchase to the date of incorporation (Pre-incorporation period). As the profits earned prior to incorporation are not available for dividend, it is necessary to separate it from divisible profits. This is possible, when the profit and loss account is prepared separately for the pre-incorporation period and post-incorporation period. And this is possible only by closing of the books and stock taking for the two periods. These involve tedious work. Therefore, the profit or loss is estimated by apportioning on some reasonable basis – time, turnover, equitable or actual.

In practice, the same sets of books of accounts are maintained throughout the accounting year.

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

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

(ii) From the date of incorporation to the closing of the accounting year (Post-incorporation period).

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

Audit fees For company's audit under the companies act, 1956. For tax audit under section 44 AB of the income tax Act , 1961.	Charge to post- incorporation period. On the basis of turnover in the respective periods.
Interest on the purchase consideration to vendor For the period from the date of acquisition of business to date of incorporation. For the period from the date.	Charge to pre-incorporation period Charge to post-incorporation period

Method of Accounting of Profit/Loss Prior to Incorporation:

(1) Prepare the trading account for the whole period i.e., from the date of purchase of business to the last date of accounts closing in order to calculate the gross profit. Date of incorporation will not affect the calculation of gross profit.

(2) Calculate time ratio and sales ratio. Time ratio is calculated by taking into consideration the time falling from the last date of balance sheet to the date of incorporation and the period between the date of incorporation to the last date of presenting final accounts. For example, if (he business is purchased on 1st January 1998 and certificate of incorporation is granted on 1st May 1998 and final accounts are being prepared on 31st December, 1998, then the time ratio is 4 months : 8 months or 1 : 2. Sales ratio is calculated taking into consideration the sales of pre-incorporation period to that of sales of post-incorporation period. For example, if sales of pre-incorporation period are Rs. 1,00,000 and that of post-incorporation Rs. 3,00,000, then the sales ratio is 1 : 3.

(3) Prepare the profit and loss account for the pre-incorporation and post-incorporation periods separately. This is done on the following basis :

(i) **Gross profit** should be apportioned between the two periods on the basis of their respective sales ratio.

(ii) **Such expenses** which are directly related on sales such as cost of sales, discount or commission on sales, discount allowed, bad debts, advertising, selling expenses, etc. should be apportioned on the basis of sales ratio of the two periods.

(iii) **Fixed expenses** such as salaries, rent, audit fees, insurance, general expenses, stationery, printing, depreciation and administrative expenses, etc. should be allocated on the basis of time ratio as these expenses are incurred on the basis of time.

(iv) **Expenses** which are incurred after the incorporation of the company such as directors' fees, preliminary expenses, interest on debentures, goodwill written off etc. should be charged wholly to the period after incorporation. Similarly expenses as salary of partners is debited lo the pre-incorporation period.

Calculation of Sales Ratio:

The calculation of sales ratio may be simple in those cases where the turnover is spread during the whole financial period. But where the turnover fluctuates from month lo month according to the nature of product (as woolen garments where the sales are made in the month of October, November, December, and January as compared to other months), the calculation of sales ratio becomes difficult. Moreover, the sales of month of October may be different from the month of December or January. Under such circumstances the sales ratio is determined taking into consideration the relationship of monthly sales with that of total sales.

Calculation of Weighted Ratio:

The total amount of certain expenses such as salary, wages etc. does not remain the same throughout the year. If the expenses remain the same throughout the year, these can be easily divided in the time ratio. But if the expenses change as salary due to more number of workers employed because of conversion of partnership business into a limited company, then weighted ratio is to be calculated by taking into consideration time and the number of workers in pre and post-incorporation periods. For example, a company is incorporated on 1st May, 1998. The total amount of wages paid is Rs. 90,000. Number of workers employed in pre-incorporation period 6, post-incorporation period 24. The wages for pre-incorporation period will be 90,000 x 1/9 = Rs. 10,000 and post-incorporation wages are 90,000 x 8/9 = Rs. 80,000. The ratio is calculated as under:

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

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

A statement should be prepared for calculating the amount of net profit before and after incorporation separately on the following principle:

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

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

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

(iv) **Certain expenses**, viz., partners' salary, directors' salary, preliminary expenses, interest on debentures, etc. are not apportioned since they relate to a particular period. For example, partners' salary is to be charged against pre-acquisition profit whereas directors' remuneration, debenture interest, etc. are to be charged against post-acquisition profit.

List of Expenses: Allocated on the basis of Sales/Turnover:

(a) Gross Profit

(b) Selling Expenses

(c) Advertisement

(d) Carriage Outwards

(e) Godown Rent

(f) Discount Allowed

(g) Salesmen's Salaries

(h) Commission to Salesmen

(i) Promotion Expenses for Sales

(j) Distributions Expenses (Variable Portions)

(k) Free Samples given

(l) Expenses incurred for After-Sale Service, etc.

(m) Delivery Van Expenses.

List of Expenses: Allocated on the basis of Time:

(a) Office and Administration Expenses

(b) Salaries to Office Staff	(c) Rent, Rates and Taxes
(d) Depreciation on Fixed Assets	(e) Printing and Stationery
(f) Insurance	(g) Audit Fees
(h) Miscellaneous Expenses	(i) Distribution Expenses (Fixed Portion)
(j) Travelling Expenses (General)	(k) Interest of Debenture
(l) General Expenses	(m) Expenses Fixed in Nature.

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

PRE-INCORPORATION PROFITS AND LOSSES

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

Illustration

Bidyut limited was incorporated on 1st July 2012 to acquire from Bijli as and from 1st January, the individual business carried on by him. The purchase price of the fixed assets and goodwill was agreed to be the sum equal to 80% of the profits made each yesr on ascertainment of the sum due.

The following Trial Balance as on 31st Dec., 2012 is presented to you to enable you to prepare a Balance sheet as at that date.

Particulars	Dr.	Cr.
	Rs	Rs.
Share Capital- 1,500 equity share of Rs 100 each, Rs 80 paid up		1,20,000
Sundry debtors	82,000	
Stock on 31st Dec., 2012	67,000	
Cash at bank and in hand	24,000	
Directors' fee	3,000	
Preliminary expenses	24,000	
Sundry creditors		32,000
Net Profit for the year after providing for all expenses under agreement entered into with Bijli		48,000
	....	....
	2,00,000	2,00,000

Solution

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

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

Notes to accounts

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

WORKING NOTE

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

Illustration

Inder and Vishnu working in partnership registered a joint stock company under the name of Fellow Travellers Ltd. on May 31, 2012 to take over their existing business. It was agreed that they would take over the assets of the partnership for a sum of Rs 3,00,000 as from Jan 1st 2012 and that until the amount was discharged, they would pay interest on the amount at rate of 6% per annum. The amount was paid on June, 30th 2012. Discharge the purchase consideration, the company issued 20,000 equity shares of Rs 10 each at a premium of re 1 each and allotted 7% debentures of the face value of Rs 1,50,000 to the vendors at par.

The summarised profit and loss account of the "Fellows travellers Ltd." For the year ended 31st December 2012 was as follows:

	Rs		Rs
To Purchase, including stock	1,40,000	By Sales:	
To Freight and carriage	5,000	1st January to 31st May 2012	60,000
To Gross profit c/d	60,000	1st June to 31st Dec, 2012	1,20,000
		By Stock in hand	25,000
	-------------		------------
	2,05,000	By Gross profit b/d	2,05,000
	-------------		------------
		By Gross profit b/d	**60,000**
To Salaries and Wages	10,000		
To Debenture Interest	5,250		
To Depreciation	1,000		
To Interest on purchase			
To Consideration (up to 30-6-2012)	9,000		
To Selling commission	9,000		
To Directors' fee	600		
To Preliminary expenses	900		
To Provision for taxes	6,000		
To Dividend on equity shares @ 5%	5,000		
To Balance c/d	13,250		

	60,000		

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

Solution

Fellow Travellers Ltd.

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

	Ratio	Pre-Incorporation	Post-Incorporation
Gross profit allocated on the basis of sale	**1:2**	**20,000**	**40,000**
Less: Administrative expenses allocated On time basis: i) Salaries and wages 10,000 ii) Depreciation 1000 ------------ 11,000 ---------------	**5:7**	**4,583**	**6,417**
Selling commission on the basis of sales	**1:2**	**3,000**	**6,000**
interest on purchase consideration (Time basis)	**5:1**	**7,500**	**1,500**
Expenses application wholly to the **Post-incorporation period**			
Debenture interest 5,250			**5,850**
Directors' Fee 600 -----------			**900**
Preliminary expenses	--------------		----------------
Balance c/d to balance sheet	**4917** ---------------		**19,333** -----------------

Fellow Travellers Ltd.
Extract from the Balance sheet as on 31 st Dec., 2012

	Particulars	Notes	Rs
	Equity and Liabilities		
1	**Shareholders' funds**	1	2,00,000
A	Share capital	2	33,250
B	Reserves and surplus		
2	**Non-current liabilities**		
A	Long-term borrowings	3	1,50,000
3	**Current Liabilities**		
A	Short term provisions	4	6,000 ------------
	Total		3,89,250 ------------

Notes to account

	Rs
1. Share Capital	
20,000 equity shares of Rs 10 each fully paid	2,00,000
2. Reserves and Surplus	
Profit prior to incorporation	4,917
Securities premium account	20,000
Profit and loss account 19,333	
Less: Provision for Tax (6,000)	
Dividend on equity share (5000)	8,333
----------------	-----------
Total	33,250
3. Long term borrowings	-----------
Secured	
7% Debentures	
4. Other current liabilities	1,50,000
Provision for taxes	6000

Ruling/Format

In the Books of ....

Statement of Profit Pre- and Post-incorporation

Particulars	Total	Basis of Allocations/ Apportionment	Pre-incorporation Profit		Post-incorporation Profit	
			Dr.	Cr.	Dr.	Cr.
			Rs.	Rs.	Rs.	Rs.
Gross Profit	• • •	Sales Ratio	—	• • •	—	• • •
Less: Expenses and Losses						
Fixed Expense	• • •	Time Ratio	• • •	—	• • •	—
(Variable Expenses before		Sales Ratio	• • •	—	• • •	—
Incorporation)	• • •	—	• • •	—	—	—
Expenses after		—	—	—	• • •	—
Incorporation	• • •					
Net Profit c/d	• • •		• • •	—	• • •	—
			• • •	• • •	• • •	• • •
Net Profit b/d	.					
Dividend		Actual	—	• • •		• • •
Any Income		Actual	—	• • •		• • •
Net Profit						
—Transferred to Capital Reserve			• • •	—	—	—
—Net Profit transferred to P & L App. A/c			—	—	• • •	—
			• • •	• • •	• • •	• • •

Alternatively

Profit & Loss Account

for the year ended

Dr. Cr.

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

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

llustration

S. Ltd was registered on 1st January 2000 to buy over the business of M/s P. Ltd. as on 1st October 2008 and obtained its certificate for commencement of business on 1st February 2009.

The accounts of the company for the period ended 30th September 2009 disclosed the following facts:

(i) The turnover for the whole period amounted to Rs. 3,00,000 of which Rs. 50,000 related to the period from 1st October 2008 to 1st February 2009.

(ii) The Trading Account showed a Gross Profit of Rs. 1,20,000.

(iii) The following items appear in the Profit and Loss Account:

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

Solution

In the Books of Exe. Pvt. Ltd.
Trading Account
for the year ended 31st March 2007

Dr.	Rs.		*Cr.* Rs.
To Opening Stock	43,000	By Sales	2,78,000
" Purchase	1,89,000	" Closing Stock	44,000
" Gross Profit *(bal. fig.)*	90,000		
	3,22,000		3,22,000

Profit & Loss Account
for the year ended 31st March 2007

Dr.	Basis of Allo-cation	Pre-incor-poration [1.4.06 to 30.6.06]	Post-incor-poration [1.7.06 to 31.3.07]		Basis of Allo-cation	Pre-incor-poration [1.4.06 to 30.6.06]	Post-incor-poration [1.7.06 to 31.3.07] *Cr.*
		Rs.	Rs.			Rs.	Rs.
To Carriage Outwards	Sales (4 : 11)	880	2,420[3]	By Gross Profit	Sales (4 : 11)	24,000	66,000[2]
" Travellers' Commission	(4 : 11) Final	2,000	5,500	" Net Loss transferred to			
" Office Salaries Final	(1 : 3)	5,250	15,750[4]	P & L App. A/c		—	23,545
" Rent & Rates	"	3,000	9,000				
" Depreciation	"	6,250	18,750				
" Adm. Expenses	"	4,975	14,925				
Expenses fully App. to P & T incorporate							
" Directors' Fees		—	18,000[5]				
" Preliminary Expenses		—	5,200				
" Net Profit trans. to —Capital Reserve		1,645	—				
		24,000	89,545			24,000	89,545

Workings

(1) Time Ratio

Pre-incorporations Period : From 1.4.1996 to 30.6.1996 = 3 months

Post-incorporation Period = From 1.7.1996 to 31.3.1997 = 9 months

∴ Time Ratio between Pre- and Post-incorporation is 3 : 9 or 1 : 3.

(2) Gross Profit = Sales + Closing Stock – Opening Stock – Purchases

= Rs. 2,78,000 + Rs. 44,000 – Rs. 43,000 – Rs. 1,89,000

= Rs. 90,000

Gross Profit will be apportioned on the basis of sales ratio which is calculated as:

(3) Sales Ratio

If any other month's sales is Re. 1, monthly sales of April 2006 and Feb. & March 2007 are Rs. 2. (i.e., doubled)

So, the Pre-incorporation Sales = 2 + 1 + 1 = 4

Similarly, Post-incorporation Sales = 1 + 1 + 1 + 1 + 1 + 1 + 1 + 2 + 2 = 11.

1.7 SUMMARY

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

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

1.8 GLOSSARY

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

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

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

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

1.9 SELF ASSESSMENT QUESTIONS

1. The Sai Deep Ltd. was incorporated on 1st August 1996, to take over the running business of Krishna Bros. with effect from 1st April 1996. The company received the certificate for commencement of business on 1st October 1996. The following P&L A/c was prepared for the year ended 31.3.1997.

Profit and Loss Account for the year ended 31.03.1997

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

Additional information:

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

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

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

(4) Bad Debts written off –

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

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

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

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

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

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

c) Expenses debited to profit and loss account.

Rent	6,000
Insurance	1,500
Salaries	27,000
Selling Expenses	9,000
Advertisement	8,000
Interest on Debentures	4,000
Audit Fees	1,200
Printing and Stationery	4,200
Depreciation on Machinery	30,000
Commission on Sales	12,600
Bad Debts (Rs 850 related to prior to incorporation)	2400
General Expenses	4,800
Directors Fees	2,600
Preliminary Expenses	7,200
Interest paid to vendors upto 1st September 2010	5,000

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

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1.10 SUGGESTED READING

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

UNIT- 2 **LESSON NO. 4-6**

MEANING OF BANKING COMPANIES, IMPORTANT TERMS IN BANKING, CONCEPT OF NON-PERFORMING ASSETS, PREPARATION OF VARIOUS ACCOUNTS AND SCHEDULES.

STRUCTURE:

2.1 INTRODUCTION

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

2.2 OBJECTIVES

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

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

2.3 MEANING AND CONCEPT OF BANKING COMPANIES

Meaning of Banking Companies:

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

Definition:

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

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

Business of Banking Companies:

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

1. The borrowing, raising or taking up on money, the lending or advancing of money either upon or without security, the drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, 'bundies', promissory notes, drafts, bills of lading, railways receipt, warrants, debentures, certificates, scrip's and other instruments and securities whether transferable or negotiable or not; granting and issuing of letters of credit, traveller's cheques and circular notes; the buying, selling and dealing in bullion and specie; the buying and selling of foreign exchange including foreign bank notes; the acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares, debentures, debenture stock bonds, obligations, securities and investments of all kinds; the purchasing and selling of bonds, scrip or other forms of securities on behalf of constituents or other, the negotiating of loans and advances; the receiving of all kinds of bonds, scrip or valuables on deposit or for safe custody or otherwise; the providing of safe deposit vaults; the collecting and transmitting of money and securities.

2. **Acting as agents** for any Government or local authority or any other person or persons; the carrying on of agency business of any description including the clearing and

forwarding of goods, giving of receipts and discharges and otherwise acting as on attorney on behalf of customers but excluding the business of (managing agent or secretary and treasurer) of a company.

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

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

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

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

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

8. Undertaking and executing trusts.

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

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

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

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

13. Acquiring and undertaking the whole or any part of the business of any person or company, when such business is of a nature enumerated or described in section 6.

14. Doing all such other things as are incidental or conclusion to the promotion or advancement of the business of the company.

15. Any other form of business which the central Government may by notification in the official Gazette, specify as a form of business in which it is lawful for a banking company to engage.

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

Restrictions on Business:

The Banking Companies are restricted from conducting certain activities.

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

Important accounting provisions of banking regulation act 1949.

Minimum Capital and reserves – Section 11.

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

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

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

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

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

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

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

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

Restrictions on loans and Advances –section 20:

A Bank cannot

i) Grant loans and advances on the security of its own shares and

ii) Grant or agree to grant loan or advance to or on behalf of

  a) Any of its directors;

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

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

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

Books of accounts

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

A) Subsidiary books

i. Receiving cashier's counter cash book;

ii. Paying cashier's counter cash book;

iii. Current accounts ledger.

iv. Savings bank accounts ledger

v. Fixed deposit accounts ledger

vi. Investments Ledger

vi. Investments Ledger

vii. Loans Ledger

viii. Bills discounted and purchased ledger

ix. Customer's acceptances endorsements and guarantee ledger

B) Principal Books

i. Cash book : It records all cash transactions

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

2.4 IMPORTANT TERMS IN BANKING BUSINESS

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

Cash Reserves – Section 18:

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

Cash credit

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

Bills for collection

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

a) On receipt of Bills for collection:

Bills for collection (Asset) account ……Dr.

To Bills for collection (Liability) account

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

Cash account ......Dr.

To Customer's account

To Commission account

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

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

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

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

c) If bills are dishonored on maturity, the bank will make a contra entry:

Bills for collection (Liability) account ......Dr. (with amount dishonored)

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

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

Format for Bills for collection (Asset) account

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

Format for Bills for collection (Liability) account

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

Purchase or discounting of bills:

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

a. When bills are discounted

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

To Discount on bills account (amount of commission)

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

b. On collection/realization of the bills

Cash account ……Dr.

To Discounted bills account

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

Rebate on bills discounted

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

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

Discount on bills account ……Dr.

To Rebate on bills Discounted account

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

Rebate on bills Discounted account ……Dr.

To Discount on bills account

Illustration

Following information is given for Punjab National Bank:

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

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

Journalize and show the necessary ledger accounts.

Solution:

Date	Particulars	(Lakhs)
1-4-2015	Rebate on bills discounted account To Discount on bills account (transfer the earned part of the discount income from Rebate on bills discounted account to Discount on bills account)	10 10
2015-2016	Bills purchased and discounted account To Discount on bills account To Customers a/c (discounting of bills during the year: [2000x0.2]x65/365)	2000 356 1644
31-3-2016	Discount on bills account To Rebate on bills discounted account (unexpired/unearned part of discount in respect of discounted bills carried forward [300x0.2]x32/365)	5.27 5.27
31-3-2016	Discount on bills account To Profit & Loss account (being discount income transferred to P&L a/c)	360.73 360.73

Discount on Bills Account

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

Rebate on Bills Discounted Account

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

Acceptances, Endorsements and other Obligations

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

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

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

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

The journal entries involved are:

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

Customer's account
To Cash account

b) For commission receivable from customer:

Customer's account

To Commission on acceptances & endorsement account

c) When customers make the payment:

Cash account

To Customer's account

Inter-office Adjustments

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

Interest on Doubtful Debts

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

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

Customer’s Loan account
To Interest account

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

Customer’s account
To Interest Suspense account

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

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

Cash account
To Customer’s Loan account

For transferring interest:

Interest Suspense account
To Interest account

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

Interest Suspense account (unrealized interest)
Bad Debts account (unrealized portion of loan)
To Customer's Loan account

2.5 CONCEPT OF NON-PERFORMING ASSETS

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

These guidelines are discussed as follows:

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

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

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

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

Advances

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

These prudential norms are discussed below.

Prudential Norms for Asset Classification and Concept of Classification of Assets

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

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

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

II. Non Performing Assets

I. Performing Assets

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

II. Non Performing Assets (NPA)

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

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

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

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

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

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

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

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

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

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

(e) in respect of agricultural finance / advance (eg. crop loans) interest and / or instalment of principal remains overdue for two harvest seasons for a period not exceeding two half years. The period of 180 days has been reduced to 90 days effective from March 31,

2004. A 'past due' account has been defined as an amount which remains outstanding 30 days beyond the due date.

Assets classification and provisioning

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

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

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

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

The provision for doubtful assets as follows:

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

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

Illustration

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

	Bills Purchased and Discounted	**Cash credit, overdraft**	**Term loans**
i) Standard Assets	5,150	4,925	2,375
ii) Sub-standard Assets	4,000	1,500	1,000
iii) Doubtful Assets:			
- upto one year	--	500	1,800
- One to 3 years	--	1,800	700
- More than 3 years	--	1,275	550
iv) Loss Assets		350	225
	9150	10,350	6,650

Solution

	Amount (Rs.)	**% of Provision**	**Amount of Provision (Rs)**
i) Standard Assets	12,450	Nil	Nil
ii) Sub-standard Assets	6,500	10%	650
iii) Doubtful Assets:			
- upto one year	2,300	20%	460
- One to 3years	2,500	30%	750
- More than 3 years	1,825	50%	912.5
iv) Loss Assets	575	100%	575
Total Provision on Advances			**3,347.5**

ASSET	Asset Treated as an NPA if:
1. Term loan	If the interest and/or installment of the principal remain overdue for a period of 90 days.
2. Cash credit and overdraft	If the Account remains “out of order” for a period of more than 90 days. An account is treated as “out of order” if a) balance outstanding remains continuously in excess of the sanctioned limit/drawing power, or b) outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period.
3. Bills purchased and discounted	If the bills remain overdue for more than 90 days.
4. Agricultural advances for short duration crops	If the installment of principal or interest thereon remains overdue for two crop season. Any amount due to the bank under any credit facility is ‘overdue’ if it is not paid on the due date fixed by the bank.
5. Agricultural advances for long duration crops	If the installment of principal or interest thereon remains overdue for one crop season.
6. Securitization Transactions	If the amount of liquidity facility remains outstanding for more than 90 Days.
7. Credit card accounts	If the minimum amount mentioned in the statement remained unpaid within 90 days from the next statement, the gap between two statements should not be more than one month.
8. Advances guaranteed by central government	If the government repudiate or reject its guarantee when called upon. Thus, central government guaranteed advances would be treated as standard assets even if overdue.

2.6 PREPARATION OF ACCOUNTS AND BALANCE SHEET AND SCHEDULES RELATED TO BANKING COMPANIES

2.6.1 FINAL ACCOUNTS

Financial Statements of Banks:

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

Items to be included Financial Statements of Banks:

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

a) **Demand deposits:** They refer to the deposits made by the customers and repayable by the bank when demanded back by the customers. They include bank deposits from bank and from others (that is, non-bank sector). For example, savings account or current account.

b) **Fixed/ Term/ Time deposits:** These are deposits repayable on the expiry of a specified period which can vary from one month to five years or more. For example, recurring deposits or annuity deposits.

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

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

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

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

Solution:

Particulars	Amount (in lakhs)
a) Provision for NPA	623
b) Provision for diminution of investments (other than held to maturity): Investments other than held to maturity =85% of 500=425.00	42.5
Less: Market value of investments =(90% of 425) = (382.50)	
c) Provision for tax:	
Total income = Interest + Other income+ Income from Investments	
= 4200+ 230+ 150 = 4580	
Less: Total Expenditures Excluding Provision for Tax	

= Interest Expended +Operating Expenses+ Provision for Contingencies

= 300+120 +(623+42.5) (= 1085.5)

= 300+120 +(623+42.5) (= 1085.5)

....

3494.5

Provision for tax = 30% of 3494.5	1048.35
	Total
Provisions and contingencies (a+b+c)	1713.85

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

5. Advances: Advances may include:

- Loans, both secured and unsecured, given to customers for a specified period of time.

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

- **Overdraft,** which is a temporary arrangement to overdraw money from one's current account upto a certain limit.

The Banking Regulation act, 1949 prescribes formats of preparing final accounts of the Banking companies. The third schedule of section 29 gives forms 'A' for the balance sheet and Form 'B' for Profit and loss account. The balance sheet consists of total 12 schedules. Schedule 1 to schedule 5 depicts capital and liabilities and schedule 6 to schedule

11 shows Assets of the bank and schedule 12 shows contingent liabilities and there is no specific schedule prescribes for bills for collection.

THE THIRD SCHEDULE

(See Section 29)

Form 'A'

FORM OF BALANCE SHEET

Balance Sheet of……………… (here enter the name of the Banking Company) **Balance Sheet as on 31st March __________ (year) (000's omitted)**			
	Schedule No.	**As on 31.3…… (Current Year)**	**As on 31.3….. (Previous Year)**
Capital & Liabilities			
Capital	1		
Reserves & Surplus	2		
Deposits	3		
Borrowings	4		
Other Liabilities and Provisions	5		
Total			
Assets			
Cash and balance with Reserve Bank of India	6		
Balances with banks and money at call and short notice	7		
Investments			
Advances	8		
Fixed Assets	9		
Other Assets	10		
Total	11		
Contingent Liabilities	12		

Form 'B'

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

			(000's omitted)
	Schedule No.	**Year ended 31.3… (Current Year)**	**Year ended 31.3… (Previous Year)**
I. Income Interest earned Other income Total II. Expenditure Interest expended Operating expenses Provisions and contingencies Total III. Profit / Loss Net profit / Loss (-) for the year Profit / Loss (-) brought forward Total IV. Appropriations Transfer to statutory reserves Transfer to other reserves Transfer to Government / Proposed dividend Balance carried over to Balance Sheet Total	 13 14 15 16		

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

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

3. Surplus / deficit of foreign branches Rs. ______

2.5.2 Various Schedules (1-16) and their contents

SCHEDULE 1- CAPITAL

Particulars	Year ended 31-3-..(current year)	Year ended 31-3-... (previous year)
For Nationalized Banks		
For Banks Incorporated outside India		
For other banks		
Authorized Capital (__shares of RS __each)		
Issued Capital (__shares of RS __each)		
Subscribed capital (__shares of RS __each)		
Called-up capital (__shares of RS __each) Less calls unpaid Add forfeited shares		
Total		

SCHEDULE 2- RESERVES AND SURPLUS

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

SCHEDULE 3- DEPOSITS

Particulars	Year ended 31-3-..(current year)	Year ended 31-3-... (previous year)
A) I. Demand Deposits a. From banks b. From others		
II. Savings Bank deposit		
III. Term Deposit a. From banks b. From others		
B) I. Deposits of branches in India II. Deposits of branches outside India		
TOTAL		

SCHEDULE 4-BORROWINGS

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

SCHEDULE 5- OTHER LIABILITIES AND PROVISIONS

Particulars	Year ended 31-3-..(current year)	Year ended 31-3-... (previous year)
Bills payable Inter office adjustments (net) Interest accrued Others (including provisions)		
TOTAL		

SCHEDULE 6- CASH AND BALANCES WITH RESERVE BANK OF INDIA

Particulars	Year ended 31-3-..(current year)	Year ended 31-3-... (previous year)
i. Cash in hand (including foreign currency notes)		
ii. Balances with Reserve Bank Of India a. In current account b. In other accounts		
TOTAL		

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

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

SCHEDULE 8- INVESTMENTS

Particulars	Year ended 31-3-..(current year)	Year ended 31-3-... (previous year)
I. Investments in India a. Government securities b. Other Approved securities c. Shares d. Debentures and bonds e. Subsidiaries and joint ventures f. Others (to be specified)		
TOTAL		
II. Investments Outside India a. Government securities (including local authorities) b. Subsidiaries and joint ventures abroad c. Other investments (if any)		
TOTAL		
Grand Total (I+II)		

SCHEDULE 9- ADVANCES

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

SCHEDULE 10- FIXED ASSETS

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

SCHEDULE 11- OTHER ASSETS

Particulars	Year ended 31-3-..(current year)	Year ended 31-3-... (previous year)
1) Inter-office adjustments (net)		
2) Interest accrued		
3) Tax paid in advance/tax deducted at source		
4) Stationary and stamps		
5) Non-banking assets acquired in satisfaction of claims		
6) Others (in case there is any unadjusted balance of loss)		
TOTAL		

SCHEDULE 12-CONTINGENT LIABILITY

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

SCHEDULE 13- INTEREST EARNED

Particulars	Year ended 31-3-..(current year)	Year ended 31-3-... (previous year)
I. Interest/discount on advances/bills II. Income on investments III. Interest on balances with RBI and other inter-bank funds IV. Others		
TOTAL		

SCHEDULE 14- OTHER INCOME

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

SCHEDULE- 15- INTEREST EXPENDED

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

SCHEDULE 16- OPERATING EXPENSES

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

2.7 SUMMARY

A bank is a commercial institution, which accepts deposits and repay on demand; lend; transfer and invest the money. Banking companies are governed by Banking Regulation Act, 1949 and also subject to the companies Act, 1956. Section 6 of the Banking Regulation Act prescribes various business of banking companies which includes borrowing, raising or taking up of money, acting as on agent for any government or local authority or any other person; contracting, guaranteeing and so on. Also the banks are restricted to deal in buying, selling or bartering of goods and also not allowed to engage in any trade related to bills of exchange received for collection or negotiation or such of its business. The various accounting provisions regarding minimum capital and reserves; restriction on commission, brokerage, discount on sale of shares, restrictions on payment of dividend, statutory reserves, cash reserves and restrictions on loans and advances given under various sections of Banking Regulation Act, 1949. The banks keep subsidiary and principal books of accounts to minimize the errors in maintaining records of voluminous transactions.

The recommendation of Narsimham Committee report on Non-performing Assets was accepted by RBI and accordingly issued directives to all the banks regarding income recognition, assets classification and loan provisioning. The assets have been classified as standard assets, sub-standard assets, doubtful assets and loss assets and provisioning norms for each category is given. Bank is a legal financial institution which takes deposits that can be withdrawn anytime. It also lends money to individuals and organizations as per their needs. There are two types of banks – scheduled banks and non-scheduled banks. The financial statements of banks comprises of balance sheet and profit and loss account. Assets of a bank are broadly classified into two categories i.e. Performing Asset and Non Performing Asset. Performing Assets-It means those assets which provides regular income and does not include more than normal business risk. A Non Performing Asset is a loan or advance where a bank cannot realize the interest which is debited to borrowers account for at least 90days. The final accounts of banking companies are prepared as per the formats given under form 'A' for balance sheet and form 'B' for profit and loss account. Out of 16 schedules, form A contains 12 schedules and form B contains the remaining 4 schedules. Restriction on commission Brokerage, Discount, etc. on sale of shares-section B: A Banking company is not allowed to pay directly or indirectly commission, Brokerage, Discount or remuneration in any form in respect of any shares issued by it, any amount exceeding two and one-half person of the paid up value of the said shares. Restriction on payment of dividend – section 15:A Banking company shall not pay dividend unless all of its capitalized expenses (including preliminary expenses, organization expenses, share selling commission, Brokerage, amount of losses incurred and any other item. Of expenditure not represented by tangible assets) have been completely written-off. However, a banking company may pay dividend on its shares without writing off. Restrictions on loans and Advances –section 20: A Bank can not i) grant loans and advances on the security of its own shares and ii) grant or agree to grant loan or advance to or on behalf of a) Any of its directors; b) Any firm in which any of its directors is interested as partner, manager or gurantor; c) Any company of which any of its directors is a director manager, employee or guarantor or in which he holds substantial interest; or d) Any individual in respect of whom any of its directors is a partner or guarantor. There are certain legal provisions which must be followed by banks. Some of these are: Authorized Capital, Subscribed Capital and Paid up Capital Section 12 of the Banking Regulation Act, 1949, provides that a banking company's subscribed capital should be atleast half of authorized capital while paid up capital should be atleast half of the subscribed capital. In other words, Share capital of a banking company can include equity shares and those preference shares which have been issued before 1 July 1944. In other words, nowadays, preference shares cannot be issued by a banking company. Moreover, no single shareholder should hold more than 1 percent of the total voting rights of the bank. Minimum Paid up Capital and Reserves Section 11(2) of the Banking Regulation Act 1949, put some limits on the banking company's minimum aggregate value of the paid up capital and reserves. These limits can be divided according to the fact whether the banking company is incorporated in India or outside India. Cash Reserves of Non-Scheduled Banks As per Section 18 of the Baking Regulations Act 1949, every non-scheduled bank is supposed to maintain a cash reserve with itself or with RBI, a sum prescribed by RBI from time to time. Currently, this prescribed sum is 3 percent of total demand and time liabilities of the bank in India.

2.8 GLOSSARY

- **Overdue-** any amount due to the bank is termed as overdue, if it is not paid on the due date.
- **Nidhi's-** These are small to tiny non-scheduled Urban Co operative banks situated in some parts of country.
- **Voucher-** these are loose leaves of journals or cash books on which transactions are recorded as they occur.

- **Banking Companies-** A bank is a commercial institution, permitted to accept, collect, transfer, lend and exchange money and claims to money both the domestically and internationally and thereby conduct smooth banking activities.
- **General Ledger-** It contains all personal ledgers, the profit and loss account and different asset accounts. These accounts are arranged in such a manner that a balance sheet can be easily prepared.
- **Cash Credit**- It is an agreement where customer can borrow money up to a certain limit from the bank.
- **Out of order**- Any account is treated as out of order if the outstanding amount continuously exceeds the sanctioned limit.

2.9 SELF ASSESSMENT QUESTIONS

1. Define Banking Companies and write a note on 'Business of banking companies.

2. Explain the provisions given by Banking Regulation Act, 1949 with regard to following–

i) Statutory Reserve

ii) Minimum capital and Reserves

iii) Restrictions on Payment of Dividend

3. On 31st March 2016, the balance of unsecured loan account (considered doubtful) was 10 lakhs and interest outstanding on doubtful debts for the year was [1] 2 lakhs. On 30^{th} June 2016, the customer was declared insolvent and a final payment of 80% was received. Pass the journal entries.

4. From the following particulars of Rishab Bank ltd. prepare profit and loss account for 2013 -2014.

Interest on Loan	69800
Interest on Fixed Deposit	73000
Rebate on Bills Discount	9600
Commission charged on customer	1820

Office expense	31000
Discount on bills discounted	38800
Interest on cash deposit	44800
Interest on overdraft	25600
Rent & taxes	3600
Other expenses	360
Printing and stationary	780
Postal expenses	300
Interest on saving deposit account	13800
Directors remuneration	840
Balance of profit and loss account	2400

5. Explain in brief the classification of assets and provisioning of NPA.

6. Explain the following terms:

1) Non-banking assets
2) Doubtful assets and loss assets
3) Rebate on bills discounted
4) Bills for collection
5) Provisions and contingencies

7. The asset of the Bank is bifurcated as performing and non-performing assets and accordingly income to be recognized.

	Interest Earned	Interest Received
Performing Assets		
Cash credit and overdraft	10,50,000	8,68,000
Bills purchased and discounted	2,10,000	2,10,000
Term loans	1,68,000	1,12,000
Non-performing Assets		
Cash credit and overdraft	2,10,000	16,800
Bills purchased and discounted	1,40,000	28,000
Term loans	1,05,000	7,000

8. From the following details: calculate the amount of provisions to be made after identifying the category of assets according to the RBI guidelines:

1. Non-performing asset for 12 months (secured) 150 lakhs.
2. Non-performing asset for 12 months (unsecured) 250 lakhs.
3. Non-performing asset for 24 months (secured) 400 lakhs.
4. Non-performing asset for 24 months (unsecured) 150 lakhs.
5. Non-performing asset for 36 months (secured) 200 lakhs.
6. Non-performing asset for 37 months (secured) 300 lakhs.
7. Non-performing asset for 50 months (secured) 100 lakhs.
8. Performing asset for 12 months (realizable value of security 90 lakhs) 150 lakhs.

9. Balance outstanding of a loan account of a customer is 40 lakhs as on 31st March 2014. Interest is not received by the bank since 1st April 2010. Identify when this asset is categorized as standard, sub-standard and doubtful asset.

2.10 SUGGESTED READING

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UNIT- 3 **Lesson no. 7-9**

MEANING OF INSURANCE, TYPES OF INSURANCE, STATUTORY AND SUBSIDIARY BOOKS, IMPORTANT TERMS, INSURANCE COMPANIES REVENUE ACCOUNT AND BALANCE SHEET

STRUCTURE:

3.1 INTRODUCTION

The IASB Proposal for International Insurance Accounting Standards: IASB's aim in establishing accounting standards for the insurance industry is to facilitate the understanding of insurers' financial statements. Insurance contracts had been excluded from the scope of international financial reporting standards, in part because accounting practices for insurance often differ substantially from those in other sectors — both non-insurance financial services and nonfinancial businesses, and from country to country. **The Pradhan Mantri Fasal Bima Yojana** (Prime Minister's Crop Insurance Scheme) was launched by Prime Minister of IndiaNarendra Modi on 18 February 2016. It envisages a uniform premium of only 2 per cent to be paid by farmers for Kharif crops, and 1.5 per cent for Rabi crops. The premium for annual commercial and horticultural crops will be 5 per cent. Prime Minister Narendra Modi has asked for integration. This scheme is dedicated to bring in more than 50% of the farmers under its wing within the next 2–3 years. Around 25% of the claims will be sent to the farmer's direct account. Also, the scheme will remain as it is. This means that there will be no cap on coverage. Also there won't be any cap on the reduction in the insured sum.This insurance scheme, unlike the previous ones, covers local calamities too, such as landslide, hailstorm, inundation, etc. inundation was not covered by the previous schemes. The government has proposed that there will only be one insurance company for the entire state. Mostly the private as well as the national agricultural insurance companies will be approached to implement it. **Comprehensive Crop Insurance Scheme(CCIS)** covered 15 states and 2 union territories. Participation in the scheme was voluntary. Around 5 million farmers and between 8-9 million hectares were annually covered by this scheme. If the actual yield in any area covered by the scheme fell short of the guaranteed yield, the farmers were entitled to an indemnity on compensation to the extent of the shortfall in yield. The General Insurance Corporation of India administered the scheme on behalf of the Ministry of Agriculture, Government of India. **Experimental Crop Insurance** scheme was introduced in 1997-98, covering non-loanee small and marginal farmers growing specified crops in selected districts. The premium was subsidized. The premium collected was about 3 crore (US$450,000) and the claims amounted to Rs. 40 crore (US$5.9 million). The Government discontinued the scheme during 1997-98 itself. **Farm Income Insurance Scheme.** The Central Government formulated the Farm Income Insurance Scheme (FIIS) during 2003-04. The two critical components of a farmer's income are yield and price. FIIS targeted these two components through a single insurance policy so that the insured farmer could get a guaranteed income.The scheme provided income protection to the farmers by insuring production and market risks. The insured farmers were ensured minimum guaranteed income (that is, average yield multiplied by the minimum support price). If the actual income was less than the guaranteed income, the insured would be compensated to the extent of the shortfall by the Agriculture Insurance Company of India. Initially, the scheme would cover only wheat and rice and would be compulsory for farmers availing crop loans. NAIS (explained in the section below) would be withdrawn for the crops covered under FIIS, but would continue to be applicable for other crops.The FIIS was withdrawn in 2004. The recent attempt by the Gujarat government to reintroduce the Farm Income Insurance Scheme (FIIS) can reform agricultural insurance and prevent farm-level distress. **National Agriculture Insurance Scheme (NAIS)** The Government of India experimented with a comprehensive crop insurance scheme which failed. The Government then introduced in 1999-2000, a new scheme titled "**National Agricultural Insurance Scheme**" (NAIS) or "**Rashtriya Krishi Bima Yojana" (RKBY)**. NAIS envisages coverage of all food crops (cereals and pulses), oilseeds, horticultural and commercial crops. It covers all farmers, both loanees and non-loanees, under the scheme. The premium rates vary from 1.5 percent to 3.5 percent of sum assured for food crops. In the case of horticultural and commercial crops, actuarial rates are charged. Small and marginal farmers are entitled to a subsidy of 50 percent of the premium charged- the subsidy is shared equally between the Government of India and the States. The subsidy is to be phased out over a period of 5 years.NAIS operates on the basis of Area approach- defined areas for each notified crop for widespread calamities. On individual basis- for localized calamities such as hailstorms, landslides, cyclones and floods. Under the scheme, each state is required to reach the level Gram Panchayat as the unit of insurance in a maximum period of 3 years. Agriculture Insurance Corporation of India is implementing the scheme.

3.2 OBJECTIVES

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

- Concept and meaning of insurance companies.
- Different types of insurance.
- Important terms related with insurance.
- Prepare books, accounts and balance sheet of insurance companies.

3.3 MEANING AND CONCEPT OF INSURANCE

Insurance is a contract, a risk transfer mechanism whereby a company (Underwriter) promised to compensate or indemnify another party (Policyholder) upon the payment of reasonable premium to the insurance company to cover the subject-matter of insurance. If you are well conversant with these principles, you will be in a better position in negotiating you insurance needs.

Insurance is a means of protection from financial loss. It is a form of risk management primarily used to hedge against the risk of a contingent, uncertain loss.

An entity which provides insurance is known as an insurer, insurance company, or insurance carrier. A person or entity who buys insurance is known as an insured or policyholder. The insurance transaction involves the insured assuming a guaranteed and known relatively small loss in the form of payment to the insurer in exchange for the insurer's promise to compensate the insured in the event of a covered loss. The loss may or may not be financial, but it must be reducible to financial terms, and must involve something in which the insured has an insurable interest established by ownership, possession, or pre existing relationship.

The insured receives a contract, called the insurance policy, which details the conditions and circumstances under which the insured will be financially compensated. The amount of money charged by the insurer to the insured for the coverage set forth in the insurance policy is called the premium. If the insured experiences a loss which is potentially covered by the insurance policy, the insured submits a claim to the insurer for processing by a

Insurability

Risk which can be insured by private companies typically shares seven common characteristics.

1. **Large number of similar exposure units**: Since insurance operates through pooling resources, the majority of insurance policies are provided for individual members of large classes, allowing insurers to benefit from the law of large numbers in which predicted losses are similar to the actual losses. However, all exposures will have particular differences, which may lead to different premium rates.

2. **Definite loss**: The loss takes place at a known time, in a known place, and from a known cause. The classic example is death of an insured person on a life insurance policy. Fire, automobile accidents, and worker injuries may all easily meet this criterion. Other types of losses may only be definite in theory. Occupational disease, for instance, may involve prolonged exposure to injurious conditions where no specific time, place, or cause is identifiable. Ideally, the time, place, and cause of a loss should be clear enough that a reasonable person, with sufficient information, could objectively verify all three elements.

3. **Accidental loss**: The event that constitutes the trigger of a claim should be fortuitous, or at least outside the control of the beneficiary of the insurance. The loss should be pure, in the sense that it results from an event for which there is only the opportunity for cost. Events that contain speculative elements such as ordinary business risks or even purchasing a lottery ticket are generally not considered insurable.

4. **Large loss**: The size of the loss must be meaningful from the perspective of the insured. Insurance premiums need to cover both the expected cost of losses, plus the cost of issuing and administering the policy, adjusting losses, and supplying the capital needed to reasonably assure that the insurer will be able to pay claims. For small losses, these latter costs may be several times the size of the expected cost of losses. There is hardly any point in paying such costs unless the protection offered has real value to a buyer.

5. **Affordable premium**: If the likelihood of an insured event is so high, or the cost of the event so large, that the resulting premium is large relative to the amount of protection offered, then it is not likely that the insurance will be purchased, even if on offer. Furthermore, as the accounting profession formally recognizes in financial accounting standards, the premium cannot be so large that there is not a reasonable chance of a significant loss to the insurer. If there is no such chance of loss, then the transaction may have the form of insurance, but not the substance (see the U.S. Financial Accounting Standards Board pronouncement number 113: "Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts").

6. **Calculable loss**: There are two elements that must be at least estimable, if not formally calculable: the probability of loss, and the attendant cost. Probability of loss is generally

an empirical exercise, while cost has more to do with the ability of a reasonable person in possession of a copy of the insurance policy and a proof of loss associated with a claim presented under that policy to make a reasonably definite and objective evaluation of the amount of the loss recoverable as a result of the claim.

7. **Limited risk of catastrophically large losses**: Insurable losses are ideally independent and non-catastrophic, meaning that the losses do not happen all at once and individual losses are not severe enough to bankrupt the insurer; insurers may prefer to limit their exposure to a loss from a single event to some small portion of their capital base. Capital constrains insurers' ability to sell earthquake insurance as well as wind insurance in hurricane zones. In the United States, flood risk is insured by the federal government. In commercial fire insurance, it is possible to find single properties whose total exposed value is well in excess of any individual insurer's capital constraint. Such properties are generally shared among several insurers, or are insured by a single insurer who syndicates the risk into the reinsurance market.

In accordance with study books of The Chartered Insurance Institute, there are the following types of insurance:

1. **Co-insurance** – risks shared between insurers
2. **Dual insurance** – risks having two or more policies with same coverage (Both the individual policies would not pay separately- a concept named contribution, and would contribute together to make up the policyholder's losses. However, in case of contingency insurances like Life insurance, dual payment is allowed)
3. **Self-insurance** – situations where risk is not transferred to insurance companies and solely retained by the entities or individuals themselves
4. **Reinsurance** – situations when Insurer passes some part of or all risks to another Insurer called Reinsurer

Principles of insurance

Principle of utmost Good faith (Uberrima Fides)

Like in other contracts, the insurance contract must be based on good faith. If the insurance contract is obtained by way of fraud or misrepresentation it is void. It means utmost good faith, this principle stated that the parties to insurance contract must disclose accurately and fully all the facts material to the risk being proposed. That is to say that the insured must make known to the insurer all facts regarding the risk to be insured. Likewise, the underwriter must highlight and explain the terms, conditions and exceptions of the insurance policy. And the policy must be void of 'small prints'.

Principle of Indemnity

The insurance contract should always be a contract of indemnity only and nothing more. According to this principle, the insurance contract should be such that in case of loss due to the eventialities mentioned in the contract, the insured should be neither better off nor worse off after receiving the insured amount. The main object of this principle is to ensure that the insured is not able to use this contract for speculation or gambling. It stated that following a loss, the insurer should ensure that they placed the insured in the exact financial position he enjoyed prior to the loss. To "indemnify" means to make whole again, or to be reinstated to the position that one was in, to the extent possible, prior to the happening of a specified event or peril. Accordingly, life insurance is generally not considered to be indemnity insurance, but rather "contingent" insurance (i.e., a claim arises on the occurrence of a specified event). There are generally three types of insurance contracts that seek to indemnify an insured:

1. A "reimbursement" policy
2. A "pay on behalf" or "on behalf of policy"
3. An "indemnification" policy

From an insured's standpoint, the result is usually the same: the insurer pays the loss and claims expenses.

If the Insured has a "reimbursement" policy, the insured can be required to pay for a loss and then be "reimbursed" by the insurance carrier for the loss and out of pocket costs including, with the permission of the insurer, claim expenses.

Under a "pay on behalf" policy, the insurance carrier would defend and pay a claim on behalf of the insured who would not be out of pocket for anything. Most modern liability insurance is written on the basis of "pay on behalf" language which enables the insurance carrier to manage and control the claim.

Under an "indemnification" policy, the insurance carrier can generally either "reimburse" or "pay on behalf of", whichever is more beneficial to it and the insured in the claim handling process.

An entity seeking to transfer risk (an individual, corporation, or association of any type, etc.) becomes the 'insured' party once risk is assumed by an 'insurer', the insuring party, by means of a contract, called an insurance policy. Generally, an insurance contract includes, at a minimum, the following elements: identification of participating parties (the insurer, the insured, the beneficiaries), the premium, the period of coverage, the particular loss event covered, the amount of coverage (i.e., the amount to be paid to the insured or beneficiary in the event of a loss), and exclusions (events not covered). An insured is thus said to be "indemnified" against the loss covered in the policy.

When insured parties experience a loss for a specified peril, the coverage entitles the policyholder to make a claim against the insurer for the covered amount of loss as specified by the policy. The fee paid by the insured to the insurer for assuming the risk is called the premium. Insurance premiums from many insureds are used to fund accounts reserved for later payment of claims – in theory for a relatively few claimants – and for overhead costs. So long as an insurer maintains adequate funds set aside for anticipated losses (called reserves), the remaining margin is an insurer's profit.

Contribution

In a situation where two or more insurers is covering a particular risk, if a loss occurred, the insurers must contribute towards the settlement of the claim in accordance with their rateable proportion.

Subrogation

It has often been said that contribution and subrogation are corollary of indemnity, which means that these two principles operates so that indemnity does not fail. Subrogation operates mainly on motor insurance. When an accident occurred involving two or more vehicles, there must be someone who is responsible for accident. On this basis, the insurer covering the policyholder who was not at fault can recover their outlay from the underwriter of the policyholder who is responsible for the incidence.

Insurable Interest

Insurable interest means that the person opting for insurance must have pecuniary interest in the property he is going to get insured and will suffer financial loss on the occurrence of the insured event. This is one of the essential requirements of any insurance contract. Therefore, a person can go for insurance of only those properties where he stands to benefit by the safety of the property, and will suffer loss, damage, injury if any harm takes place to such property. Thus, if you want to insure Taj Mahal or Red Fort, you will not be allowed to do so as you do not have any pecuniary interest in these properties. This is the financial or monetary interest that the owner or possessor of property has in the subject-matter of insurance. The mere fact that it might be detrimental to him should a loss occurred because of his financial stake in that assets gives him the ability to insure the property.

Material Facts Disclosure

In the Insurance contract, the proposer is required to disclose to the insurer all the material facts in respect of the proposed insurance. This duty of disclosing the material facts not only applies to the material facts which are known to him but also extends to material facts which he is supposed to know. Thus, in case of Life Insurance the proposer must disclose the true age and details of the existing illnesses / diseases. Similarly, in case of the insurance of a building against fire, the proposer must disclose the details of the goods stored if such goods are of hazardous nature.

Social effect

Insurance can have various effects on society through the way that it changes who bears the cost of losses and damage. On one hand it can increase fraud; on the other it can help societies and individuals prepare for catastrophes and mitigate the effects of catastrophes on both households and societies.

Insurance can influence the probability of losses through moral hazard, insurance fraud, and preventive steps by the insurance company. Insurance scholars have typically used moral hazard to refer to the increased loss due to unintentional carelessness and insurance fraud to refer to increased risk due to intentional carelessness or indifference.Insurers attempt to address carelessness through inspections, policy provisions requiring certain types of maintenance, and possible discounts for loss mitigation efforts. While in theory insurers could encourage investment in loss reduction, some commentators have argued that in practice insurers had historically not aggressively pursued loss control measures—particularly to prevent disaster losses such as hurricanes—because of concerns over rate reductions and legal battles. However, since about 1996 insurers have begun to take a more active role in loss mitigation, such as through building codes.

FUNCTIONS AND BENEFITS OF INSURANCE

Insurance has many functions and benefits, some of which we may describe as primary and others as ancillary or secondary, as follows:

(a) **Primary functions/benefits:** Insurance is essentially a risk transfer mechanism, removing, for a premium, the potential financial loss from the individual and placing it upon the insurer. The primary benefit is seen in the financial compensation made available to insured victims of the various insured events. On the commercial side, this enables businesses to survive major fires, liabilities, etc. From a personal point of view, the money is of great help in times of tragedy (life insurance) or other times of need.

(**b**) **Ancillary functions/benefits:** Insurance contributes to society directly or indirectly in many different ways. These will include:

- **(i) Employment:** the insurance industry is a significant factor in the local workforce;
- **(ii) Financial services:** since the relative decline in manufacturing in Hong Kong, financial services have assumed a much greater role in the local economy, insurance being a major element in the financial services sector;
- **(iii) Loss prevention and loss reduction (collectively referred to as 'loss control'):** the practice of insurance includes various surveys and inspections related to risk management. These are followed by requirements (conditions for acceptance of risk) and/or recommendations to improve the 'risk'. As a consequence, we may say that there are fewer fires, accidents and other unwanted happenings;

(iv) **Savings/investments**: life insurance, particularly, offers a convenient and effective way of providing for the future. With the introduction of the Mandatory Provident Fund Schemes in 2000, the value of insurance products in providing for the welfare of people in old age or family tragedy is very evident;

(v) **Economic growth/development**: it will be obvious that few people would venture their capital on costly projects without the protection of insurance (in most cases, bank financing will just not be available without insurance cover). Thus, developments of every kind, from erection of bridges to building construction and a host of other projects, are encouraged and made possible partly because insurance is available.

3.4 PREPARATION OF REVENUE ACCOUNTS AND BALANCE SHEET OF LIFE INSURANCE COMPANIES AS PER PRESCRIBED FORM

FINAL ACCOUNTS OF INSURANCE COMPANIES

Insurance is a form of contract under which one party agrees in return of a consideration to pay an agreed amount of money to another party to compensate for a loss, damage or some uncertain event. There are two types of insurance i.e., Life insurance and General Insurance.

Life Insurance – under this type of insurance the corporation guarantees to pay a certain sum of money to the policy holder on reaching a certain age or on his death whichever is earlier. Life insurance has an element both of protection and investment. General Insurance – it includes all other types of insurance except life insurance. e.g. – Fire, Marine, Accident, Theft.etc. Under this type of insurance the insurer undertakes to indemnify the loss suffered by the insured on happening of a certain event in consideration for a fixed premium. Insurance Regulatory and Development Authority (IRDA) In order to regulate the insurance business, the government set up in 1996, the Insurance Regulatory Authority (IRA). Now this authority is known as the Insurance Regulatory and Development Authority. In 2002, the authority came with regulations for the preparation of the financial statement of insurance companies.

Accounts of insurance companies

1. **IRDA** has prescribed in specified formats for preparation of financial statements of insurance business in part V of 'schedule A' of IRDA regulations 2002.

2. **Financial statements** have to be in conformity with the accounting standards issued by the Institute of Charted Accountants of India (ICAI). IRDA Act,1999 provide legal framework of insurance accounting in India.

3. **BOOKS FOR MAINTENANCE OF ACCOUNTS**

1. Statutory Book:

The Insurance Act, 1938, requires the following books to be maintained by all insurance company –

I. Register of Policies – It contains all the details in respect of each policy such as name and address of the policy holder, the date when the policy was effected and a record of any assignment of the policy.

II. Register of claims – All the particulars of claims are recorded – date of claim, name and address of claimant, the date on which the claim was discharged, the case of a claim which is rejected and reasons for rejection.

III. Register of agents – It contains all the information of licensed insurance agents such as name and address of the agent, date of appointment, etc.

2. Subsidiary Book:

Apart from statutory books, the insurance companies also maintain the following books

I. Ledgers – Life insurance Fund ledger; revenue ledger and miscellaneous ledger

II. Cash books – Receipts cash books and expenditure cash books.

III. Journal – Journal for recording transactional relating to outstanding premium and claims and inter-departmental transfer.

IV. First year premium book

V. Renewal premium book

VI. Surrender policy book

This book consists of 3 registers & Register of claims:- contains date of claim, names address of policy holder, date of policy etc. & Register of licensed insurance:- name of Insurance agent, address, no. of license, commission due etc.

Register of proposal, premium register, general cash book, commission register, cash receipt register address of claimant etc.

4. FINAL ACCOUNTS OF LIFE INSURANCE COMPANIES

1. REVENUE ACCOUNT

Sets out all income & expenses relating to the insurance business. income includes a) Premium after adjusting reinsurance ceded & reinsurance accepted b) Income from investments Expenses includes a) Commission b) Operating expenses c) Benefits paid d) Bonus paid e) Change in valuation of liability against life policies in force.

2. PROFIT AND LOSS ACCOUNT

All income and expenses relating to shareholders account. income comprises of:- a) Depreciation relating to assets held by shareholder's fund, investment expenses, directors fund. b) Transfer of funds to policy holder's fund. c) Preliminary expenses written off.

3. BALANCE SHEET

Balance sheet includes: a) Share holders fund b) Policy holders fund c) Investments related to policy holder's fund.

4. RECEIPTS AND PAYMENTS ACCOUNT CASH FLOW STATEMENTS

This statement of insurance company needs to be worked out as directed method as per IRDA requirements. Major items are:-

a) **Operating activities**:- Receipts and payments from policy holders, payment to reinsurers agent, employee expenses & investment income.

b) **Investing activities:-**Purchase and sales of investment, purchase of fixed assets

c) **Financing activities:-** Issue of share capital or raising of funds from other sources.

5. FINAL ACCOUNTS OF GENERAL INSURANCE COMPANIES

a) Revenue account A separate revenue account is prepared for each type of business. eg. fire, marine etc. It records: incomes & expenses of particular business, profit/loss is transferred to profit & loss account.

b)Profit & loss account It records incomes & expenses of general nature and it show how profit has been appropriated in addition to profit/loss of different business. Its balance is shown in balance sheet.

c) Balance sheet It records various assets and liabilities of General insurance companies.

PREPARATION OF FINANCIAL STATEMENTS

Insurers assume and manage risk in return for a premium. The premium for each policy, or contract, is calculated based in part on historical data aggregated from many similar policies and is paid in advance of the delivery of the service. The actual cost of each policy to the insurer is not known until the end of the policy period (or for some insurance products long after the end of the policy period), when the cost of claims can be calculated with finality. The insurance industry is divided into two major segments: property/casualty, also known as general insurance or nonlife, particularly outside the United States, and life/health. Broadly speaking, property/casualty policies cover homes, autos and businesses; life/health insurers sell life, long-term care and disability insurance, annuities and health insurance. U.S. insurers submit financial statements to state regulators using statutory accounting principles, but there are significant differences between the accounting practices of property/casualty and life insurers due to the nature of their products. These include:

Financial Statements

An insurance company’s annual financial statement is a lengthy and detailed document that shows all aspects of its business. In statutory accounting, the initial section includes a balance sheet, an income statement and a section known as the Capital and Surplus Account, which sets out the major components of policyholders’ surplus and changes in the account during the year. As with GAAP accounting, the balance sheet presents a picture of a company’s financial position at one moment in time—its assets and its liabilities—and the income statement provides a record of the company's operating results from the previous period. An insurance company's policyholders' surplus—its assets minus its liabilities—serves as the company's financial cushion against catastrophic losses and as a way to fund expansion. Regulators require insurers to have sufficient surplus to support the policies they issue. The greater the risks assumed, and hence the greater the potential for claims against the policy, the higher the amount of policyholders' surplus required.

Asset Valuation

Property/casualty companies need to be able to pay predictable claims promptly and also to raise cash quickly to pay for a large number of claims in case of a hurricane or other disaster. Therefore, most of their assets are high quality, income-paying government and corporate bonds that are generally held to maturity. Under SAP, they are valued at amortized cost rather than their current market cost. This produces a relatively stable bond asset value from year to year (and reflects the expected use of the asset.)

However, when prevailing interest rates are higher than bonds' coupon rates, amortized cost overstates asset value, producing a higher value than one based on the market. (Under the amortized cost method, the difference between the cost of a bond at the date of purchase and its face value at maturity is accounted for on the balance sheet by gradually changing the bond's value. This entails increasing its value from the purchase price when the bond was bought at a discount and decreasing it when the bond was bought at a premium.) Under GAAP, bonds may be valued at market price or recorded at amortized cost, depending on whether the insurer plans to hold them to maturity (amortized cost) or make them available for sale or active trading (market value). The second largest asset category for property/casualty companies, preferred and common stocks, is valued at market price. Life insurance companies generally hold a small percentage of their assets in preferred or common stock. Some assets are "nonadmitted" under SAP and therefore assigned a zero value but are included under GAAP. Examples are premiums overdue by 90 days and office furniture. Real estate and mortgages make up a small fraction of a property/casualty company's assets because they are relatively illiquid. Life insurance companies, whose liabilities are longer term commitments, have a greater portion of their investments in commercial mortgages. The last major asset category is reinsurance recoverables. These are amounts due from the company's reinsurers. (Reinsurers are insurance companies that insure other insurance companies, thus sharing the risk of loss.) Amounts due from reinsurance companies are categorized according to whether they are overdue and, if so, by how many days. Those recoverables deemed uncollectible are reported as a surplus penalty on the liability side of the balance sheet, thus reducing surplus.

Liabilities and Reserves

Liabilities, or claims against assets, are divided into two components: reserves for obligations to policyholders and claims by other creditors. Reserves for an insurer's obligations to its policyholders are by far the largest liability. Property/casualty insurers have three types of reserve funds: unearned premium reserves, or pre-claims liability; loss and loss adjustment reserves, or post claims liability; and other.

Unearned premiums are the portion of the premium that corresponds to the unexpired part of the policy period. Premiums have not been fully "earned" by the insurance company until the policy expires. In theory, the unearned premium reserve represents the amount that the company would owe all its policyholders for coverage not yet provided if one day the company suddenly went out of business. If a policy is canceled before it expires, part of the original premium payment must be returned to the policyholder.

Loss reserves are obligations that an insurance company has incurred – from claims that have been or will be filed on the exposures the insurer protected. Loss adjustment reserves are funds set aside to pay for claims adjusters, legal assistance, investigators and other expenses associated with settling claims. Property/casualty insurers set up claim reserves only for accidents and other events that have happened.

Some claims, like fire losses, are easily estimated and quickly settled. But others, such as products liability and some workers compensation claims, may be settled long after the policy has expired. The most difficult to assess are loss reserves for events that have already happened but have not been reported to the insurance company, known as "incurred but not reported" (IBNR). Examples of IBNR losses are cases where workers inhaled asbestos fibers but did not file a claim until their illness was diagnosed 20 or 30 years later. Actuarial estimates of the amounts that will be paid on outstanding claims must be made so that profit on the business can be calculated. Insurers estimate claims costs, including IBNR claims, based on their experience. Reserves are adjusted, with a corresponding impact on earnings, in subsequent years as each case develops and more details become known.

Revenues, Expenses and Profits

Profits arise from insurance company operations (underwriting results) and investment results. Policyholder premiums are an insurer's main revenue source. Under SAP, when a property/casualty policy is issued, the pre-claim liability or unearned premium is equal to the written premium. (Written premiums are the premiums charged for coverage under policies written regardless of whether they have been collected or "earned." Each day the policy remains in force, one day of unearned premium is earned, and the unearned premium falls by the amount earned. For example, if a customer pays $365 for a one-year policy starting January 1, the initial unearned premium reserve would be $365, and the earned premium would be $0. After one day, the unearned premium reserve would be $364, and the earned premium would be $1.

Under GAAP, policy acquisition expenses, such as agent commissions, are deferred on a pro-rata basis in line with GAAP's matching principle. This principle states that in determining income for a given period, expenses must be matched to revenues. As a result, under GAAP (and assuming losses and other expenses are experienced as contemplated in the rate applied to calculate the premium) profit is generated steadily throughout the duration of the contract. In contrast, under SAP, expenses and revenues are deliberately mismatched. Expenses associated with the acquisition of the policy are charged in full as soon as the policy is issued but premiums are earned throughout the policy period. SAP mismatches the timing of revenues and acquisition expenses so the balance sheet is viewed more conservatively. By recognizing acquisition expenses before the income generated by them is earned, SAP forces an insurance company to finance those expenses from its policyholders' surplus. This appears to reduce the surplus available to pay unexpected claims. In effect, this accounting treatment requires an insurer to have a larger safety margin to be able to fulfill its obligation to policyholders.

Preparing a Balance Sheet

When someone, whether a creditor or investor, asks you how your company is doing, you'll want to have the answer ready and documented. The way to show off the success of your company is a balance sheet. A balance sheet is a documented report of your company's assets and obligations, as well as the residual ownership claims against your equity at any given point in time. It is a cumulative record that reflects the result of all recorded accounting transactions since your enterprise was formed. You need a balance sheet to specifically know what your company's net worth is on any given date. With a properly prepared balance sheet, you can look at a balance sheet at the end of each accounting period and know if your business has more or less value, if your debts are higher or lower, and if your working capital is higher or lower. By analyzing your balance sheet, investors, creditors and others can assess your ability to meet short-term obligations and solvency, as well as your ability to pay all current and long-term debts as they come due. The balance sheet also shows the composition of assets and liabilities, the relative proportions of debt and equity financing and the amount of earnings that you have had to retain. Collectively, this information will be used by external parties to help assess your company's financial status, which is required by both lending institutions and investors before they will allot any money toward your business.

I. Balance Sheet Many people and organizations are interested in the financial affairs of your company, whether you want them to be or not. You of course want to know about the progress of your enterprise and what's happening to your livelihood. However, your creditors also want assurance that you will be able to pay them when they ask. Prospective investors are looking for a solid company to bet their money on, and they want financial information to help them make a sound decision. Your management group also requires detailed financial data and the labor unions (if applicable) will want to know your employees are getting a fair share of your business earnings.

II. Common Classifications On the balance sheet you list your assets and equities under classifications according to their general characteristics. It is a relatively simple matter to make a comparison of one classification with another or to make comparisons within a classification because similar assets or similar equities are listed together. Some of the most commonly used classifications are:

Current Assets

Current assets include cash and other assets that in the normal course of events are converted into cash within the operating cycle. For example, a manufacturing enterprise will use cash to acquire inventories of materials. These inventories of materials are converted into finished products and then sold to customers. Cash is collected from the customers. This circle from cash back to cash is called an operating cycle. In a merchandising business one part of the cycle is eliminated. Materials are not purchased for conversion into finished products. Instead, the finished products are purchased and are sold directly to the customers. Several operating cycles may be completed in a year, or it may take more than a year to complete one operating cycle. The time required to complete an operating cycle depends upon the nature of the business. It is conceivable that almost all of the assets that are used to conduct your business, such as buildings, machinery, and equipment, can be converted into cash within the time required to complete an operating cycle. However, your current assets are only those that will be converted into cash within the normal course of your business. The other assets are only held because they provide useful services and are excluded from the current asset classification. If you happen to hold these assets in the regular course of business, you can include them in the inventory under the classification of current assets. Current assets are usually listed in the order of their liquidity and frequently consist of cash, temporary investments, accounts receivable, inventories and prepaid expenses.

Cash

Cash is simply the money on hand and/or on deposit that is available for general business purposes. It is always listed first on a balance sheet. Cash held for some designated purpose, such as the cash held in a fund for eventual retirement of a bond issue, is excluded from current assets.

Marketable Securities

These investments are temporary and are made from excess funds that you do not immediately need to conduct operations. Until you need these funds, they are invested to earn a return. You should make these investments in securities that can be converted into cash easily; usually short-term government obligations.

Accounts Receivable

Simply stated, accounts receivables are the amounts owed to you and are evidenced on your balance sheet by promissory notes. Accounts receivable are the amounts billed to your customers and owed to you on the balance sheet's date. You should label all other accounts receivable appropriately and show them apart from the accounts receivable arising in the course of trade. If these other amounts are currently collectible, they may be classified as current assets.

Inventories

Your inventories are your goods that are available for sale, products that you have in a partial stage of completion, and the materials that you will use to create your products. The costs of purchasing merchandise and materials and the costs of manufacturing your various product lines are accumulated in the accounting records and are identified with either the cost of the goods sold during the fiscal period or as the cost of the inventories remaining at the end of the period.

Prepaid expenses

These expenses are payments made for services that will be received in the near future. Strictly speaking, your prepaid expenses will not be converted to current assets in order to avoid penalizing companies that choose to pay current operating costs in advance rather than to hold cash. Often your insurance premiums or rentals are paid in advance.

Investments

Investments are cash funds or securities that you hold for a designated purpose for an indefinite period of time. Investments include stocks or the bonds you may hold for another company, real estate or mortgages that you are holding for income-producing purposes. Your investments also include money that you may be holding for a pension fund.

Plant Assets

Often classified as fixed assets, or as plant and equipment, your plant assets include land, buildings, machinery, and equipment that are to be used in business operations over a relatively long period of time. It is not expected that you will sell these assets and convert them into cash. Plant assets simply produce income indirectly through their use in operations.

Intangible Assets

Your other fixed assets that lack physical substance are referred to as intangible assets and consist of valuable rights, privileges or advantages. Although your intangibles lack physical substance, they still hold value for your company. Sometimes the rights, privileges and advantages of your business are worth more than all other assets combined. These valuable assets include items such as patents, franchises, organization expenses and goodwill expenses. For example, in order to become incorporated you must incur legal costs. You can designate these legal costs as organizing expenses.

Other Assets

During the course of preparing your balance sheet you will notice other assets that cannot be classified as current assets, investments, plant assets, or intangible assets. These assets are listed on your balance sheet as other assets. Frequently, your other assets consist of advances made to company officers, the cash surrender value of life insurance on officers, the cost of buildings in the process of construction, and the miscellaneous funds held for special purposes.

Current Liabilities

On the equity side of the balance sheet, as on the asset side, you need to make a distinction between current and long-term items. Your current liabilities are obligations that you will discharge within the normal operating cycle of your business. In most circumstances your current liabilities will be paid within the next year by using the assets you classified as current. The amount you owe under current liabilities often arises as a result of acquiring current assets such as inventory or services that will be used in current operations. You show the amounts owed to trade creditors that arise from the purchase of materials or merchandise as accounts payable. If you are obligated under promissory notes that support bank loans or other amounts owed, your liability is shown as notes payable. Other current liabilities may include the estimated amount payable for income taxes and the various amounts owed for wages and salaries of employees, utility bills, payroll taxes, local property taxes and other services.

Long-Term Liabilities

Your debts that are not due until more than a year from the balance sheet date are generally classified as long-term liabilities. Notes, bonds and mortgages are often listed under this heading. If a portion of your long-term debt is due within the next year, it should be removed from the long-term debt classification and shown under current liabilities.

Deferred Revenues

Your customers may make advance payments for merchandise or services. The obligation to the customer will, as a general rule, be settled by delivery of the products or services and not by cash payment. Advance collections received from customers are classified as deferred revenues, pending delivery of the products or services.

Owner's Equity

Your owner's equity must be subdivided on your balance sheet: One portion represents the amount invested directly by you, plus any portion of retained earnings converted into paid-in capital. The other portion represents your net earnings that are retained. This rigid distinction is necessary because of the nature of any corporation. Ordinarily, stockholders, or owners, are not personally liable for the debts contracted by a company. A stockholder may lose his investment, but creditors usually cannot look to his personal assets for satisfaction of their claims. Under normal circumstances, the stockholders may withdraw as cash dividends an amount measured by the corporate earnings. The distinction in this rule gives the creditors some assurance that a certain portion of the assets equivalent to the owner's investment cannot be arbitrarily withdrawn. Of course, this portion could be depleted from your balance sheet because of operating losses. The owner's equity in an unincorporated business is shown more simply. The interest of each owner is given in total, usually with no distinction being made between the portion invested and the accumulated net earnings. The creditors are not concerned about the amount invested. If necessary, creditors can attach the personal assets of the owners.

Cost

Cost is conventionally used as the basis for accountability. Assets, when acquired under normal circumstances, are recorded at the price negotiated between two independent parties dealing at arm's length. Simply stated, the cost of an asset to the purchaser is the price that he or she must pay now or later in order to obtain it. The fair value of the asset is not relevant in recording the transaction on your balance sheet. A purchaser may acquire an asset at a cost that is greater or less than the fair value determined in the marketplace. If the asset is acquired, the purchaser accounts for the assets at his cost, value notwithstanding. A simple formula to remember in determining cost is: Assets = Liability + Equity or Equity = Assets - Liability

III. Preparing Your Balance Sheet

Title and Heading

In practice, the most widely used title is Balance Sheet; however Statement of Financial Position is also acceptable. Naturally, when the presentation includes more than one time period the title "Balance Sheets" should be used.

Heading

In addition to the statement title, the heading of your balance sheet should include the legal name of your company and the date or dates that your statement is presented. For example, a comparative presentation might be headed:

XYZ CORPORATION

BALANCE SHEETS

Format

There are two basic ways that balance sheets can be arranged. In Account Form, your assets are listed on the left-hand side and totaled to equal the sum of liabilities and stockholders' equity on the right-hand side. Another format is Report Form, a running format in which your assets are listed at the top of the page and followed by liabilities and stockholders' equity. Sometimes total liabilities are deducted from total assets to equal stockholders' equity.

Captions

Captions are headings within your statement that designate major groups of accounts to be totalled or sub totalled. Your balance sheet should include three primary captions: Assets, Liabilities and Stockholders' Equity. In the report form of presentation, the placement of your primary captions would be as follows:

ASSETS

LIABILITIES AND STOCKHOLDERS' EQUITY

Except in certain specialized industries your balance sheet should include the following secondary captions:

CURRENT ASSETS

CURRENT LIABILITIES

Your remaining assets and liabilities are generally combined into two or three other secondary captions, based on their materiality.

Order of Presentation of Captions

First, start with items held primarily for conversion into cash and rank them in the order of their expected conversion. Then, follow with items held primarily for use in operations but that could be converted into cash, and rank them in the order of liquidity. Finally, finish with items whose costs you will defer to future periods or that you cannot convert into cash. Following these guidelines, your major assets should normally be presented in the following order:

Cash

- Short-term marketable securities
- Trade notes and accounts receivable
- Inventories
- Long-term investments
- Property and equipment
- Intangible assets

- Deferred charges

Liabilities are ordinarily presented in the order of maturity as follows:

- Demand notes
- Trade accounts payable
- Accrued expenses
- Long-term debt
- Other long-term liabilities

Components of stockholders' equity are usually presented the following order:

- Preferred stock
- Common stock
- Additional paid-in capital
- Retained earnings
- Accumulated other comprehensive income
- Treasury stock

IV. Sample Trial Balance Sheet

Trial Balance

Cash	10000	
Accounts Receivable	28000	
Inventory	55000	
Prepaid Expenses	2000	
Equipment	25000	
Computers	15000	
Accumulated Deprication Equipment		8000
Accumulated Deprication Computers		6000
Goodwill	10000	
Accounts Payable		25000

Expenses Payable		5000
Payroll Taxes Withheld		2500
Loans Payable - Short Term		10000
Loans Payable - Long Term		30000
Capital Stock		10000
Paid In Capital		5000
Retained Earnings		22000
	145000	**123500**
Net Profit		21500
	145000	145000

Balance Sheet	
Assets	
Current Assets:	**Rs.**
Cash	xxx
Accounts Receivable	xxx
Inventory	xxx
Prepaid Expenses	xxx
Fixed Assets:	
Equipment	xxx
Equipment Depreciation	xxx
Computers	xxx
Computer Depreciation	xxx
Other Assets:	
Goodwill	xxx
Liabilities	
Current Liabilities:	
Accounts Payable	xxx
Expenses Payable	xxx
Payroll Taxes Withheld	xxx
Loans Payable (short term)	xxx
Long-term Liabilities:	
Loans Payable (long term)	xxx

Shareholders' Equity		
Beginning Retained Earnings		xxx
Net Income	xxx	
Capital Stock	xxx	
Paid in Capital	xxx	
	Currents Assets	
	Accumulated Depreciation	
Net Fixed Assets		
Other Assets		
Total Current Liabilities		
Total Long Term Liabilities		
Total Liabilities		
Ending Retained Earnings		
Total Shareholders' Equity		
Total Liabilities and Shareholders' Equity		

Ratios

Now that the balance sheet is complete, here are some simple ratios you can calculate using the information provided on the balance sheet.

Current Ratio

Computation: Total current assets divided by total current liabilities.

Total Current Assets / Total Current Liabilities

The current ratio is a rough indication of a firm's ability to service its current obligations. Generally, the higher the current ratio, the greater the cushion between current obligations and a firm's ability to pay them. The stronger ratio reflects a numerical superiority of current assets over current liabilities. However, the composition and quality of current assets is a critical factor in the analysis of an individual firm's liquidity.

Quick Ratio

Computation: Cash and equivalents plus trade receivables divided by total current liabilities.

Cash & Equivalents + Trade Receivables / (net) Total Current Liabilities

Also known as the "acid test" ratio, this is a refinement of the current ratio and is a more conservative measure of liquidity. The quick ratio expresses the degree to which a company's current liabilities are covered by the most liquid current assets. Generally, any value of less than 1 to 1 implies a reciprocal dependency on inventory or other current assets to liquidate short-term debt.

Fixed/Worth Ratio

Computation: Fixed assets (net of accumulated depreciation) divided by tangible net worth.

Net Fixed Assets / Tangible Net Worth

This ratio measures the extent to which owner's equity (capital) has been invested in plant and equipment (fixed assets). A lower ratio indicates a proportionately smaller investment in fixed assets in relation to net worth and a better cushion for creditors in case of liquidation. Similarly, a higher ratio would indicate the opposite situation. The presence of substantial leased fixed assets (not shown on the balance sheet) may deceptively lower this ratio.

Debt/Worth Ratio

Computation: Total liabilities divided by tangible net worth.

Total Liabilities / Tangible Net Worth

This ratio expresses the relationship between capital contributed by creditors and that contributed by owners. It expresses the degree of protection provided by the owners for the creditors. The higher the ratio, the greater the risk being assumed by creditors. The lower the ratio, the greater the long-term financial safety. A firm with a low debt/worth ratio usually has greater flexibility to borrow in the future. A more highly leveraged company has a more limited debt capacity.

Types of Life Insurance Policies

1. **Whole life policy** - In this type of policy, the sum assured becomes payable to the beneficiary only on the death of the insured. The insured has to pay the premium throughout his life.

2. **Endowment policy** - It is a policy which runs for a fixed period or up to a particular age to the insured.

3. **With profit policy -** In this policy, the policy holder to receive , in addition to the sum assured , a share in the profit made by the Life insurance Corporation.

4. **Without profit policy** - In this policy, the holder gets only the stated sum on the maturity of the policy.

Explanation of items in the final accounts of Life Insurance Company

Claims - The amount paid or payable by the insurance company to the insured for the losses occurs or the particular event happens is called claims. A claim is usually the expenditure of an insurance company.

Annuity - Annuity is an annual payment which a life insurance company guarantees to pay for a lumpsum money received in the beginning.

Surrender value of a policy - Surrender value is the amount paid by the insurance company to the insured for surrendering all claims of the policy to the company.. Usually this amount will get after the payment of two annual premiums.

Bonus in Reduction of Premium - Here, instead of paying bonus in cash to the policy holders, the insurance company deducts the amount from the premium payable to it. The amount of bonus so adjusted in the premium amount is called bonus in reduction of premium.

Consideration for Annuities Granted – Any lumpsum payment received by the insurance company in lieu of granting annuity is called consideration for annuities granted.

Reinsurance - When an insurance company undertakes a big policies in large amount, they reduce their risks by re-insuring it with other insurance companies. Such a process is called reinsurance.

Double insurance - If the same subject matter is insured with more than one insurance company, it is known as Double insurance. Life assurance fund - It is an accumulated reserve fund which is created from excess of income over expenditure in every year.

Reversionary bonus - Reversionary bonus is a bonus which is paid by the insurance company along with the maturity value of the policy.

Commission on reinsurance ceded and Commission on reinsurance Accepted - Insurance companies earn commission from other insurance companies for giving them business under reinsurance contract. This commission is called commission on reinsurance ceded. If some other insurance companies give insurance to us, commission paid on such reinsurance is called commission on reinsurance accepted.

Illustration

The Life Assurance Fund of an insurance company on 31.03.2009 showed a balance of Rs. 87, 76,500. It was later found that the following were not taken into consideration:

1 Dividend from investment - 4, 80,000

2 Income tax on the above - 48,000

3 Bonus in reduction of premium - 8, 77,500

4 Claims covered under reinsurance - 4, 23,000

5 Claims intimated but not accepted by the company - 7, 62,000

Solution

	Rs.	Rs.
Balance of Life Assurance fund		87, 76,500
Add- Dividend	4, 80,000	
Recovered under Reinsurance	4, 23,000	
	………..	9, 03,000
		………….
		96, 79,500
Less- Claims intimated	7, 62,000	
Income-Tax	48,000	
Bonus in reduction of premium	8, 77,500	
	…………..	16, 87,500
		………….
Correct balance of Life Assurance Fund		79, 92,000
		…………

Ascertain the correct balance of Fund.

Illustration

Following balances are extracted from the books of Bharat Assurance Company as on 31st March, 2012.

Life fund on 1^{st} April, 2011 Rs. 15,70,562; Claims by death Rs. 1,16,980. Claims by maturity Rs. 96,420; Premium Rs. 2,70,572; Management expenses Rs.29,890; Commission Rs.36,541; Consideration for annuities granted Rs.10,620; Interest, dividend and rent Rs.52,461; Income tax on profit Rs.3,060; Surrenders Rs.21,768; Annuities Rs. 29,420; Bonus paid in cash Rs.9,450; Bonus paid in reduction of premium Rs.3,500; Preliminary expenses Rs.600; Claims admitted but not paid at the end of the year Rs. 80,034; Annuities due but not paid Rs.22,380; Capital paid up Rs.6,00,000; Govt. Securities Rs.16,90,890; Sundry Assets Rs.5,68,110. Additional relevant date; claims covered under reinsurance Rs.10,000. Further claims intimated Rs.8,000. Further bonus utilised in reduction of premiums Rs.1,500. Interest accrued Rs.15,400. Premiums outstanding Rs.7,400. Prepare a Revenue Account and the Balance Sheet taking all figures in thousands Rs.

Solution

Bharat Assurance Company
REVENUE ACCOUNT
for the year ending 31^{st} March, 2012

Particulars	Schedule	Current Year	Previous Year
Premiums Earned (Net)	1	2,79,472	
Income from Investments:			
Interest, Dividend and Rent (52,461 +15,400)		67,861	
Other Income:			
Consideration for Annuities Created		10,620	

		....	
Total (a)		3,57,953	
Commission	2	35,541	
Operating Expenses Related to Insurance Business	3	29,890	
Total			**2,79,472**

SCHEDULE 2 – COMMISSION

Commission Paid	36,541
Net Commission	36,541

SCHEDULE 3 – OPERATING EXPENSES RELATED TO INSURANCE BUSINESS

Management Expenses	29,890
Total	29,890

SCHEDULE 4 – BENEFITS PAID (NET)

Insurance Claims:		
(a) Claims by Death : Paid	1,16,980	
Less : Covered under Reinsurance	10,000	
	1,06,980	
Add : Further Claims Intimated	8000	1,14,980
(b) Claims by Maturity		96,420
(c) Annuities		29,420
(d) Surrenders		21,768
Total		**2,62,588**

SCHEDULE 5 – SHARE CAPITAL

Paid up Share Capital	6,00,000
Less : Preliminary Expenses	600
Total	**5,99,400**

SCHEDULE 6 – RESERVES AND SURPLUS

Life Assurance Fund on 1/4/2011		15,70,562	
Add : Surplus as per Revenue A/c	14,484		
Less : Income Tax on Profit	8,060		
		11,424	15,81,986
Total			**15,81,986**

SCHEDULE 8 - INVESTMENTS

Government Securities	16,90,890
Total	**16,90,890**

SCHEDULE 12 – ADVANCES AND OTHER ASSETS

Other Assets	
Interest Accrued on Investments	15,400
Outstanding Premiums	7,400
Amount Due from Other Insurance Companies	10,000
Sundry Assets	5,68,110
Total	**6,00,910**

SCHEDULE 13 – CURRENT LIABILITIES

Claims Outstanding (80,034 + 8,000)	88,034
Annuities Due	22,380
Total	**1,10,414**

Corporate Accounting Page 146

Determination of Profit in Life Insurance Business

A life policy is generally taken for a number of years. The premium received for such long term contract cannot be treated as income for ascertaining the profits for that year. The future premium may or may not be received depends on the existence of the insured. Thus on a particular date a liability of the corporation is to be calculated as the premium to be received in future will generally be less than the amount payable as claims. There is a gap between claims which are expected to arise and premium which are expected to be received. The gap is known as Net liability. It becomes desirable to create a reserve equal to its net liability in order to ascertain the profit. The Life insurance business made the valuation of net liability every year in order to ascertain the profit. This is done by a person called Actuary. The process by which net liability is ascertained by this person is known as actuarial valuation. The net liability is compared with life assurance fund on a particular datein order to ascertain the surplus or deficiency. This comparison is made by preparing a Valuation Balance sheet, which is given as follows: -

Valuation Balance Sheet

Liabilities	**Amount**	**Assets**	**Amount**
Net Liability as per Actuary's valuation		Life Assurance Fund	
		Deficit (Bal. Fig)	
Surplus (Bal. Fig)	**...........**		**..............**

Only surplus and not deficiency will be shown in the Balance sheet. With profit policy holders have a right to participate in the profits of life insurance business to the extent of 95% of true profit. The balance 5% may be utilized for such purpose as determined by the central government. For calculation of true profit, surplus as disclosed by the valuation Balance sheet must be adjusted.

Surplus as per Valuation Balance Sheet		**………**
Less: Actuarial expenses	…….	
Dividends payable to shareholders	……..	
		……..
Add: Interim bonus paid		……..
Surplus		**………**

95% of net profit is payable as bonus to policyholders. While paying the above bonus, interim bonus paid already has to be deducted.

3.5 TYPES OF INSURANCE

Any risk that can be quantified can potentially be insured. Specific kinds of risk that may give rise to claims are known as perils. An insurance policy will set out in detail which perils are covered by the policy and which are not. Below are non-exhaustive lists of the many different types of insurance that exist. A single policy that may cover risks in one or more of the categories set out below. For example, vehicle insurance would typically cover both the property risk (theft or damage to the vehicle) and the liability risk (legal claims arising from an accident). A home insurance policy in the United States typically includes coverage for damage to the home and the owner's belongings, certain legal claims against the owner, and even a small amount of coverage for medical expenses of guests who are injured on the owner's property.

Business insurance can take a number of different forms, such as the various kinds of professional liability insurance, also called professional indemnity (PI), which are discussed below under that name; and the business owner's policy (BOP), which packages into one policy many of the kinds of coverage that a business owner needs, in a way analogous to how homeowners' insurance packages the coverages that a homeowner needs.

Health insurance policies

Health insurance policies cover the cost of medical treatments. Dental insurance, like medical insurance, protects policyholders for dental costs. In most developed countries, all citizens receive some health coverage from their governments, paid for by taxation. In most countries, health insurance is often part of an employer's benefits.

Income protection insurance

Long-term disability insurance covers an individual's expenses for the long term, up until such time as they are considered permanently disabled and thereafter Insurance companies will often try to encourage the person back into employment in preference to and before declaring them unable to work at all and therefore totally disabled.

- Disability overhead insurance allows business owners to cover the overhead expenses of their business while they are unable to work.
- Total permanent disability insurance provides benefits when a person is permanently disabled and can no longer work in their profession, often taken as an adjunct to life insurance.

- Workers' compensation insurance replaces all or part of a worker's wages lost and accompanying medical expenses incurred because of a job-related injury.

Life insurance

Life insurance provides a monetary benefit to a decedent's family or other designated beneficiary, and may specifically provide for income to an insured person's family, burial, funeral and other final expenses. Life insurance policies often allow the option of having the proceeds paid to the beneficiary either in a lump sum cash payment or an annuity. In most states, a person cannot purchase a policy on another person without their knowledge.

Annuities provide a stream of payments and are generally classified as insurance because they are issued by insurance companies, are regulated as insurance, and require the same kinds of actuarial and investment management expertise that life insurance requires. Annuities and pensions that pay a benefit for life are sometimes regarded as insurance against the possibility that a retiree will outlive his or her financial resources. In that sense, they are the complement of life insurance and, from an underwriting perspective, are the mirror image of life insurance.

Certain life insurance contracts accumulate cash values, which may be taken by the insured if the policy is surrendered or which may be borrowed against. Some policies, such as annuities and endowment policies, are financial instruments to accumulate or liquidate wealth when it is needed.

In many countries, such as the United States and the UK, the tax law provides that the interest on this cash value is not taxable under certain circumstances. This leads to widespread use of life insurance as a tax-efficient method of saving as well as protection in the event of early death.

In the United States, the tax on interest income on life insurance policies and annuities is generally deferred. However, in some cases the benefit derived from tax deferral may be offset by a low return. This depends upon the insuring company, the type of policy and other variables (mortality, market return, etc.). Moreover, other income tax saving vehicles (e.g., IRAs, 401(k) plans, Roth IRAs) may be better alternatives for value accumulation.

Property

Property insurance provides protection against risks to property, such as fire, theft or weather damage. This may include specialized forms of insurance such as fire insurance, flood insurance, earthquake insurance, home insurance, inland marine insurance or boiler insurance. The term property insurance may, like casualty insurance, be used as a broad category of various subtypes of insurance, some of which are listed below:

- **Aviation insurance** protects aircraft hulls and spares, and associated liability risks, such as passenger and third-party liability. Airports may also appear under this subcategory, including air traffic control and refuelling operations for international airports through to smaller domestic exposures.
- **Boiler insurance** (also known as boiler and machinery insurance, or equipment breakdown insurance) insures against accidental physical damage to boilers, equipment or machinery.
- **Builder's risk insurance** insures against the risk of physical loss or damage to property during construction. Builder's risk insurance is typically written on an "all risk" basis covering damage arising from any cause (including the negligence of the insured) not otherwise expressly excluded. Builder's risk insurance is coverage that protects a person's or organization's insurable interest in materials, fixtures or equipment being used in the construction or renovation of a building or structure should those items sustain physical loss or damage from an insured peril.[29]
- **Crop insurance** may be purchased by farmers to reduce or manage various risks associated with growing crops. Such risks include crop loss or damage caused by weather, hail, drought, frost damage, insects, or disease.[30]
- **Earthquake insurance** is a form of property insurance that pays the policyholder in the event of an earthquake that causes damage to the property. Most ordinary home insurance policies do not cover earthquake damage. Earthquake insurance policies generally feature a high deductible. Rates depend on location and hence the likelihood of an earthquake, as well as the construction of the home.

- **Fidelity bond** is a form of casualty insurance that covers policyholders for losses incurred as a result of fraudulent acts by specified individuals. It usually insures a business for losses caused by the dishonest acts of its employees.

- **Flood insurance** protects against property loss due to flooding. Many U.S. insurers do not provide flood insurance in some parts of the country. In response to this, the federal government created the National Flood Insurance Program which serves as the insurer of last resort.

- **Home insurance** also commonly called hazard insurance or homeowners insurance (often abbreviated in the real estate industry as HOI), provides coverage for damage or destruction of the policyholder's home. In some geographical areas, the policy may exclude certain types of risks, such as flood or earthquake, that require additional coverage. Maintenance-related issues are typically the homeowner's responsibility. The policy may include inventory, or this can be bought as a separate policy, especially for people who rent housing. In some countries, insurers offer a package which may include liability and legal responsibility for injuries and property damage caused by members of the household, including pets.[31]

- **Landlord insurance** covers residential and commercial properties which are rented to others. Most homeowners' insurance covers only owner-occupied homes.

- **Marine insurance** and marine cargo insurance cover the loss or damage of vessels at sea or on inland waterways, and of cargo in transit, regardless of the method of transit. When the owner of the cargo and the carrier are separate corporations, marine cargo insurance typically compensates the owner of cargo for losses sustained from fire, shipwreck, etc., but excludes losses that can be recovered from the carrier or the carrier's insurance. Many marine insurance underwriters will include "time element" coverage in such policies, which extends the indemnity to cover loss of profit and other business expenses attributable to the delay caused by a covered loss.

- **Supplemental natural disaster insurance** covers specified expenses after a natural disaster renders the policyholder's home uninhabitable. Periodic payments are made directly to the insured until the home is rebuilt or a specified time period has elapsed.

- **Surety bond insurance** is a three-party insurance guaranteeing the performance of the principal.
- **Volcano insurance** is a specialized insurance protecting against damage arising specifically from volcanic eruptions.
- **Windstorm insurance** is an insurance covering the damage that can be caused by wind events such as hurricanes.
- **Liability insurance** is a very broad superset that covers legal claims against the insured. Many types of insurance include an aspect of liability coverage. For example, a homeowner's insurance policy will normally include liability coverage which protects the insured in the event of a claim brought by someone who slips and falls on the property; automobile insurance also includes an aspect of liability insurance that indemnifies against the harm that a crashing car can cause to others' lives, health, or property. The protection offered by a liability insurance policy is twofold: a legal defense in the event of a lawsuit commenced against the policyholder and indemnification (payment on behalf of the insured) with respect to a settlement or court verdict. Liability policies typically cover only the negligence of the insured, and will not apply to results of wilful or intentional acts by the insured.

Credit

Credit insurance repays some or all of a loan when the borrower is insolvent.

- Mortgage insurance insures the lender against default by the borrower. Mortgage insurance is a form of credit insurance, although the name "credit insurance" more often is used to refer to policies that cover other kinds of debt.
- Many credit cards offer payment protection plans which are a form of credit insurance.
- Trade credit insurance is business insurance over the accounts receivable of the insured. The policy pays the policy holder for covered accounts receivable if the debtor defaults on payment.
- Collateral protection insurance (CPI) insures property (primarily vehicles) held as collateral for loans made by lending institutions.

Other types

- **All-risk insurance** is an insurance that covers a wide range of incidents and perils, except those noted in the policy. All-risk insurance is different from peril-specific insurance that cover losses from only those perils listed in the policy. In car insurance, all-risk policy includes also the damages caused by the own driver.

- **Bloodstock insurance** covers individual horses or a number of horses under common ownership. Coverage is typically for mortality as a result of accident, illness or disease but may extend to include infertility, in-transit loss, veterinary fees, and prospective foal.

- **Business interruption insurance** covers the loss of income, and the expenses incurred, after a covered peril interrupts normal business operations.

- **Legal expenses insurance** covers policyholders for the potential costs of legal action against an institution or an individual. When something happens which triggers the need for legal action, it is known as "the event". There are two main types of legal expenses insurance: before the event insurance and after the event insurance.

- **Livestock insurance** is a specialist policy provided to, for example, commercial or hobby farms, aquariums, fish farms or any other animal holding. Cover is available for mortality or economic slaughter as a result of accident, illness or disease but can extend to include destruction by government order.

- **Media liability insurance** is designed to cover professionals that engage in film and television production and print, against risks such as defamation.

- **Nuclear incident insurance** covers damages resulting from an incident involving radioactive materials and is generally arranged at the national level. (See the nuclear exclusion clause and for the US the Price-Anderson Nuclear Industries Indemnity Act.)

- **Pet insurance insures** pets against accidents and illnesses; some companies cover routine/wellness care and burial, as well.

- **Pollution insurance** usually takes the form of first-party coverage for contamination of insured property either by external or on-site sources. Coverage is also afforded for liability to third parties arising from contamination of air, water, or land due to the sudden and accidental release of hazardous materials from the insured site. The policy usually covers the costs of cleanup and may include coverage for releases from underground storage tanks. Intentional acts are specifically excluded.

- **Purchase insurance** is aimed at providing protection on the products people purchase. Purchase insurance can cover individual purchase protection, warranties, guarantees, care plans and even mobile phone insurance. Such insurance is normally very limited in the scope of problems that are covered by the policy.

- **Tax insurance** is increasingly being used in corporate transactions to protect taxpayers in the event that a tax position it has taken is challenged by the IRS or a state, local, or foreign taxing authority.

- **Title insurance** provides a guarantee that title to real property is vested in the purchaser or mortgagee, free and clear of liens or encumbrances. It is usually issued in conjunction with a search of the public records performed at the time of a real estate transaction.

- **Travel insurance** is an insurance cover taken by those who travel abroad, which covers certain losses such as medical expenses, loss of personal belongings, travel delay, and personal liabilities.

- **Tuition insurance insures** students against involuntary withdrawal from cost-intensive educational institutions

- **Interest rate insurance** protects the holder from adverse changes in interest rates, for instance for those with a variable rate loan or mortgage

- **Divorce insurance** is a form of contractual liability insurance that pays the insured a cash benefit if their marriage ends in divorce.

- **Fraternal insurance** is provided on a cooperative basis by fraternal benefit societies or other social organizations.

- **No-fault insurance** is a type of insurance policy (typically automobile insurance) where insureds are indemnified by their own insurer regardless of fault in the incident.
- **Protected self-insurance** is an alternative risk financing mechanism in which an organization retains the mathematically calculated cost of risk within the organization and transfers the catastrophic risk with specific and aggregate limits to an insurer so the maximum total cost of the program is known. A properly designed and underwritten Protected Self-Insurance Program reduces and stabilizes the cost of insurance and provides valuable risk management information.
- **Retrospectively rated insurance** is a method of establishing a premium on large commercial accounts. The final premium is based on the insured's actual loss experience during the policy term, sometimes subject to a minimum and maximum premium, with the final premium determined by a formula. Under this plan, the current year's premium is based partially (or wholly) on the current year's losses, although the premium adjustments may take months or years beyond the current year's expiration date. The rating formula is guaranteed in the insurance contract. Formula: retrospective premium = converted loss + basic premium × tax multiplier. Numerous variations of this formula have been developed and are in use.
- **Formal self-insurance** is the deliberate decision to pay for otherwise insurable losses out of one's own money.[citation needed] This can be done on a formal basis by establishing a separate fund into which funds are deposited on a periodic basis, or by simply forgoing the purchase of available insurance and paying out-of-pocket. Self-insurance is usually used to pay for high-frequency, low-severity losses. Such losses, if covered by conventional insurance, mean having to pay a premium that includes loadings for the company's general expenses, cost of putting the policy on the books, acquisition expenses, premium taxes, and contingencies. While this is true for all insurance, for small, frequent losses the transaction costs may exceed the benefit of volatility reduction that insurance otherwise affords.[citation needed]
- **Reinsurance** is a type of insurance purchased by insurance companies or self-insured employers to protect against unexpected losses. Financial reinsurance is a form of

reinsurance that is primarily used for capital management rather than to transfer insurance risk.

- **Social insurance** can be many things to many people in many countries. But a summary of its essence is that it is a collection of insurance coverages (including components of life insurance, disability income insurance, unemployment insurance, health insurance, and others), plus retirement savings, that requires participation by all citizens. By forcing everyone in society to be a policyholder and pay premiums, it ensures that everyone can become a claimant when or if he/she needs to. Along the way this inevitably becomes related to other concepts such as the justice system and the welfare state.

- **Stop-loss insurance** provides protection against catastrophic or unpredictable losses. It is purchased by organizations who do not want to assume 100% of the liability for losses arising from the plans. Under a stop-loss policy, the insurance company becomes liable for losses that exceed certain limits called deductibles.

- **Closed community and governmental self-insurance** Some communities prefer to create virtual insurance amongst themselves by other means than contractual risk transfer, which assigns explicit numerical values to risk. A number of religious groups, including the Amish and some Muslim groups, depend on support provided by their communities when disasters strike. The risk presented by any given person is assumed collectively by the community who all bear the cost of rebuilding lost property and supporting people whose needs are suddenly greater after a loss of some kind. In supportive communities where others can be trusted to follow community leaders, this tacit form of insurance can work. In this manner the community can even out the extreme differences in insurability that exist among its members. Some further justification is also provided by invoking the moral hazard of explicit insurance contracts. In the United Kingdom, The Crown (which, for practical purposes, meant the civil service) did not insure property such as government buildings. If a government building was damaged, the cost of repair would be met from public funds because, in the long run, this was cheaper than paying insurance premiums. Since many UK government buildings have been sold to property companies, and rented back, this arrangement is now less common and may have disappeared altogether. In the United States, the most prevalent form of self-insurance is governmental risk management pools. They are self-funded cooperatives, operating as carriers of coverage for the majority of governmental entities today, such as county governments, municipalities, and school districts. Rather than these entities independently self-insure and risk bankruptcy from a large judgment or catastrophic loss, such governmental entities form a risk pool. Such pools begin their operations by capitalization through member deposits or bond issuance. Coverage (such as general liability, auto liability, professional liability, workers compensation, and property) is offered by the pool to its members, similar to coverage offered by insurance companies. However, self-insured pools offer members lower rates (due to not needing insurance brokers), increased benefits (such as loss prevention services) and subject matter expertise. Of approximately 91,000 distinct governmental entities operating in the United States, 75,000 are members of self-insured pools in various lines of coverage, forming approximately 500 pools. Although a relatively small corner of the insurance market, the annual contributions (self-insured premiums) to such pools have been estimated up to 17 billion dollars annually.

3.6 IMPORTANT TERMS IN INSURANCE

Premium- This is the actual cost of your insurance plan. Keep in mind that the higher the premium, the higher your coverage and thus, the less you will have to pay in medical bills throughout the year.

Deductible- The Deductible is the amount that you must pay out of your own pocket before the insurance company will begin paying towards any covered expenses. The deductible affects how much money you will pay to the doctor or hospital, and is typically paid at the time of treatment.

Accidental Death Benefit - In a life insurance policy, benefit in addition to the death benefit paid to the beneficiary, should death occur due to an accident. There can be certain exclusions as well as time and age limits.

Actual Cash Value- Cost of replacing damaged or destroyed property with comparable new property, minus depreciation and obsolescence. For example, a 10-year-old sofa will not be replaced at current full value because of a decade of depreciation.

Adjustable Rate- An interest rate that changes based on changes in a published market-rate index.

Agent -Individual who sells and services insurance policies in either of two classifications:

Aggregate Limit - Usually refers to liability insurance and indicates the amount of coverage that the insured has under the contract for a specific period of time, usually the contract period, no matter how many separate accidents might occur.

Annuity - An agreement by an insurer to make periodic payments that continue during the survival of the annuitant(s) or for a specified period.

Automobile Liability Insurance - Coverage if an insured is legally liable for bodily injury or property damage caused by an automobile.

Benefit Period - In health insurance, the number of days for which benefits are paid to the named insured and his or her dependents. For example, the number of days that benefits are calculated for a calendar year consists of the days beginning on Jan. 1 and ending on Dec. 31 of each year.

Broker - Insurance salesperson that searches the marketplace in the interest of clients, not insurance companies.

Broker-Agent - Independent insurance salesperson who represents particular insurers but also might function as a broker by searching the entire insurance market to place an applicant's coverage to maximize protection and minimize cost. This person is licensed as an agent and a broker.

Captive Agent - Representative of a single insurer or fleet of insurers who is obliged to submit business only to that company, or at the very minimum, give that company first refusal rights on a sale. In exchange, that insurer usually provides its captive agents with an allowance for office expenses as well as an extensive list of employee benefits such as pensions, life insurance, health insurance, and credit unions.

Casualty Insurance - That type of insurance that is primarily concerned with losses caused by injuries to persons and legal liability imposed upon the insured for such injury or for damage to property of others. It also includes such diverse forms as plate glass, insurance against crime, such as robbery, burglary and forgery, boiler and machinery insurance and Aviation insurance. Many casualty companies also write surety business.

Claim - A demand made by the insured, or the insured's beneficiary, for payment of the benefits as provided by the policy.

Coinsurance - In property insurance, requires the policyholder to carry insurance equal to a specified percentage of the value of property to receive full payment on a loss. For health insurance, it is a percentage of each claim above the deductible paid by the policyholder. For a 20% health insurance coinsurance clause, the policyholder pays for the deductible plus 20% of his covered losses. After paying 80% of losses up to a specified ceiling, the insurer starts paying 100% of losses.

Collision Insurance - Covers physical damage to the insured's automobile (other than that covered under comprehensive insurance) resulting from contact with another inanimate object.

Comprehensive Insurance - Auto insurance coverage providing protection in the event of physical damage (other than collision) or theft of the insured car. For example, fire damage or a cracked windshield would be covered under the comprehensive section.

Coverage - The scope of protection provided under an insurance policy. In property insurance, coverage lists perils insured against, properties covered, locations covered, individuals insured, and the limits of indemnification. In life insurance, living and death benefits are listed.

Copayment - A predetermined, flat fee an individual pays for health-care services, in addition to what insurance covers. For example, some HMOs require a $10 copayment for each office visit, regardless of the type or level of services provided during the visit.

Creditable Coverage - Term means that benefits provided by other drug plans are at least as good as those provided by the new Medicare Part D program. This may be important to people eligible for Medicare Part D but who do not sign up at their first opportunity because if the other plans provide creditable coverage, plan members can later convert to Medicare Part D without paying higher premiums than those in effect during their open enrollment period.

Death Benefit - The limit of insurance or the amount of benefit that will be paid in the event of the death of a covered person.

Deductible - Amount of loss that the insured pays before the insurance kicks in.

Defense Base Act Insurance:- Required insurance per FAR 52.228-3 for all federally funded public works contracts overseas (OCONUS). Provides contractually required protection for the contractor's civilian employees for medical expenses, lost wages, disability, and or death, including War Hazard, arising from work related injury or occupational illness.

Direct Writer - An insurer whose distribution mechanism is either the direct selling system or the exclusive agency system.

Earned Premium - The amount of the premium that as been paid for in advance that has been "earned" by virtue of the fact that time has passed without claim. A three-year policy that has been paid in advance and is one year old would have only partly earned the premium.

Employers Liability Insurance - Coverage against common law liability of an employer for accidents to employees, as distinguished from liability imposed by a workers' compensation law.

Errors & Omissions Insurance - Also known as Professional Liability Insurance protects your organization from claims if your client holds you liable for errors, or failure to deliver work as promised in the contract.

Exclusions - Items or conditions that are not covered by the general insurance contract.

General Liability Insurance - Insurance designed to protect business owners and operators from a wide variety of liability exposures. Exposures could include liability arising from accidents resulting from the insured's premises or operations, products sold by the insured, operations completed by the insured, and contractual liability.

Grace Period - The length of time (usually 31 days) after a premium is due and unpaid during which the policy, including all riders, remains in force. If a premium is paid during the grace period, the premium is considered to have been paid on time. In Universal Life policies, it typically provides for coverage to remain in force for 60 days following the date cash value becomes insufficient to support the payment of monthly insurance costs.

Hazard - A circumstance that increases the likelihood or probable severity of a loss. For example, the storing of explosives in a home basement is a hazard that increases the probability of an explosion.

Health Maintenance Organization (HMO) - Prepaid group health insurance plan that entitles members to services of participating physicians, hospitals and clinics. Emphasis is on preventative medicine, and members must use contracted health-care providers.

Indemnity - Restoration to the victim of a loss by payment, repair or replacement.

Insurable Interest - Interest in property such that loss or destruction of the property could cause a financial loss.

Liability Insurance - Insurance that pays and renders service on behalf of an insured for loss arising out of his responsibility, due to negligence, to others imposed by law or assumed by contract.

Medical Loss Ratio - Total health benefits divided by total premium.

Mortgage Insurance Policy - In life and health insurance, a policy covering a mortgagor with benefits intended to pay off the balance due on a mortgage upon the insured's death, or to meet the payments due on a mortgage in case of the insured's death or disability.

National Association of Insurance Commissioners (NAIC) - Association of state insurance commissioners whose purpose is to promote uniformity of insurance regulation, monitor insurance solvency and develop model laws for passage by state legislatures.

Personal Accident Insurance: Provides your employees and beneficiaries with financial compensation in the unfortunate event of an accident during an international trip or living and working overseas. It offers 24 hour cover for Accidental Death and Dismemberment (AD&D), Disablement and pays for Medical Expense, Medical Evacuation and Repatriation. Personal Accident benefits are payable in addition to DBA or Workers Compensation benefits.

Personal Injury Protection - Pays basic expenses for an insured and his or her family in states with no-fault auto insurance. No-fault laws generally require drivers to carry both liability insurance and personal injury protection coverage to pay for basic needs of the insured, such as medical expenses, in the event of an accident.

Policy - The written contract effecting insurance, or the certificate thereof, by whatever name called, and including all clause, riders, endorsements, and papers attached thereto and made a part thereof.

Premium - The price of insurance protection for a specified risk for a specified period of time.

Reinsurance - In effect, insurance that an insurance company buys for its own protection. The risk of loss is spread so a disproportionately large loss under a single policy doesn't fall on one company. Reinsurance enables an insurance company to expand its capacity; stabilize its underwriting results; finance its expanding volume; secure catastrophe protection against shock losses; withdraw from a line of business or a geographical area within a specified time period.

Renewal - The automatic re-establishment of in-force status effected by the payment of another premium.

Replacement Cost - The dollar amount needed to replace damaged personal property or dwelling property without deducting for depreciation but limited by the maximum dollar amount shown on the declarations page of the policy.

Risk Class - Risk class, in insurance underwriting, is a grouping of insureds with a similar level of risk. Typical underwriting classifications are preferred, standard and substandard, smoking and nonsmoking, male and female.

Risk Management - Management of the pure risks to which a company might be subject. It involves analyzing all exposures to the possibility of loss and determining how to handle these exposures through practices such as avoiding the risk, retaining the risk, reducing the risk, or transferring the risk, usually by insurance.

Term Life Insurance - Life insurance that provides protection for a specified period of time. Common policy periods are one year, five years, 10 years or until the insured reaches age 65 or 70. The policy doesn't build up any of the non-forfeiture values associated with whole life policies.

Transit and Cargo Insurance: Covers goods in transit across high-risk regions by land, air or sea. Our War and Terrorism extension provides transit coverage against acts of war.

Umbrella Policy - Coverage for losses above the limit of an underlying policy or policies such as homeowners and auto insurance. While it applies to losses over the dollar amount in the underlying policies, terms of coverage are sometimes broader than those of underlying policies.

Unearned Premiums - That part of the premium applicable to the unexpired part of the policy period.

Whole Life Insurance - Life insurance which might be kept in force for a person's whole life and which pays a benefit upon the person's death, whenever that might be.

3.7 SUMMARY

Insurance involves pooling funds from many insured entities (known as exposures) to pay for the losses that some may incur. The insured entities are therefore protected from risk for a fee, with the fee being dependent upon the frequency and severity of the event occurring. In order to be an insurable risk, the risk insured against must meet certain characteristics. Insurance as a financial intermediary is a commercial enterprise and a major part of the financial services industry, but individual entities can also self-insure through saving money for possible future losses. In most countries, life and non-life insurers are subject to different regulatory regimes and different tax and accounting rules. The main reason for the distinction between the two types of company is that life, annuity, and pension business is very long-term in nature – coverage for life assurance or a pension can cover risks over many decades. By contrast, non-life insurance cover usually covers a shorter period, such as one year. In the United States, standard line insurance companies are insurers that have received a license or authorization from a state for the purpose of writing specific kinds of insurance in that state, such as automobile insurance or homeowners' insurance.[37] They are typically referred to as "admitted" insurers. Generally, such an insurance company must submit its rates and policy forms to the state's insurance regulator to receive his or her prior approval, although whether an insurance company must receive prior approval depending upon the kind of insurance being written. Standard line insurance companies usually charge lower premiums than excess line insurers and may sell directly to individual insureds. They are regulated by state laws, which include restrictions on rates and forms, and which aim to protect consumers and the public from unfair or abusive practices. These insurers also are required to contribute to state guarantee funds, which are used to pay for losses if an insurer becomes insolvent. Excess line insurance companies (also known as Excess and Surplus) typically insure risks not covered by the standard lines insurance market, due to a variety of reasons (e.g., new entity or an entity that does not have an adequate loss history, an entity with unique risk characteristics, or an entity that has a loss history that does not fit the underwriting requirements of the standard lines insurance market). They are typically referred to as non-admitted or unlicensed insurers. Non-admitted insurers are generally not licensed or authorized in the states in which they write business, although they must be licensed or authorized in the state in which they are domiciled. These companies have more flexibility and can react faster than standard line insurance companies because they are not required to file rates and forms. However, they still have substantial regulatory requirements placed upon them. Most states require that excess line insurers submit financial information, articles of incorporation, a list of officers, and other general information. They also may not write insurance that is typically available in the admitted market, do not participate in state guarantee funds (and therefore policyholders do not have any recourse through these funds if an insurer becomes insolvent and cannot pay claims), may pay higher taxes, only may write coverage for a risk if it has been rejected by three different admitted insurers, and only when the insurance producer placing the business has a surplus lines license. Generally, when an excess line insurer writes a policy, it must, pursuant to state laws, provide disclosure to the policyholder that the policyholder's policy is being written by an excess line insurer. Reinsurance companies are insurance companies that sell policies to other insurance companies, allowing them to reduce their risks and protect themselves from very large losses. The reinsurance market is dominated by a few very large companies, with huge reserves. A reinsurer may also be a direct writer of insurance risks as well. Captive insurance companies may be defined as limited-purpose insurance companies established with the specific objective of financing risks emanating from their parent group or groups. This definition can sometimes be extended to include some of the risks of the parent company's customers. In short, it is an in-house self-insurance vehicle. Captives may take the form of a "pure" entity (which is a 100% subsidiary of the self-insured parent company); of a "mutual" captive (which insures the collective risks of members of an industry); and of an "association" captive (which self-insures individual risks of the members of a professional, commercial or industrial association). Captives represent commercial, economic and tax advantages to their sponsors because of the reductions in costs they help create and for the ease of insurance risk management and the flexibility for cash flows they generate. Additionally, they may provide coverage of risks which is neither available nor offered in the traditional insurance market at reasonable prices. The types of risk that a captive can underwrite for their parents include property damage, public and product liability, professional indemnity, employee benefits, employers' liability, motor and medical aid expenses. The captive's exposure to such risks may be limited by the use of reinsurance. Captives are becoming an increasingly important component of the risk management and risk financing strategy of their parent. There are also companies known as "insurance consultants". Like a mortgage broker, these companies are paid a fee by the customer to shop around for the best insurance policy amongst many companies. Similar to an insurance consultant, an 'insurance broker' also shops around for the best insurance policy amongst many companies. However, with insurance brokers, the fee is usually paid in the form of commission from the insurer that is selected rather than directly from the client. Neither insurance consultants nor insurance brokers are insurance companies and no risks are transferred to them in insurance transactions. Third party administrators are companies that perform underwriting and sometimes claims handling services for insurance companies. These companies often have special expertise that the insurance companies do not have. The financial stability and strength of an insurance company should be a major consideration when buying an insurance contract. An insurance premium paid currently provides coverage for losses that might arise many years in the future. For that reason, the viability of the insurance carrier is very important. In recent years, a number of insurance companies have become insolvent, leaving their policyholders with no coverage (or coverage only from a government-backed insurance pool or other arrangement with less attractive payouts for losses). A number of independent rating agencies provide information and rate the financial viability of insurance companies. Global insurance premiums grew by 2.7% in inflation-adjusted terms in 2010 to $4.3 trillion, climbing above pre-crisis levels. The return to growth and record premiums generated during the year followed two years of decline in real terms. Life insurance premiums increased by 3.2% in 2010 and non-life premiums by 2.1%. While industrialised countries saw an increase in premiums of around 1.4%, insurance markets in emerging economies saw rapid expansion with 11% growth in premium income. The global insurance industry was sufficiently capitalised to withstand the financial crisis of 2008 and 2009 and most insurance companies restored their capital to pre-crisis levels by the end of 2010. With the continuation of the gradual recovery of the global economy, it is likely the insurance industry will continue to see growth in premium income both in industrialised countries and emerging markets in 2011. The insurance company indemnifies, or compensates, the insured in the case of certain losses only up to the insured's interest. Benefit insurance – as it is stated in the study books of The Chartered Insurance Institute, the insurance company does not have the right of recovery from the party who caused the injury and is to compensate the Insured regardless of the fact that Insured had already sued the negligent party for the damages (for example, personal accident insurance). Insurable interest – the insured typically must directly suffer from the loss. Insurable interest must exist

3.8 GLOSSARY

- **Accident Insurance** - insurance for unforeseen bodily injury.
- **Advance Premiums** - occur when a policy has been processed, and the premium has been paid prior to the effective date. These are a liability to the company and not included in written premium or the unearned premium reserve.
- **Agent** - an individual who sells, services, or negotiates insurance policies either on behalf of a company or independently.
- **Arbitration** - a binding dispute resolution tactic whereby a conciliator with no interest in the outcome intercedes.
- **Assessed Value** - estimated value for real or personal property established by a taxing entity
- **Asset** - probable future economic benefits obtained or controlled by a particular entity as a
- **Authorized Reinsurance** - reinsurance placed with a reinsurer who is licensed or otherwise allowed to conduct reinsurance within a state.
- **Beneficiary** - an individual who may become eligible to receive payment due to will, life insurance policy, retirement plan, annuity, trust, or other contract.
- **Benefits (Medical & Hospital Expenses)** - total expenditures for health care services paid to or on behalf of a member.

- **Blanket coverage** - coverage for property and liability that extends to more than one location, class of property or employee.
- .**Captive Agent** - an individual who sells or services insurance contracts for a specific insurer or fleet of insurers.
- **Captive Insurer** - an insurance company established by a parent firm for the purpose of insuring the parent's exposures.
- **Carrying Value (Amount)** - the SAP book value plus accrued interest and reduced by any valuation allowance and any nonadmitted adjustment applied to the individual investment.
- **Casualty Insurance** - a form of liability insurance providing coverage for negligent acts and omissions such as workers compensation, errors and omissions, fidelity, crime, glass, boiler, and various malpractice coverages.
- **Claim** - a request made by the insured for insurer remittance of payment due to loss incurred and covered under the policy agreement.
- **Coinsurance** - A clause contained in most property insurance policies to encourage policy holders to carry a reasonable amount of insurance. If the insured fails to maintain the amount specified in the clause (Usually at least 80%), the insured shares a higher proportion of the loss. In medical insurance a percentage of each claim that the insured will bear.
- **Comprehensive/Major Medical** - policies that provide fully insured indemnity, HMO, PPO, or Fee for Service coverage for hospital, medical, and surgical expenses. Coverage excludes Short-Term Medical Insurance, the Federal Employees Health Benefit Program and non-comprehensive coverage such as basic hospital only, medical only, hospital confinement indemnity, surgical, outpatient indemnity, specified disease, intensive care, and organ and tissue transplant coverage.
- **Convertible Term Insurance Policy** - an insurance policy that can be converted into permanent insurance without a medical assessment. The insurer is required to renew the policy regardless of the health of the insured subject to policy conditions.

- **Credit** - individual or group policies that provide benefits to a debtor for full or partial **Credit Accident and Health (group and individual)** - coverage provided to or offered to borrowers in connection with a consumer credit transaction where the proceeds are used to repay a debt or an installment loan in the event the consumer is disabled as the result of an accident, including business not exceeding 120 months duration.
- **Credit Disability** - makes monthly loan/credit transaction payments to the creditor upon the disablement of an insured debtor.
- **Credit Health Insurance** - policy assigning creditor as beneficiary for insurance on a debtor thereby remitting balance of payment to creditor should the debtor become disabled.
- **Credit Involuntary Unemployment** - credit insurance that provides a monthly or lump sum benefit during an unpaid leave of absence from employment resulting from specified causes, such as layoff, business closure, strike, illness of a close relative and adoption or birth of a child. This insurance is sometimes referred to as Credit Family Leave.
- **Credit Life Insurance** - policy assigning creditor as beneficiary for insurance on a debtor thereby remitting balance of payment to creditor upon death of debtor.
- **Credit Personal Property Insurance** - insurance written in connection with a credit transaction where the collateral is not a motor vehicle, mobile home or real estate and that covers perils to the goods purchased through a credit transaction or used as collateral for a credit transaction and that concerns a creditor's interest in the purchased goods or pledged collateral, either in whole or in part; or covers perils to goods purchased in connection with an open-end transaction.
- **Credit Placed Insurance** - insurance that is purchased unilaterally by the creditor, who is the named insured, subsequent to the date of the credit transaction, providing coverage against loss, expense or damage to property as a result of fire, theft, collision or other risks of loss that would either impair a creditor's interest or adversely affect the value of collateral. "Creditor Placed Home" means "Creditor Placed Insurance"

on homes, mobile homes and other real estate. "Creditor Placed Auto" means insurance on automobiles, boats or other vehicles.

- **Credit Risk** - part of the risk-based capital formula that addresses the collectability of a company's receivables and the risk of losing a provider or intermediary that has received advance capitation payments.
- **Encumbrance** - outstanding mortgages or other debt related to real estate and any unpaid accrued acquisition or construction costs.
- **Endorsement** - an amendment or rider to a policy adjusting the coverages and taking precedence over the general contract.
- **Excess and Umbrella Liability** - liability coverage of an insured above a specific amount set forth in a basic policy issued by the primary insurer; or a self insurer for losses over a stated amount; or an insured or self insurer for known or unknown gaps in basic coverages or self insured retentions.
- **Excess of Loss Reinsurance** - loss sharing mechanism where an insurer pays all claims up to a specified amount and a reinsurance company pays any claims in excess of stated amount.
- **Excess Workers' Compensation** - either specific and/or aggregate excess workers' compensation insurance written above an attachment point or self-insured retention.
- **Expense Ratio** - percentage of premium income used to attain and service policies. Derived by subtracting related expenses from incurred losses and dividing by written premiums.
- **Experience Rating** - rating system where each group is rated entirely on the basis of its own expected claims in the coming period, with retrospective adjustments for prior periods. This method is prohibited under the conditions for federal qualification.
- **Exposure** - risk of possible loss.
- **Extra Expense Insurance** - a type of property insurance for extraordinary expenses related to business interruption such as a back-up generator in case of power failure.

- **Federal Flood Insurance** - coverage for qualifying residents and businesses in flood prone regions through the National Flood Insurance Act, a federally subsidized flood insurance program enacted in 1968.
- **Federally Reinsured Crop** - crop insurance coverage that is either wholly or in part reinsured by the Federal Crop Insurance Corporation (FCIC) under the Standard Reinsurance Agreement (SRA). This includes the following products: Multiple Peril Crop Insurance (MPCI); Catastrophic Insurance, Crop Revenue Coverage (CRC); Income Protection and Revenue Assurance.
- **Insurable Interest** - A right or relationship in regard to the subject matter of the insured contract such that the insured can suffer a financial loss from damage, loss or destruction to it. (Bickelhaupt and Magee)
- **Insurance** - an economic device transferring risk from an individual to a company and reducing the uncertainty of risk via pooling.
- **Insurance Holding Company System** - consists of two or more affiliated persons, one or
- **Lapse** - termination of a policy due to failure to pay the required renewal premium.
- **Level Premium Insurance** - life insurance policy for which the cost is equally distributed over the term of the premium period, remaining constant throughout.
- **Life – Endowment** - insurance that pays the same benefit amount should the insured die during the term of the contract, or if the insured survives to the end of the specified coverage term or age.
- **Life – Flexible Premium Adjustable Life** - a group life insurance that provides a face amount that is adjustable to the certificate holder and allows the certificate holder to vary the modal premium that is paid or to skip a payment so long as the certificate value is sufficient to keep the certificate in force, and under which separately identified interest credits (other than in connection with dividend accumulation, premium deposit funds or other supplementary accounts) and mortality and expense charges are made to individual certificates while providing minimum guaranteed values.

- **Life Settlements** - a contract or agreement in which a policyholder agrees to sell or transfer ownership in all or part of a life insurance policy to a third party for compensation that is less than the expected death benefit of a policy.

- **Lifetime Disability Benefit** - a provision in some disability income policies to recoup lost wages for the term of disability or remainder of insured's life in case of permanent disability.

- .**Margin Premium** - a deposit that an organization is required to maintain with a broker with respect to the Futures Contracts purchased or sold.

- **Mutual Insurance Company** - a privately held insurer owned by its policyholders, operated as a non-profit that may or may not be incorporated.

- **Mutual Insurance Holding Company** - a company organized as a mutual and owning a capital stock insurer or insurers for the benefit of pooling risk for many people, typically those in the same industry.

- **Named Insured** - the individual defined as the insured in the policy contract. .

- **Named Peril Coverage** - insurance for losses explicitly defined in the policy contract.

- **National Association of Insurance Commissioners (NAIC)** - the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight. NAIC staff supports these efforts and represents the collective views of state regulators domestically and internationally. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S.

- **Pet Insurance Plans** - veterinary care plan insurance policy providing care for a pet animal (e.g., dog or cat) of the insured owner in the event of its illness or accident.

- insured's premises.

- **Premium** - Money charged for the insurance coverage reflecting expectation of loss.

- **Premiums Earned** - the portion of premium for which the policy protection or coverage has already been given during the now-expired portion of the policy term.
- **Premiums Net** - is the amount calculated on the basis of the interest and mortality table used to calculate the reporting entity's statutory policy reserves.
- **Premiums Written** - total premiums generated from all policies (contracts) written by an insurer within a given period of time.
- **Primary Insurance** - coverage that takes precedence when more than one policy covers the same loss.
- **Pure Premium** - that portion of the premium equal to expected losses void of insurance company expenses, premium taxes, contingencies, or profit margin.
- **Pure Risk** - circumstance including possibility of loss or no loss but no possibility of gain.
- **Reinsurance** - a transaction between a primary insurer and another licensed (re) insurer where the reinsurer agrees to cover all or part of the losses and/or loss adjustment expenses of the primary insurer. The assumption is in exchange for a premium. Indemnification is on a proportional or non-proportional basis.
- **Reserve Credit** - reduction of reserve amounts for reinsurance ceded. Reductions may
- **Self-Insurance** - type of insurance often used for high frequency low severity risks where risk is not transferred to an insurance company but retained and accounted for internally.
- .**Social Insurance** - compulsory insurance plan administered by a federal or state government agency with the primary emphasis on social adequacy.
- **Specified Disease Coverage** - coverage that provides primarily pre-determined benefits for expenses of the care of cancer and/or other specified diseases.
- **Specified/Named Disease** - policies that provide benefits only for the diagnosis

and/or treatment of a specifically named disease or diseases. Benefits can be paid as expense incurred, per diem or as a principal sum.

- **Standard Risk** - a person who, according to a company's underwriting standards, is considered a normal risk and insurable at standard rates. High or low risk candidates may qualify for extra or discounted rates based on their deviation from the standard.
- **State Children's Health Insurance Program** - policies issued in association with the Federal/State partnership created by title XXI of the Social Security Act.
- **State of Domicile** - the state where a company's home office is located.
- **Stock Insurance Company** - business owned by stockholders.
- **Substandard Risk** - (impaired risk) risks deemed undesirable due to medical condition or hazardous occupation requiring the use of a waiver, a special policy form, or a higher premium charge.
- **Surplus** - insurance term referring to retained earnings.
- **Unearned Premium Reserve** - all premiums (fees) received for coverage extending beyond the statement date; appears as a liability on the balance sheet.
- **Universal Life Insurance** - adjustable life insurance under which premiums and coverage are adjustable, company expenses are not specifically disclosed to the insured but a financial report is provided to policyholder's annually.
- **Variable Annuity** - an annuity contract under which the premium payments are used to purchase stock and the value of each unit is relative to the value of the investment portfolio.
- **Variable Life Insurance** - life insurance whose face value and/or duration varies depending upon the value of underlying securities.

3.9 SELF ASSESSMENT QUESTIONS

1. "Insurance contracts are based on utmost good faith" Comment.

2. What is meant by constructive total loss in insurance? Discuss the rules regarding abandonment in this regard.

3. Distinguish between re-insurance and double insurance.

4. "Insurance interest must exist in all contracts of insurance". Comment.

5. Prepare balance sheet and revenue account of life insurance companies as per prescribed form.

6. A Life Assurance Corporation get its valuation made once in every two years. The life assurance fund on 31st March, 2012 amounted to Rs.41,92,000 before providing for Rs.32,000 for the shareholders' dividend for the year 2011-12. Its actuarial valuation on 31st march, 2012, disclosed net liability of Rs.40,40,000 under the assurance and annuity contracts. An interim bonus of Rs.40,000 was paid to the policy holders during the period ending 31st March, 2012. Prepare a statement showing the amount now available as bonus to policy holders.

3.10 SUGGESTED READING

- John Clay and Stephen Holton, "Guide to Preparing Financial Statements" (Practitioners Publishing, 1997)
- Peter Atrill and Eddie McLaney, "Accounting and Finance for Non-Specialists" (Prentice Hall, 1997)
- Leopold Bernstein and John Wild, "Analysis of Financial Statements" (McGraw-Hill, 2000)
- Daniel L. Jensen, "Advanced Accounting" (McGraw-Hill College Publishing, 1997)
- Martin Mellman et. al., "Accounting for Effective Decision Making" (Irwin Professional Press, 1994)
- Eric Press, "Analyzing Financial Statements" (Lebahar-Friedman, 1999)
- Gerald I. White, "The Analysis and Use of Financial Statements" (John Wiley & Sons, 1997)
- SK Gupta, Foreign Exchange Law and Practice, Taxmann
- SS Gulshan, Mercantile Law, excel Books
- Rustam S. Davar, Khorshed D.P. (Davar) Madon, General Principles of Indian Law, Progressive Corp.

CONCEPT AND ACCOUNTS OF HOLDING COMPANIES, SUBSIDIARY COMPANIES, LEGAL REQUIREMENTS, IMPORTANT CONCEPTS, CONSOLIDATED BALANCE SHEET

STRUCTURE:

4.1 INTRODUCTION

A holding company is a company that owns other companies' outstanding stock. The term usually refers to a company that does not produce goods or services itself; rather, its purpose is to own shares of other companies to form a corporate group. Holding companies allow the reduction of risk for the owners and can allow the ownership and control of a number of different companies.

In the United States, 80% or more of stock, in voting and value, must be owned before tax consolidation benefits such as tax-free dividends can be claimed. That is, if Company A owns 80% or more of the stock of Company B, Company A will not pay taxes on dividends paid by Company B to its stockholders, as the payment of dividends from B to A is essentially Company A transferring cash from one company to the other. Any other shareholders of Company B will pay the usual taxes on dividends, as they are legitimate and ordinary dividends to these shareholders.

Sometimes a company intended to be a pure holding company identifies itself as such by adding "Holding" or "Holdings" to its name.Holding companies are formed to organize and manage a group of smaller companies. If you are a business owner of investor, you may consider forming a holding company to protect your business assets or get a more favorable tax rate. A holding company ias an entity formed to buy and hold the majority of stock of other companies; a subsidiary is a business whose majority of stock is owned by a holding company. A holding company buys, absorbs or otherwise obtains a majority percentage of stock in another company, which becomes known as its subsidiary. Typically, a holding company must control 50 percent or more of a company's stock before it's considered a subsidiary. Holding companies may also own other holding companies — in this case, they're known as top holding companies. The holding company has all rights and responsibilities of ownership for its subsidiaries. The subsidiaries, while not independently owned, often continue to operate as individual entities, though major corporate decisions are made by the holding company. A holding company directs the management and operations of the subsidiaries it owns and maintains the authority to add or remove board members, directors and other key management and personnel. A holding company may have strict managerial control or may allow subsidiaries to act with some level of autonomy for day-to-day business operations, including lower- and midlevel hiring and certain budgeting decisions. A subsidiary has little to no financial control over its operations. Even independently acting subsidiaries are ultimately financially controlled by their holding company. This includes financial activities such as investment decisions, sales projections and budgeting. If a subsidiary was itself a holding company prior to becoming a subsidiary of another holding company, all of its subsidiaries also become subsidiaries of the top holding company.

A company has to either control the Board of directors or hold more than half of the equity capital of the other company. A holding company is any regular corporation, LLC, or LP that owns investments in other companies but doesn't engage in any operations itself. That is, Berkshire Hathaway is a holding company because it doesn't do anything. Instead, it owns 100% of the stock of GEICO, which is an insurance company. It owns 80% or 90% of the stock of Nebraska Furniture Mart, which is a huge furniture retailer. It owns more than 8% of the stock of Coca-Cola through its insurance holdings. But Berkshire itself just has a handful of employees and a bank vault full of stock certificates. Any money it has comes from dividends paid by the subsidiaries on June 30th and December 31st of each year. It can be used to silo investment assets and protect them, such as Dunkin' Donuts putting its intellectual property into its own LLC. It can be used to transfer wealth to friends and family. If you own a collection of businesses, rental properties, or other valuables, it is far more convenient to transfer shares in a parent company than it is in each individual asset. It can permit you to structure deals so you control far more money than you otherwise could afford. If you had $10 million and used it to buy control of a $20 million insurance group that had $70 million in float, you would be controlling $70 million from your holding company. In essence, a holding company is in the business of providing capital and people. Berkshire Hathaway refuses to provide management to the subsidiaries it purchases; they don't run businesses. General Electric, on the other hand, is one of the greatest machines of all time and can have someone else running a company within 12 hours.

4.2 OBJECTIVES

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

- Concept and meaning of holding and subsidiary companies.
- Legal requirements of holding companies.
- Prepare consolidated Balance sheet of holding companies.

- Draw accounts of holding companies.

4.3 LEGAL REQUIREMENTS OF HOLDING COMPANIES

A holding company may invest in subsidiaries in a variety of industries to diversify its investment, lower its risk potential and, in some instances, take advantage of shared loss and tax consolidation. Although a holding company may enjoy the profits of its subsidiaries, it also has a fiduciary responsibility to the subsidiaries it controls. A subsidiary that regains a majority of its shares also regains its autonomy from its holding company.

How to Prepare the Reports

A. Applicability of GAAP, Consolidation Rules and SEC Consistency Holding companies are required to prepare and file the Consolidated Financial Statements for Holding Companies in accordance with generally accepted accounting principles (GAAP) and these instructions. All reports shall be prepared in a consistent manner. The holding company's financial records shall be maintained in such a manner and scope so as to ensure that the Consolidated Financial Statements for Holding Companies can be prepared and filed in accordance with these instructions and reflect a fair presentation of the holding company's financial condition and results of operations. Holding companies should retain workpapers and other records used in the preparation of these reports. Scope of the ''consolidated holding company'' to be reported in the submitted reports For purposes of this report, the holding company should consolidate its subsidiaries on the same basis as it does for its annual reports to the SEC or, for those holding companies that do not file reports with the SEC, on the same basis as described in generally accepted accounting principles (GAAP). Generally, under the rules for consolidation established by the SEC and by GAAP, holding companies should consolidate any company in which it owns more than 50 percent of the outstanding voting stock. Each holding company shall account for any investments in unconsolidated subsidiaries, associated companies, and those corporate joint ventures over which the holding company exercises significant influence according to the equity method of accounting, as prescribed by GAAP. The equity method of accounting is described in Schedule HC, item 8. (Refer to the Glossary entry for ''subsidiaries'' for the definitions of the terms subsidiary, associated company, and corporate joint venture.) Rules of Consolidation For purposes of these reports, all offices (i.e., branches, subsidiaries, VIEs, and IBFs) that are within the scope of the consolidated holding company as defined above are to be reported on a consolidated basis. Unless the instructions specifically state otherwise, this consolidation shall be on a line-by-line basis, according to the caption shown. As part of the consolidation process, the results of all transactions and all intercompany balances (e.g., outstanding asset/debt relationships) between offices, subsidiaries, and other entities included in the scope of the consolidated holding company are to be eliminated in the consolidation and must be excluded from the Consolidated Financial Statements for Holding Companies. (For example, eliminate in the consolidation

(1) loans made by the holding company to a consolidated subsidiary and the corresponding liability of the subsidiary to the holding company,

(2) a consolidated subsidiary's deposits in another holding company consolidated subsidiary and the corresponding cash or interest-bearing asset balance of the subsidiary, and

(3) the intercompany interest income and expense related to such loans and deposits of the holding company and its consolidated subsidiary.) Exception: For purposes of reporting the total assets of captive insurance and reinsurance subsidiaries in Schedule HC-M, Memoranda, items 7(a) and 7(b), only, holding companies should measure the subsidiaries' total assets before eliminating intercompany transactions between the consolidated subsidiary and other offices or General Instructions FR Y9C GEN-3 General Instructions March 2013

Under section 4

(1) For the purpose of this Act, **a company shall**, subject to the provisions of sub-section (3), be **deemed** to be a subsidiary of another if, but only if:

(a) that other controls the composition of its Board of Directors: or

(b) where the first-mentioned company is any other company, holds more than half in nominal value of its equity share capital ; or

(c) the first-mentioned company is a subsidiary of any company which is that other's subsidiary.

(2). For the purposes of this Act, a company **shall be deemed** to be the holding company of another if, but only if, that other is its subsidiary.

(3). In this section, the expression ‘company’ includes any body corporate and the expression ‘equity share capital’ has the same meaning as in sub section (2) of section 85.

(4). In the case of a body corporate which is incorporated in a country out side India, a subsidiary or holding company of the body corporate under the law of such country **shall be deemed** to be a subsidiary or holding company of the body corporate within the meaning and for the purposes of this Act also, whether the requirements of this section are fulfilled or not.

(5). A private company, being a subsidiary of a body corporate incorporated outside India, which, if incorporated in India, would be a public company within the meaning of this Act, **shall be deemed** for the purposes of this Act to be a subsidiary of a public company if the entire share capital in that private company is not held by that body corporate whether alone or together with one or more other bodies corporate incorporated outside India”. [Emphasis supplied]”

Company is a juristic person with different identity from that of its members. Each and every company is a distinct and separate legal entity. The relationship of holding and subsidiary, is therefore, essentially a legal fiction. Legal fiction denotes a fact which is, but for the legal fiction, not existing. In other words the purpose of legal fiction is to assume a thing as existing whereas in reality no such thing exist. Thus both holding and subsidiary companies are separate legal entities and they are related to each other by virtue of a legal fiction creating a subsidiary –holding company relationship. The law has to assume such relationship so as to bring both the holding and subsidiary companies under one roof to regulate them.

Section 4 of the Act which defines the terms “holding company” and “subsidiary company” is a legal fiction created by the Act. Further this legal fiction contains sub-fictions within it. The interpretation of a legal fiction has been beautifully explained by the Supreme Court. Justice S.R.Das J observed that “when legal fiction is created, for what purpose, one is led to ask at once, is it so created”.[2] Once the purpose is ascertained full effect must be given to the statutory fiction and it should be carried to its logical conclusion[3]. The overall impact is that the fiction created by this section is applicable to the entire Act.

In other words wherever the term subsidiary is used in the Act the effect of section 4 has to be given.

Mode of creation of a subsidiary company.

A subsidiary company is a business entity that is controlled by another organization through ownership of a majority of its voting stock. This separate legal structure may be used to gain certain tax benefits, track the results of a separate business unit, segregate risk from the rest of the organization, or prepare certain assets for sale. A larger business may own dozens or even hundreds of subsidiary companies.

Section 4 of the Act prescribes three conditions under which a company becomes a subsidiary of another company. A company shall be deemed to be a subsidiary of another if, but only if, (1) the other controls the composition of its Board of Directors, (2) the other company holds more than half of its equity capital and (3) the controlling company, as above said, is a subsidiary of another company.

In other words to be a holding company, a company has to either control the Board of directors or hold more than half of the equity capital of the other company. The above two methods of control need not be exercised by the holding company by itself and the control can be exercised through a subsidiary company also. It is pertinent to point out here that the Indian Law does not require the holding company to be a member of the subsidiary company. All that the Indian law requires is the actual control of the subsidiary company by a holding company in any one or both methods i.e. Board control or Share control.

As far as foreign companies are concerned, the law states that, in the case of a body corporate which is incorporated in a country outside India, a subsidiary or holding company of the body corporate under the law of such country shall be deemed to be a subsidiary or holding company of the body corporate within the meaning and for the purposes of this Act also, whether the requirements of this section are fulfilled or not.

Thus if a foreign company is a holding company of another company as per the laws of the country of that company, for the purposes of the Act, it will be treated in the same manner in India also even though the holding company may not be satisfying the two methods of controlling the subsidiary company. It is to be noted here that the holding and subsidiary relationship is inter se the two foreign companies only. In other words if A is the holding company of B in a foreign country, in India also A will be treated as the holding company of B.

Meaning of the term "body corporate" used in Section 4.

The term body corporate includes companies incorporated outside India. Sub-section (5) of section 4 includes, for the purpose of the section, any body corporate in the definition of company. The moot question is whether the term "any body corporate" include other non-corporate entities also, say partnership firms, association of persons etc., The answer to this question can be found if we ask another pertinent question i.e. what for section 4 is enacted?

Section 4 of the Act seeks to create a holding-subsidiary relationship between two companies. A company cannot be a holding or subsidiary company of another non-corporate entity. Thus essentially there has to be incorporated companies to create the holding-subsidiary relationship between them. Therefore, it can be concluded that, the term any body corporate essentially refers to a company incorporated outside India. Any meaning other than this will not be in conformity with the provisions of section 4.

Subsidiary of foreign company.

A company incorporated in India can become a subsidiary of a company incorporated outside India in any one of the three ways provided for in sub-section (1) of section 4. In other words Indian company shall be a subsidiary of a foreign company if

a. Indian company's Board of Directors are controlled by the foreign company; or

b. More than half of the equity share capital of the Indian company is held by the foreign company.

c. The foreign company is a subsidiary of another foreign company.

For example (1) A (Fco) appoints majority or all of the Board of directors of B (Ico). (2) A holds more than 50% of the equity share capital of B. (3) A is the subsidiary of another Fco C. Then B is a subsidiary of C also.

Effect of sub-section (7) of section 4.

Under Indian law a private company subsidiary of a public company is treated as a public company and made subject to all stringent legal compliance applicable to a public company. However, by virtue of sub- section (7) of section 4 of the Act, in the case of a private company which is a subsidiary of a foreign public company a different treatment is given whereby under certain conditions such subsidiary is treated as a private company.

Indian private company, which is a subsidiary of a foreign company, shall be treated as a private company under two circumstances. When the foreign holding company if incorporated in India would not have been a public company under the Act i.e such a foreign company could have been incorporated only as a private company. This situation involves two private companies as both holding and subsidiary companies are private companies.

The other circumstance is when the foreign holding company, if incorporated in India would have been a public company under the Act and the entire equity share capital of the subsidiary is held by such foreign company either **alone or together with** one or more bodies corporate incorporated outside India. Otherwise such Indian subsidiary shall be treated as a private company subsidiary of a public company. Under this situation the holding company is a public company and the subsidiary is a private company.

Let us critically analyze the provisions of sub-section (7) by breaking it into various limbs.

i. A private company

ii. Being a subsidiary of a body corporate incorporated outside India

iii. Which

iv. If incorporated in India

v. Would be a public company within the meaning of this Act,

vi. **Shall be deemed** for the purposes of this Act to be a subsidiary of a public company

vii. If the **entire share capital** in that private company is not held

viii. By that body corporate

ix. Whether **alone or together with** one or more other bodies corporate incorporated outside India.

The first two limbs are connected with fourth and fifth limbs by the third limb. These five limbs explain the factual relation ship between the Indian private company which is the subsidiary of a foreign public company. It considers the Indian private company as a subsidiary of the foreign company in the first place and further stipulates that such foreign company if incorporated in India would have been a public company i.e. within the meaning of section 3(1)(iv) of the Act. This is the first condition relating to the status of the foreign holding company. Sixth limb states what the treatment will be accorded to the private company if the conditions of seventh, eighth and ninth limbs are not met with by such foreign company. These limbs provide the second condition that such foreign company should hold the **entire equity share capital** of the private company either alone or together with one or more foreign bodies corporate. If all these conditions are met by the foreign holding company the Indian private company will be treated as a private company.

Holding entire share capital of a Wholly Owned Subsidiary

A pertinent question, in relation to holding the entire share capital of the subsidiary (in the case of a wholly owned subsidiary), that arises is whether all the shares to be registered in the name of the foreign holding company? In other words in a wholly owned subsidiary of a foreign public company can Indian individuals hold shares in trust?

Answer to this question lies in section 49 of the Act which governs the manner in which investment to be made by a company in the shares of another company. In a wholly owned subsidiary there is only one shareholder i.e. the holding company. However to transact business and to convene Board and company meetings at least two individuals are required. The general practice, in pursuant to section 49(3), is that the holding company makes at least one Individual to hold a share in trust on behalf of it and such a share is registered in the name of the individual. The individual and the holding company file appropriate declarations with the ROC in compliance with section 187-D (1) and (2) of the Act.

Section 3 (i) of the Act defines “a company” to be incorporated in India. Again, the definition of “body corporate” in section 2 (7) of the Act includes a foreign company. A body corporate, for the limited purposes of section 4 (5), is included in the definition of “a company”. For the purposes of section 4 (5) and (7) a body corporate could only be a company incorporated outside India. Though a body corporate is not a company for the purposes of Section 49, the foreign holding company being a body corporate, b y virtue of legal fiction created by section 4(5), becomes a company for the purposes of section 49 of the Act also. In view of this the shares held by the individual in trust for the holding company in the subsidiary shall be treated as the share holding of the holding company.

Section 49 of the Act has to be read in conjunction with section 4 of the Act. Though the term “a company”, in section 49 of the Act, does not include a body corporate expressly, section 4 of the act includes the same expressly. The effect of section 49 is obvious on section 4 as a holding company holds the entire shares of the subsidiary (WOS) company. Further Section 4(7) deals with the manner of share holding of a holding company in its subsidiary company and section 49 deals with different situations in which a company is deemed to hold shares of another company in its own name. Thus the provisions of these two sections cannot be read in isolation.

Crucial test that decides the issue is share holding

Sub-section (7) is thus, primarily, concerned with subsidiary within the meaning of sub-section (1)(b)(ii) of section 4 of the Act. The criteria are the direct shareholding by the foreign company either full or in part in the subsidiary. If the Act intended to cover the foreign public company holding shares through one of its subsidiaries the word **"through"** would have been employed instead of the words **"together with".** There is no ambiguity in the language employed by the legislature. The intention to cover only such foreign public companies which have direct investment in Indian private companies is very clear. If the foreign company, to which the relationship of subsidiary has to be determined, is not holding any shares in the Indian Company such foreign company is out of the purview of sub-section (7).

The share holding pattern is the test applied by the Act, in case the holding company is a public company, to determine the status of subsidiary. The provisions of section 4 (7) of the Act are applicable only to such foreign holding company which actually holds shares in the subsidiary either alone or together with other foreign bodies corporate. The crucial point is that unless the holding company holds any share in the subsidiary no reference to such a holding company to be made while applying the provisions of subsection 7 of section 4 of the Act.

Single-holding.

In a case of single holding i.e. one holding company and one subsidiary company the impact of subsection (7) is quite simple. If the holding company is a private company sub-section (7) will have no application. If the holding company is a public company, if the entire equity share capital is not held by the holding company either alone or together with other bodies corporate the subsidiary will be treated as a private company subsidiary of a public company.

To illustrate this with the earlier example, if A is a private foreign company holding more than 50% or the entire equity share capital of the Indian private company B, B becomes a subsidiary of A. As A is a private company Sub-section (7) is not applicable and B remains a private company.

Suppose A is a public company. If A holds the entire share capital of B either alone or together with other bodies corporate, B will be treated as a private company. If even a single share is held by an Indian (individual or company) in company B, it will be treated as a private company subsidiary of a public company.

In other words sub-section (7) will have its impact only when the holding company is a public company.

Chain-holding.

It is only in the event of chain holding where there are subsidiaries and sub-subsidiaries involving public and private companies the real impact of sub-section (7) is felt. It becomes a daunting task to interpret and apply the law enunciated in sub-section (7) of section 4 of the Act as chain-holding involves lot of combinations.

Now let us suppose, in the earlier example, that A is a private company and subsidiary of C which is a public company and C is not holding any share in B. There can be two situations. Situation I. A holds the entire share capital of B.

Situation II.A holds 60% of the equity share capital of B and rest of the shares is held by Indian public company D.

If C also holds share in B there can be two situations.

Situation III. A holds 90% and C holds 10% of the equity share capital of B.

Situation IV: A holds 40%, C holds 20% of the equity share capital of B and rest of the share capital is held by D.

What is the position of B in all these situations?

In situation I and II since C is not at all holding any shares in B, provisions of sub-section (7) are not applicable and B will be treated as a private company. In situation III C holds 10% and A holds 90% of the equity share capital of B. Here C is holding the entire equity share capital of B together with A. Provisions of sub-section (7) are applicable and B will be treated as a private company. In situation IV C together with A holds only 60% of the equity share capital of B. Here also provisions of sub-section (7) are applicable and B will be treated as a private company subsidiary of a public company.

What is the implication when a private company becomes a subsidiary of a public company under section 4(7) of the Act?

The expression private company subsidiary of a public company used in various places in the Companies Act, 1956 (the Act) has wider application so as to bring a private company which is a subsidiary of a foreign public company into its scope. As has been discussed, a private company incorporated in India though becomes a subsidiary of a foreign public company in any one of the ways mentioned under section 4(1) of the Act, it is only such private company which becomes a subsidiary of a foreign public company under section 4(1)(b)(ii) is considered for the expression "private company subsidiary of a public company", for the purposes of the Act, by sub-section (7) of section 4 of the Act. When a private company becomes a subsidiary of a public company within the meaning of section 4(7) it shall remain as a subsidiary of a public company for all purposes of the Act.

Investment planning through a subsidiary is a global phenomenon. The legislature also recognises this and it has aptly enacted sub-section (7) of section 4 of the Act by bringing subsidiary having Indian investment (whatsoever is the extent) into the fold of public company. However investors are free to adopt the chain-holding method to come out of this by channelising the investment through a wholly owned off shore subsidiary.

4.4 CONCEPT OF HOLDING AND SUBSIDIARY COMPANIES

A corporation that limits its business to the ownership of stock in and the supervision ofmanagement of other corporations.

A holding company is organized specifically to hold the stock of other companies and ordinarilyowns such a dominant interest in the other company or companies that it can dictate policy Holding companies must comply with the federal anti trust laws that proscribe the secret and totalacquisition of the stock of one corporation by another, since this would lessen competition andcreate a monopoly.

Meaning under Companies act 1956

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 capitals. OR

iii) The company is a subsidiary of any company which is that other company's subsidiary.

Advantages of Holding Companies

According to the Internal Revenue Service, there are two criteria for being considered a holding company:

1) at least 60 percent of adjusted gross income must come from dividends, rents, royalties and interest; and

2) five or fewer individuals, directly or indirectly during 6 months of the tax year, must

own more than 50 percent of the outstanding stock of a company. The first criterion is referred to as the "personal holding company income test" and the second is the "stock ownership requirement" test. Both tests must be met in order to be considered a personal holding company.

Holding Company Benefits and Advantages

The holding company generally produces no products or services and is simply a vehicle for owning shares of other companies. If the holding company owns 80 percent of the voting stock of another company (the subsidiary), the holding company can qualify for tax-free dividends. Another benefit is the reduced risk exposure. The only risk the holding company has is the capital invested. The holding company also benefits from the subsidiary's goodwill and reputation, while being sheltered from risks faced by the subsidiary in the case of legal issues, tax liabilities and lawsuits.

Other Benefits Associated With Holding Company

Structuring a holding company makes sense from a number of perspectives. When raising capital a larger holding company has more diversity of assets than an individual company, which makes raising capital easier. In addition, if the holding company loans the subsidiary money, the holding company can secure the loan with the assets of the subsidiary, thereby creating a collateralized loan that places the company in first position in the event of bankruptcy. Furthermore, the holding company can set corporate policies over all subsidiaries without interfering with individual management of the subsidiaries.

Disadvantages of the Holding Company

Structuring a holding company is less expensive and provides a legally easier way of gaining control over a number of different companies. However, due to the ease and relative informality and informational filing requirements, required of holding companies, the government has discretion regarding the use of "antitrust" laws to force the closure of holding companies. Although antitrust laws can be used to manipulate or harass holding companies in some fashion, ensuring that the organization is structured properly and does not concentrate controlling interests within a particular industry, then antitrust issues are unlikely.

Following are the advantages of Holding Company:

1) Subsidiary company maintained their separate identity.
2) The public may not be aware the existence of combination among the various company.
3) Holding company need not to be invest entire amount in the share capital in subsidiary company still enjoy controlling power in such company.
4) It would be possible to carry forward losses for income tax purposes.
5) Each subsidiary company prepares its own accounts and therefore financial position and profitability of each undertaking is known.
6) Holding company may additional acquired or disposed of and the shares in subsidiary company in market whenever if desired.

Disadvantages of Holding Companies

1) There is a possibility of fraudulent manipulation of accounts.
2) Intercompany transaction may not be at a fair prices.
3) Minority share holders interest may not be properly protected.
4) The accounts of various companies may be made upon different dates to, manipulate profit or financial position of Group companies.
5) The shareholders in the holding company may not be aware of true financial position of subsidiary company.
6) Creditors and outsiders shareholder in the subsidiary company may not be aware of true financial position of subsidiary company.
7) The Subsidiary Companies may be force to appoint person of the choice of holding company such as Auditors, Directors other officers etc. at in dually high remuneration.
8) The Subsidiary Company may be force for purchases or sale of goods, certain assets etc. as per direction of holding company.

PRESENTATION OF ACCOUNTS BY HOLDING COMPANIES

As laid down in section (212) of the companies Act, 1956. A holding company requires to attach its balance sheet. The following documents and present the same to its shareholders.

a) A copy of the Balance Sheet of the subsidiary.

b) A copy of the Profit and Loss Account of the subsidiary.

c) A copy of the Report of the Board of Directors of the subsidiary.

d) A copy of the Auditors Report of subsidiary.

e) A statement indicating the extent of holding company's interest in the subsidiary at the end of the accounting year of the subsidiary.

f) Where the financial year of the subsidiary company does not coincident with the financial year of the holding company. A statement showing the following:

i) Whether there are any changes in holding companies interest in subsidiary company since the close of financial year of the subsidiary company.

ii) Details of material changes which have occurred between the end of the financial year or the subsidiary company an end of the financial year of the holding company.

4.5 CONSOLIDATED BALANCE SHEET

A company may purchase either the whole or the majority of shares of another company so as to have controlling interest in such a company or companies. The controlling company is known as the holding company and the company so controlled is known as subsidiary company. Holding company has the power to nominate the majority of the directors of subsidiary company. Consolidated balance sheet is a single balance sheet of holding and subsidiary companies. In India, it is not compulsory on the part of the holding company to prepare the consolidated balance sheet. But in England, it is a must on the part of the holding company to prepare the consolidated balance sheet in addition to its normal balance sheet. A consolidated balance sheet presents the assets and liabilities of a parent company and all its subsidiaries on a single document, with no distinctions on which items belong to which companies. If your company has $1 million in assets and it purchases subsidiaries with assets of $400,000 and $300,000, respectively, then your consolidated balance sheet will show $1.7 million in assets, and the sheet will commingle those assets. For example, in the asset section, accounts receivable will list the total amount of receivables held by all three companies. 1.6 AS. 21 – Consolidation of Financial statement AS. 21 come into effect in respect of accounting periods commencing on or after 1st April i.e. for year ending 31st March 2002. The A.S. 21 is applicable to all the enterprises that prepare consolidated financial statement. It is mandatory for Listed companies and Banking companies. 4 As per AS 21, The Consolidated financial statements would include:

i) Profit & Loss A/c

ii) Balance sheet

iii) Cash flow statement

iv) Notes of Accounts except typical notes.

v) Segment reporting AS 21 also desire various import terms, as well as treatment and same while preparing consolidated financial statement. Consolidated financial statements should be prepared for both domestic as well as foreign subsidiaries.

When to Consolidate

A company must issue consolidated financial statements whenever it owns a controlling stake in another business — that is, whenever it owns more than 50 percent of that business. If the parent company owns 100 percent of the subsidiary, this is pretty straightforward. Complications arise, however, if the parent company owns a controlling stake with less than 100 percent ownership. Part of the subsidiary belongs to someone else, and that must be reflected on the balance sheet. The parent company handles this by consolidating the balance sheet as usual, then creating a separate account in the owners' equity section of the sheet. This account, called "minority interest" or "non-controlling interest," is equal to the value of the portion of the subsidiary that the parent company doesn't own. In essence, the parent company claims all of the subsidiary's assets and liabilities on the balance sheet and then "gives some of the value back" in the equity section.

Alternatives to Consolidation

When one company owns a less-than-controlling stake in another — that is, less than 50 percent — then it does not consolidate the balance sheet. Say your business owns 45 percent of another company. Your balance sheet would list only your company's assets, liabilities and equity. Your investment in the other company would exist as a single asset on your balance sheet, equal to the value of your 45 percent stake.

Other Statements

Parent companies don't just consolidate the balance sheet; they consolidate all of their financial statements. So the parent company's consolidated income statement combines the revenue, expenses, gains, losses and taxes of the parent and all its subsidiaries. Likewise, the consolidated cash flow statement combines all the companies' operational, investment and financing cash flows. The combined owners' equity statement looks like the equity section of the balance sheet: It will show the combined equity in all the companies and "give back"

A holding company is required to present to its shareholders consolidated balance sheet of holding company and its subsidiaries. Consolidated balance sheet is nothing but addicting of up or combining the balance sheet of holding and its subsidiary together. However assets and liabilities are straight forward, i.e. added line to line and combination of share capital, reserves, and accumulated losses are not directly added in consolidated balance sheet. Preparation of consolidated balance sheet. The following points need special attention while preparing consolidated balance sheet.

1) Share of holding company and share of minority (outside shareholders).

2) Date of Balance sheet of holding company and that of various subsidiary companies must be same. If they are not so necessary adjustment must be made before consolidation.

3) Date of Acquisition of control in subsidiary companies.

4) 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.

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.

SUBSIDIARY COMPANY

A subsidiary company is a business entity that is controlled by another organization through ownership of a majority of its voting stock. This separate legal structure may be used to gain certain tax benefits, track the results of a separate business unit, segregate risk from the rest of the organization, or prepare certain assets for sale. A larger business may own dozens or even hundreds of subsidiary companies.

A **subsidiary**, **subsidiary company** or **daughter company** is a company that is owned or controlled by another company, which is called the *parent company*, *parent*, or *holding company*. The subsidiary can be a company, corporation, or limited liability company. In some cases it is a government or state-owned enterprise.

In the United States railroad industry, an **operating subsidiary** is 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 of the parent company.

Subsidiaries are a common feature of business life, and all multinational corp orations organize their operations in this way.

Examples include holding companies such as Berkshire Hathaway, Leucadia National Corporation, Time Warner, or Citigroup; as well as more focused companies such as IBM or Xerox. These, and others, organize their businesses into national and functional subsidiaries, often with multiple levels of subsidiaries.

Subsidiaries are the 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.[8] 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, therefore any copyrights trademarks and patents remain with the subsidiary until the parent shuts down the subsidiary.

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 corporate group, although this term can also apply to cooperating companies and their subsidiaries with varying degrees of shared ownership.

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, such as DanJaq, a closely held family company, which controls Eon Productions, the large corporation which manages the James Bond franchise. Conversely, the parent may be larger than some or all of its subsidiaries (if it has more than one), as the relationship is defined by control of ownership shares, not numbers of employees.

The parent and the subsidiary do not necessarily have to operate in the same locations, or operate the same businesses, yet not only is it possible that they could conceivably be competitors in the marketplace, but such arrangements happen frequently at the end of a hostile takeover or voluntary merger. 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.

A subsidiary corporation or company is one in which another, generally larger, corporation, knownas the parent corporation, owns all or at least a majority of the shares. As the owner of thesubsidiary, the parent corporation may control the activities of the subsidiary. This arrangementdiffers from a merger, in which a corporation purchases another company and dissolves thepurchased company's organizational structure and identity.

Subsidiaries can be formed in different ways and for various reasons. A corporation can form asubsidiary either by purchasing a controlling interest in an existing company or by creating thecompany itself. When a corporation acquires an existing company, forming a subsidiary can bepreferable to a merger because the parent corporation can acquire a controlling interest with asmaller investment than a merger would require. In addition, the approval of the stockholders of theacquired firm is not required as it would be in the case of a merger.

When a company is purchased, the parent corporation may determine that the acquired company'sname recognition in the market merits making it a subsidiary rather than merging it with the parent.A subsidiary may also produce goods or services that are completely different from those producedby the parent corporation. In that case it would not make sense to merge theoperations.Corporations that operate in more than one country often find it useful or necessary tocreate subsidiaries. For example, a multinational corporation may create a subsidiary in a countryto obtain favorable tax treatment, or a country may require multinational corporations to establishlocal subsidiaries in order to do business there.

Corporations also create subsidiaries for the specific purpose of limiting their liability in connectionwith a risky new business. The parent and subsidiary remain separate legal entities, and theobligations of one are separate from those of the other. Nevertheless, if a subsidiary becomesfinancially insecure, the parent corporation is often sued by creditors. In some instances courts willhold the parent corporation liable, but generally the separation of corporate identities immunizes theparent corporation from financial responsibility for the subsidiary's liabilities.

One disadvantage of parentsubsidiary relationship is the possibility of multiple taxation.Another is the duty of the parent corporation to promote the subsidiary's corporate interests, to actin its best interest, and to maintain a separate corporate identity. If the parent fails to meet theserequirements, the courts will perceive the subsidiary as merely a business conduit for the parent, and the two corporations will be viewed as one entity for liability purposes.

The terms "holding company" and "subsidiary" are used to describe the financial, managerial, legal and governing relationships between different types of business organizations, including corporations and financial institutions. A holding company is an entity formed to buy and hold the majority of stock of other companies; a subsidiary is a business whose majority of stock is owned by a holding company.

Ownership

A holding company buys, absorbs or otherwise obtains a majority percentage of stock in another company, which becomes known as its subsidiary. Typically, a holding company must control 50 percent or more of a company's stock before it's considered a subsidiary. Holding companies may also own other holding companies — in this case, they're known as top holding companies. The holding company has all rights and responsibilities of ownership for its subsidiaries. The subsidiaries, while not independently owned, often continue to operate as individual entities, though major corporate decisions are made by the holding company.

Management

A holding company directs the management and operations of the subsidiaries it owns and maintains the authority to add or remove board members, directors and other key management and personnel. A holding company may have strict managerial control or may allow subsidiaries to act with some level of autonomy for day-to-day business operations, including lower- and midlevel hiring and certain budgeting decisions.

Financial Control

A subsidiary has little to no financial control over its operations. Even independently acting subsidiaries are ultimately financially controlled by their holding company. This includes financial activities such as investment decisions, sales projections and budgeting. If a subsidiary was itself a holding company prior to becoming a subsidiary of another holding company, all of its subsidiaries also become subsidiaries of the top holding company.

Legal Responsibility

A holding company may invest in subsidiaries in a variety of industries to diversify its investment, lower its risk potential and, in some instances, take advantage of shared loss and tax consolidation. Although a holding company may enjoy the profits of its subsidiaries, it also has a fiduciary responsibility to the subsidiaries it controls. A subsidiary that regains a majority of its shares also regains its autonomy from its holding company.

4.6 CONCEPT OF MINORITY INTEREST, COST OF CONTROL, REVENUE PROFIT AND CAPITAL PROFITS

MINORITY INTEREST

The claim of outside shareholders in the subsidiary company has to be assessed and shown as liability in the consolidated balance sheet. Minority interest in the net assets of the company is nothing but the proportionate share of aggregation of share capital, reserve surpluses funds etc. proportionate share of all assets should be deducted from the minority interest. Thus, minority interest is the share of outsider in the following.

1) Share in share capital in subsidiary.

2) Share in reserves (Both pre and post acquisition of subsidiary).

3) Share in accumulated losses should be deducted.

4) Proportionate share of profit or loss on revaluation of assets.

5) Preference share capital of subsidiary company held by outsiders and dividend due on such share capital, if there are profits.

Minority interest means outsiders interest. It is treated as liability and shown in consolidated balance sheet as current liability. This amount is basically intrinsic value of shares held by minority. When the outsiders hold some of the shares of S Ltd, their proportionate share in the assets and liabilities of S Ltd is known as minority interest. The majority interest is calculated by using the following equation:

Paid up value of shares held by outsiders		Xxx
Add: Outsiders' share of capital profits	xxx	Xxx
Outsiders' share of revenue profits	xxx	
Less: Outsiders' share of capital loss	xxx	
Outsiders' share of revenue loss	xxx	Xxx
Minority interest		Xxx

If preference shares of S Ltd are held by outsiders, the face value of such shares with dividend due there on will be included in the minority interest. Minority interest is shown as a liability in the consolidated balance sheet.

COST OF CONTROL (GOOD WILL)/CAPITAL RESERVE

The holding company acquires more than 50% of the shares of the subsidiary company. Such shares may be acquired at a market price. Which may be at a premium or at discount. This amount is reflected in the balance sheet of holding company of the assets side as investment in the shares of subsidiary company. This is the price paid for shares in net assets of subsidiary company as on date of its acquisition. Net assets of the subsidiary company consist of share capital, accumulated profits and reserve after adjustment, accumulated losses as on the date of acquisition. If the amount paid by the holding company for the shares of subsidiary company is more than its proportionate share in the net asset of the subsidiary company as on the date of acquisition, the difference is considered as goodwill. If there is excess of proportionate share in net assets of subsidiary company intrinsic of shares acquired and cost of shares acquired by holding company there will be capital reserve in favour of holding company. It goodwill already exists in the balance sheet of holding company or both the goodwill thus calculated, will be added up to the existing goodwill. Capital Reserve will be deducted from Goodwill. In short, net amount resulting from goodwill and capital Reserve will be shown in the consolidated Balance sheet. If H Ltd purchases the shares of S Ltd at a higher price than their actual value, the excess payment is known as cost of control or good will (Loss on purchase of shares of S Ltd). On the other hand, if the shares are purchased at a lower price than their actual value, the extent of lower payment is known as capital reserve (profit on purchase of shares of S Ltd). The cost of control/capital reserve is calculated as follows:

Amount paid for 'N' shares of S Ltd		xxxx
Paid up value of shares held by H Ltd	xxx	
Add: H Ltd' share of capital profits	xxx	xxx
(or)	Xxx	Xxx
Less: H Ltd' share of capital losses Cost of control/capital reserve		Xxx*

*If it is positive, the amount will be treated as cost of control and if it is negative, the amount will be treated as capital reserve. The amount of cost of control is shown in the asset side of the consolidated balance sheet and the capital reserve is shown in the liability of the consolidated balance sheet.

REVENUE PROFITS / LOSSES

These are otherwise known as post-acquisition profits/losses. These profits/losses are earned By S Ltd after the acquisition shares by H Ltd. These profits/losses are to divided among h Ltd and outsiders on th ebasis of their shareholding proportions. H Ltd' share of revenue profits/losses is added/deducted from its P&l account in the consolidated balance sheet. The outsiders' share of revenue profits/losses is adjusted on minority interest.

CAPITAL PROFITS / LOSSES

These are otherwise known as pre-acquisition profits or losses. These are reverses/ P&L (Cr) or (Dr) balance on the date of purchase of shares of S ltd by H ltd. These profits/losses are to be divided among H Ltd and outsiders on the basis of their shareholding proportions. H Ltd' share of capital profits/losses is adjusted on the calculation of cost of control(good will)/capital reserve. The outsiders' share of capital profits/losses is adjusted on minority interest. The holding company may acquire the shares in the subsidiary company either on the balance sheet date or any date earlier than balance sheet date. All the profit earned by the subsidiary company till the date of acquisition of shares by holding company have to be taken as capital profits for the holding company. Such reserves loose their individual identity and considered as capital profits. In case, the holding company acquired shares on a date other than balance sheet date of subsidiary, the profits of subsidiary company will have to be apportioned between capital profits and Revenue profits from the point of view of the holding company. Thus any profit earned by subsidiary company before the date of acquisition is the capital profit, while any profit earned by subsidiary company after the date of acquisition is Revenue profits. While preparing the consolidated balance sheet share in capital profits should be adjusted with the cost of control and Revenue profits / Reserves should be merged with the balances in the Reserve and surpluses of the holding company.

4.7 PREPARATION OF CONSOLIDATED BALANCE SHEET

PREFERENCE SHARES IN SUBSIDIARY COMPANY :

In case the subsidiary company has also Preference share capital, its treatment on consolidation will be as follows:

a) Nominal value of non participating Preference share capital of the subsidiary company is held by the holding company should be adjusted in cost of control against the cost of Preference shares.

b) Preference shares held by outsiders. Paid up value of such Preference shares should be included in Minority interest.

BONUS SHARES:

The issue of bonus shares by the subsidiary company will increase the number of shares held by the holding company as well as by the minority share holders without any additional cost. However ratio of holding will not change. Issue of bonus shares may or may not affect the cost of control depending upon whether such shares are issued out of capital profits or revenue profits.

i) Issue of bonus shares out of pre acquisition profits (capital profits): In case the subsidiary company issues bonus shares out of capital profits the cost of control remains 16 unaffected in the consolidated balance sheet on account of issue of bonus shares. As share capital increases by the amount of bonus and capital profits decreases by the same amount. Hence, there is not effect on cost of control when bonus shares are issued from pre acquisition profits.

ii) Issue of bonus share of post acquisition profits (Revenue profits): In this case, a part of revenue profits will get capitalised resulting decrease in cost of control or increase in capital reserve. Issue of bonus shares whether out of capital profits or revenue profits will not affect on minority interest. Minority interest will remain unaffected.

TREATMENT OF DIVIDEND :

i) **Dividend** paid When subsidiary company pays dividend, the holding company will naturally receive its due share. On receipt the holding company will debit bank account. However account to be credited depends upon whether dividend received out of pre-acquisition profit or out of post acquisition profit. Dividend received by the holding company out of Pre-acquisition profit should be credited to investment account. Only the dividend out of post acquisition profit should be treated as Revenue income and credited to profit and loss account.

ii) **Proposed dividend** : In case the subsidiary company has proposed dividend on its shares which is not accounted by the holding company for such dividend due on their investment in subsidiary company profits.

Profit may be then analysed between capital Revenue in the usual manner.

iii) **Dividend payable :** In case subsidiary company has declared dividend and the holding company taken credits for such dividend in its account, following treatments should be given.

1. No adjustment in respect of such dividend should be done in the subsidiary company book.
2. In the holding company books dividend out of pre-acquisition profit should be credited investment account. Dividend out of post acquisition profit should be credited to profit and loss account.
3. In the consolidated Balance-sheet the amount of dividend payable by the subsidiary company will be cancelled against the amount of dividend receivable by the holding company. Dividend payable to minorities may be either included in the minority interest or be shown separately as liability in the consolidated balance sheet.

iv) **Intension to propose dividend:** In case subsidiary company as intension to propose dividend, such proposed dividend given in adjustment may be completely ignored while preparing the consolidated balance sheet. Alternatively proposed dividend on share capital held by minority may be deducted from minorities interest and shown separately liability in the consolidated balance sheet.

PRELIMINARY EXPENSES:

The preliminary expenses of subsidiary company may be taken as capital loss or the amount may be added with the amount of preliminary expenses of the holding company.

PROVISION FOR TAXATION:

Any provision for taxation provided by the subsidiary company should be taken to the consolidated balance sheet and be shown on the liability side.

PURCHASE OF SHARES IN INSTALLMENT: A holding company may purchase shares of the subsidiary company in installments. In such circumstances division of profit between pre and post acquisition will depend upon the lots in which shares are purchased. However, if small purchases are made over the period of time then date of purchase of shares which results in acquiring in controlling interest may be taken as cut of line for division of profits between capital and Revenue.

SALE OF SHARES : When a holding company disposed off a part of its holding in the subsidiary company and the relationship of holding and subsidiary company continues as it holds majority of shares of subsidiary. Sale of shares by holding company may be treated as follows. 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.

CONSOLIDATED PROFIT AND LOSS ACCOUNT

The consolidated profit and loss account of the holding company and its subsidiaries are prepared to show the operating activities of the companies comprising the groups. While preparing the consolidated profit and loss account of the holding company and its subsidiary, the items appearing in the profit and loss account of the holding company and the subsidiary companies have to be aggregated. But while doing so, the following adjustment have to be made.

1) Prepare profit and loss account in columnar form Amounts relating to inter company transactions are entered in the adjustment column against the respective items and are subtracted while entering amounts in the total columns.

2) All inter company operating transactions are eliminated such as purchase and sale of goods, interest on loans among the group companies.

3) All inter company profits are adjusted.

4) Dividends received from the subsidiary company by the holding company should be eliminated from both the sides of consolidated profit and loss account.

5) Interest accrued and outstanding on Debenture of the subsidiary company held by the holding company should be 23 accounted by holding and subsidiary company both and then its should be eliminated.

6) Readjustment of Depreciation on Revaluation on fixed Assets at the time of acquisition of shares by the holding company should be adjusted in consolidated balance sheet and respective fixed assets and in the consolidated profit and loss account.

7) The minority interest in the profit of subsidiary company should be transferred minority interest account, in the proportion of total profit after adjustment of revaluation of fixed Assets, but before adjusting unrealized profit on stock.

8) The share of holding company in pre-acquisition profit should be transferred to cost of control, in case shares are acquired during the year.

9) Share of holding company in the past acquisition profits shall be considered as revenue profits.

10) The balance in holding company columns will represents the total profit or loss made or suffered by the group as a whole.

11) Group Consisting more than one subsidiaries: There are three situations

a) A holding company may have a number of subsidiaries without any mutual holding between the subsidies.

b) There may be change holding i.e. the holding company may hold shares in a subsidiary company which is also holding company of its subsidiary company, there may be different combinations.

There may be cross holding i.e. subsidiary company may have shares in the holding company as well. However, according to company's Act, subsidiary company cannot acquires shares in its holding company after becoming subsidiary company, but it can continue to hold those shares in the holding company, which were acquired before it became subsidiary company.

FOREIGN SUBSIDIARIES:

Foreign subsidiaries companies final A/c should be consolidated along with other subsidiary companies in the usual manner. The trial balance of the subsidiary or balance sheet and profit and loss A/c of the foreign subsidiary is the first converted into home currency. The rules of conversion are the same as for foreign branches which can be summarized as under.

a) Fixed Assets and fixed liabilities should be converted at the rate of exchange prevailing as on date when such assets were purchased or such liabilities are incurred or the payment was made if they are acquired or raised after acquisitions of shares.

b) Floating assets and liabilities should be converted at the rate of exchange prevailing on the last day of the accounting year.

c) Revenue items or net profit for the year should converted at the average rate of exchange ruling during the period under review.

d) Opening stock should be converted at the rate of exchange at the beginning of the year.

e) Share capital and Reserves of subsidiary company as on date of acquisition, should be converted at the rate of exchange prevailing on date of acquisition.

f) Any remittances for purchases of goods by subsidiary company from holding company or vice-versa should be converted at the actual rates prevailing on the date of purchase or date of receipt of remittances.

g) Fixed assets / Fixed liabilities as on date of acquisition which are carried forward should be converted at the rate of exchange prevailing on date of acquisition of shares; if rate on date of acquisition on fixed assets not given. After converting the various items of trial balance a new trial balance can be prepared, difference if any in the new trial balance should be transferred to exchange fluctuation account. Such difference may be carried and shown in the Balance sheet either as an asset or as a liability depending on whether balance debit or credit, alternatively difference in exchange can be transferred to profits & loss account.

ELIMINATION OF INVESTMENTS IN SHARES OF SUBSIDIARY COMPANY :

Investment in shares in subsidiary company represents the cost paid by the holding company to acquire the shares of the subsidiary company. The investment in shares of the subsidiary company entitles the holding company to share the net assets of the subsidiary company. While preparing consolidated balance sheet all the assets and liabilities of subsidiary company have to be merged with those of the holding company and therefore it is logical to eliminate investments of the holding company in the shares of the subsidiary company. Share in net assets of the outside shareholders should treat as the minority interest it is shown in the balance sheet on the liability side of holding company.

CONTINGENT LIABILITIES:

As 29 defines a contingent liabilities as: A possible obligation that arises from past events and whose existence will be confirmed only by occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity or a present obligation that arises from the past events but not recognized / provided.

Such contingent liability may be of two types:

a) External contingent liability.

b) Internal contingent liability.

Internal contingent liability relates in respect of transactions between holding and subsidiary company and it will not be shown as foot note in the consolidated balance sheet, as they appear as actual liability in the consolidated balance sheet.

4.8 TREATMENT OF UNREALISED PROFIT, REVALUATION OF ASSETS AND MUTUAL OWING

UNREALIZED PROFIT:

The problem of unrealized profit arises in those cases where the companies of the same group have sold goods to each other at the profits and goods still remain unsold at the end of the year company to whom the goods are sold. While preparing the consolidated balance sheet, unrealized profit has to be eliminated from the consolidated balance sheet in the following manner.

1. Unrealised profits should be deducted from the current revenue profits of the holding company.

2. The same should be deducted from the stock of the company consolidated balance sheet. Minority shareholders will not be affected in any way due to unrealized profits

For e.g.

The sock in trade of S. Ltd. includes Rs. 60,000 in respect of goods purchased from H Ltd. These goods have been sold by H ltd. at a profit of 20% on invoice price.

Therefore, unrealized proft $= \frac{60,000 \times 20}{100} = 12,000$

Urealized profit Rs. 12,000 should be deducted from closing stock in the consolidated balance sheet and from Revenue profit i.e from profit and loss account.

REVALUATION OF ASSETS AND LIABILITIES:

The holding company may decide to revalue the assets and liabilities of the subsidiary company on the date of acquisition of share in the subsidiary company. Any profit or loss on such revaluation is a capital profit or loss. Profit on revaluation of assets of the subsidiary company whether before or after date of acquisition of shares by the holding company, the same must be shared by the holding company, and the minority share holders in proportion to their respective holding. The minority share holders share should be added to the minority interest. But the holding company share should be treated as capital profits and considered in cost of control. Further readjustment for depreciation on increase in the value of assets should be made in the profit and loss account in the subsidiary company. And same should be deducted from the Revenue profits of the subsidiary company.

Illustration

(Revaluation of Fixed Assets) From the following balance sheet of H. Ltd. and its subsidiary S Ltd. drawn up at 31.12.2010. Prepare a consolidated Balance sheet as on that date having regard to the following.

i) Reserve and profit and loss account (cr.) of S. Ltd. stood at Rs. 50,000 and 30,000 respectively, on the date of acquisition of its 80% shares. Held by H Ltd. as on 1/01/2010 and

ii) Machinery (Book value Rs. 2,00,000) and furniture (Book value Rs. 40,000) of S Ltd. were revalued at Rs.3,00,000 and Rs. 30,000 respectively for the purpose of fixing the price of its shares there was no purchase or sale of these assets since the date of acquisition.

MUTUAL OWING / INTER COMPANY TRANSACTIONS :

The holding company and the subsidiary company may have number of inter company transactions in any one or more of the following matters.

1. Loan advanced by the holding company to the subsidiary company or vice versa.
2. Bill of Exchange drawn by holding company on subsidiary company or vice versa.
3. Sale or purchase of goods on credit by holding company form subsidiary company or vice versa.
4. Debentures issued by one company may be held by the other.

As a result of these inter company transactions, certain accounts appear in the balance sheet of the holding company as well as the subsidiary company. In the consolidated balance sheet all these common accounts should be eliminated.

For e.g. S Ltd. has taken loan of Rs. 20,000 from H Ltd. then S ltd. balance sheet shows a liability of Rs. 20,000 while H Ltd. balance sheet shows on assets of Rs. 20,000. 2. H Ltd. draws a bill of Rs. 50,000 on S Ltd., then H Ltd. books it will show bills receivable Rs. 50,000 while S Ltd. books will show bills payable Rs. 50,000. 11 3. S Ltd. issued debentures of Rs. 1,00,000 which are held by H Ltd. then S Ltd. balance sheet will show a liability of Rs. 50,000 while H Ltd. books will show an assets of Rs. 50,000. All the above inter company transactions have to be eliminated while preparing the consolidated balance sheet. These can be done by deducting inter company transactions from the respective items on both sides of balance sheet.

Important adjustments made while preparing the consolidated balance sheet. It has been explained with the help of an example:

H Ltd is a holding company and S Ltd refers to subsidiary company.

'H' LTD'S INVESTMENT IN SHARES OF 'S' LTD

The share of S Ltd is held by H Ltd as investments. This represents the ownership of H Ltd in the equity or net assets of S Ltd. If the entire shares of S Ltd are held by H Ltd, the investment of H Ltd in the share of S Ltd is replaced by the capital of S Ltd, while preparing the consolidated balance sheet.

The effects of the above transactions are involved in the consolidated balance sheet is shown below:

CONSOLIDATED BALANCE SHEET

Liabilities	Rs	Rs	Assets	Rs	Rs
Sundry creditors(H Ltd + S Ltd)	Xxx		Sundry debtors(H Ltd + S Ltd)	xxx	
Less: Mutual Owings	xxx	xxx	Less: Mutual Owings	xxx	xxx
Bills payable(H Ltd + S Ltd)	xxx		Bills receivable(H Ltd + S Ltd)	xxx	
Less: Mutual Owings	xxx	xxx	Less: Mutual Owings	xxx	xxx
Loans(H Ltd + S Ltd)	xxx		Loans(H Ltd + S Ltd)	xxx	
Less: Mutual Owings	xxx	xxx	Less: Mutual Owings	xxx	xxx
Debentures(H Ltd + S Ltd)	xxx		Investment in debentures(H Ltd + S Ltd)	xxx	
Less: Mutual Owings	xxx	xxx	Less: Mutual Owings	xxx	xxx
		Xxx			xxx

UNREALISED PROFIT ON STOCK OR STOCK RESERVE

If intercompany transfer of stock takes place at a profit, there may be an unrealized profit on stock unsold at the close of financial year. The unrealized profits on stock should be deducted from stock on the asset side of the consolidated balance sheet. In the liability side, the amount of stock reserve should be deducted from the P& L account. For example, if H Ltd purchased from S Ltd goods worth Rs. 40,000 on which S Ltd had charged a profit of 25 percent on cost and goods worth Rs.25,000 remained unsold at the end of the financial year. The unrealized profit on stock is (25/125% of 25,000) 5,000. The effect of this transaction on the consolidated balance sheet is shown below:

CONSOLIDATED BALANCE SHEET

Liabilities	Rs	Rs	Assets	Rs	Rs
P & L Account	xxx		Stock- H Ltd	xxx	
Less: Stock reserve	xxx	xxx	S Ltd	xxx	
			Less: Stock reserve	xxx	
				xxx	Xxx
		Xxx			xxx

REVALUATION OF ASSETS AND LIABILITIES

If assets and liabilities of S Ltd are revalued at the time of acquisition of shares, there will be revaluation profits/losses. The revaluation profits/losses are treated as capital profits/losses. Profits at the end of the year will be charged with depreciation on the revised values in case the value of fixed assets appreciates and excess depreciation will be credited back to the profit, in case the value of assets depreciates. H Ltd' share of revaluation profits/losses is adjusted in the calculation of Good will/Capital reserve. S Ltd' share of revaluation profits/losses is adjusted in the calculation of minority interest.

ISSUE OF BONUS SHARES BY S LTD

S Ltd issues bonus shares either out to capital profits or revenue profits. If bonus shares are issued out of capital profits, there will be no effect on consolidated balance sheet. This is because H Ltd' share of capital profits is reduced on account of issue of bonus shares and on the other hand, paid up value of shares are held by H Ltd and outsiders increases. There will be no change in the values of the cost of control/capital reserve or minority interest.

Bonus shares issued out of revenue profits will have effect on the consolidated balance sheet. The value of shares held by H Ltd and outsiders will increase. The increased paid up value of shares of H Ltd will reduce the cost of control or increase the capital reserve. But there will be no change in the minority interest.

TREATMENT OF DIVIDEND

S Ltd may declare dividend from either capital profits or revenue profits. The effect of dividend declared out of capital profits on the consolidated balance sheet is shown below:

CONSOLIDATED BALANCE SHEET

Liabilities	Rs	Rs	Assets	Rs	Rs
			Investments in shares of S Ltd	xxx xxx	xxx
			Less: H Ltd share of dividend	xxx xxx	
			Cash/ Bank		xxx
			Add: H Ltd share of dividend		
		xxx			xxx

* This amount will be the amount paid for the purchase of shares for calculating the cost of control/capital reserve.

If dividend is declared out of revenue profits, the effect on the consolidated balance sheet is shown below:

CONSOLIDATED BALANCE SHEET

Liabilities	Rs	Rs	Assets	Rs	Rs
P & L Account(H Ltd)	xxx		Cash/ Bank	xxx	
Add: H Ltd share of dividend	xxx	xxx	Add: H Ltd share of dividend	xxx	xxx

Note: Outsiders' share of dividend will not affect the consolidated balance sheet. The outsiders receive the dividend in cash and use the dividend amount as they like.

INTERIM DIVIDEND FROM S LTD

The H Ltd may receive interim dividend from S ltd. The interim dividend is to be apportioned between pre-acquisition period and post-acquisition period, on the assumption of that the interim dividend has been earned throughout the year.

PROPOSED DIVIDEND

The proposed dividend may appear in the liability side of S ltd. It should be assumed that the proposed dividend is out of revenue profits. H Ltd' share of proposed dividend will be added to H Ltd' P& L account and the share of outsiders will be added to minority interest.

Therefore, it can be concluded that**:** In India, it is not compulsory to prepare the consolidated balance sheet on the part of the H Ltd. But it is desirable to prepare the consolidated balance sheet by H Ltd., since it has many advantages. By going through the consolidated balance sheet, anyone can know about the transactions between H Ltd and S Ltd.

4.9 SUMMARY

A holding company is a company that owns other companies' outstanding stock. The term usually refers to a company that does not produce goods or services itself; rather, its purpose is to own shares of other companies to form a corporate group. Holding companies allow the reduction of risk for the owners and can allow the ownership and control of a number of different companies. In the United States, 80% or more of stock, in voting and value, must be owned before tax consolidation benefits such as tax-free dividends can be claimed. That is, if Company A owns 80% or more of the stock of Company B, Company A will not pay taxes on dividends paid by Company B to its stockholders, as the payment of dividends from B to A is essentially Company A transferring cash from one company to the other. Any other shareholders of Company B will pay the usual taxes on dividends, as they are legitimate and ordinary dividends to these shareholders. Sometimes a company intended to be a pure holding company identifies itself as such by adding "Holding" or "Holdings" to its name. After the financial crisis of 2007–08, many U.S. investment banks converted to holding companies. According to the Federal Financial Institutions Examination Council's (FFIEC) website, JPMorgan Chase & Co., Bank of America Corp., Citigroup Inc., Wells Fargo & Co., and Goldman Sachs Groups, Inc. were the five largest bank holding companies in the finance sector, as of 31 December 2013, based on total assets. The Public Utility Holding Company Act of 1935 in the United States caused many energy companies to divest their subsidiary businesses. Between 1938 and 1958 the number of holding companies declined from 216 to 18. An energy law passed in 2005 removed the 1935 requirements, and has led to mergers and holding company formation among power marketing and power brokering companies. In US broadcasting, many major media conglomerates have purchased smaller broadcasters outright, but have not changed the broadcast licenses to reflect this, resulting in stations that are (for example) still licensed to Jacor and Citicasters, effectively making them such as subsidiary companies of their owner iHeartMedia. This is sometimes done on a per-market basis. For example, in Atlanta both WNNX and later WWWQ are licensed to "WNNX LiCo, Inc." (LiCo meaning "license company"), both owned by Susquehanna Radio (which was later sold to Cumulus Media). In determining caps to prevent excessive concentration of media ownership, all of these are attributed to the parent company, as are leased stations, as a matter of broadcast regulation.

In the United States, a personal holding company is defined in section 542 of the Internal Revenue Code. A corporation is a personal holding company if both of the following requirements are met: Gross income test: At least 60% of the corporation's adjusted ordinary gross income is from dividends, interest, rent, and royalties. Stock ownership test: More than 50% in value of the corporation's outstanding stock is owned by five or fewer individuals. A parent company is a company that owns enough voting stock in another firm (subsidiary) to control management and operations by influencing or electing its board of directors. A parent company could simply be a company that wholly owns another company. This would be known as a "wholly owned subsidiary". When an existing company establishes a new company and keeps majority shares with itself, and invites other companies to buy minority shares, it is called a parent company.

Consolidated financial statements present the financial position and results of operations for a parent (controlling entity) and one or more subsidiaries (controlled entities) as if the individual entities actually were a single company or entity. Consolidation is required when a corporation owns a majority of another corporation's outstanding common stock. The accounting principles applied in the preparation of the consolidated financial statements are the same accounting principles applied in preparing separate-company financial statements. Two companies are considered to be related companies when one controls the other company. Consolidated financial statements are generally considered to be more useful than the separate financial statements of the individual companies when the companies are related. Whether the subsidiary is acquired or created, each individual company maintains its own accounting records, but consolidated financial statements are needed to present the companies together as a single economic entity for general-purpose financial reporting. Consolidated financial statements are presented primarily for the benefit of the shareholders, creditors, and other resource providers of the parent. Significantly, consolidated financial statements often represent the only means of obtaining a clear picture of the total resources of the combined entity that are under the control of the parent company. While consolidated financial statements are useful, their limitations also must be kept in mind. Some information is lost any time data sets are aggregated; this is particularly true when the information involves an aggregation across companies that have substantially different operating characteristics. Subsidiaries are legally separate from their parents, the creditors and stockholders of a subsidiary generally have no claim on the parent, nor do the stockholders of the subsidiary share in the profits of the parent. Therefore, consolidated financial statements usually are of little use to those interested in obtaining information about the assets, capital, or income of individual subsidiaries.

4.10 GLOSSARY

1. **Holding Company:** The terms "holding company" is used to describe the financial, managerial, legal and governing relationships between different types of business organizations, including corporations and financial institutions. A holding company is an entity formed to buy and hold the majority of stock of other companies; a subsidiary is a business whose majority of stock is owned by a holding company. A company has to either control the Board of directors or hold more than half of the equity capital of the other company.

2. **Subsidiary company:** is a business entity that is controlled by another organization through ownership of a majority of its voting stock. This separate legal structure may be used to gain certain tax benefits, track the results of a separate business unit, segregate risk from the rest of the organization, or prepare certain assets for sale. A larger business may own dozens or even hundreds of subsidiary companies.

3. **Minority Interest:** The claim of outside shareholders in the subsidiary company has

to be assessed and shown as liability in the consolidated balance sheet. Minority interest in the net assets of the company is nothing but the proportionate share of aggregation of share capital, reserve surpluses funds etc. proportionate share of all assets should be deducted from the minority interest.

4. **Unrealised Profits:** The problem of unrealized profit arises in those cases where the companies of the same group have sold goods to each other at the profits and goods still remain unsold at the end of the year company to whom the goods are sold. While preparing the consolidated balance sheet, unrealized profit has to be eliminated from the consolidated balance sheet in the following manner. Unrealised profits should be deducted from the current revenue profits of the holding company. The same should be deducted from the stock of the company consolidated balance sheet. Minority shareholders will not be affected in any way due to unrealized profits.

5. **Revenue Profits / Losses** These are otherwise known as post-acquisition profits/ losses. These profits/losses are earned By S Ltd after the acquisition shares by H Ltd. These profits/losses are to divided among h Ltd and outsiders on th ebasis of their shareholding proportions. H Ltd' share of revenue profits/losses is added/deducted from its P&l account in the consolidated balance sheet. The outsiders' share of revenue profits/losses is adjusted on minority interest.

6. **Capital Reserve:** Capital Profit: The holding company may acquire the shares in the subsidiary company either on the balance sheet date or any date earlier than balance sheet date. All the profit earned by the subsidiary company till the date of acquisition of shares by holding company have to be taken as capital profits for the holding company. Such reserves loose their individual identity and considered as capital profits. In case, the holding company acquired shares on a date other than balance sheet date of subsidiary, the profits of subsidiary company will have to be apportioned between capital profits and Revenue profits from the point of view of the holding company.

7. **Consolidated Balance sheet:** Consolidated balance sheet is a single balance sheet of holding and subsidiary companies. In India, it is not compulsory on the part of the holding company to prepare the consolidated balance sheet. But in England, it is a must on the part of the holding company to prepare the consolidated balance sheet in

addition to its normal balance sheet. A consolidated balance sheet presents the assets and liabilities of a parent company and all its subsidiaries on a single document, with no distinctions on which items belong to which companies.

4.11 SELF ASSESSMENT QUESTIONS

1. Discuss Accounting treatment of pre-acquisition dividend received by holding company.

2. How holding co. treats Bonus share received from subsidiary co. out of pre-acquisition profit from subsidiary co.

3. What is accounting treatment in holding companies dividend received, out of post-acquisition profit.

4. Why profit of subsidiary company is divided into pre and post acquisition.

5. How do you treat subsidiaries companies debentures purchased by holding company in open market and debentures interest paid by subsidiary company to holding company?

6. How do you treat pre-acquisition divided received by Holding company, from its subsidiary company?

7. Accounting treatment in respect of dividend distribution tax provided by subsidiary company.

8. How you prepare consolidated profit & Loss A/c? 14. State in brief procedure for consolidation of Foreign subsidiary company; Balance Sheet with Indian Holding Co.

9.

Balance sheets as on 31st March, 2010.

Liabilities	H Ltd.	S Ltd.	Assets	H Ltd.	S Ltd.
Share capital			Fixed Assets	3,00,000	1,00,000
Equity Shares of Rs. 10 each fully paid	5,00,000	2,00,000	60% shares in S Ltd. at cost	1,62,400	--
General Reserve	1,00,000	50,000	Current Assets	2,77,600	2,39,000
Profit and loss Account	60,000	35,000	Preliminary Expenses	--	6,000
creditors	80,000	60,000			
	7,40,000	3,45,000		7,40,000	3,45,000

H Ltd. acquired the share on 1st April 2009 on which date General Reserve and profit and loss Account of S Ltd. showed balances of Rs. 40,000 and Rs. 8,000 respectively. No part of preliminary expenses was written off during the year ending 31st March, 2010. prepare the consolidated balance sheet of H Ltd. and its subsidiary S Ltd. as on 31st March 2010.

10. (Revaluation of Fixed Assets) From the following balance sheet of H. Ltd. and its subsidiary S Ltd. drawn up at 31.12.2010. Prepare a consolidated Balance sheet as on that date having regard to the following.

i) Reserve and profit and loss account (cr.) of S. Ltd. stood at Rs. 50,000 and 30,000 respectively, on the date of acquisition of its 80% shares. Held by H Ltd. as on 1/01/2010 and ii) Machinery (Book value Rs. 2,00,000) and furniture (Book value Rs. 40,000) of S Ltd. were revalued at Rs.3,00,000 and Rs. 30,000 respectively for the purpose of fixing the price of its shares there was no purchase or sale of these assets since the date of acquisition.

Balance sheets of H Ltd. S Ltd. as at 31st December, 2010.

Liabilities	H Ltd. Rs.	S Ltd. Rs.	Assets	H Ltd. Rs.	S Ltd. Rs.
Share capital					
Shares of Rs. 100 each	10,00,000	2,00,000	Machinery	6,00,000	1,80,000
Reserves	4,00,000	1,50,000	Furniture	1,00,000	34,000
Profit & loss A/c	2,00,000	50,000	Other Assets (current)	8,80,000	2,86,000
Creditors	3,00,000	1,00,000	Shares in S Ltd. 1600 at Rs. 200 each	3,20,000	--
	19,00,000	**5,00,000**		**19,00,000**	**5,00,000**

4.12 RECOMMENDED READING

- M.C.Shulka, T.S.Grewal and S.C.Gupta, Advance Accounts, S.Chand & CompanyLtd,Vol.II.
- S.P. Jain and K.L. Narang, Advanced Accountancy, Kalayani Publishing House.
- M.A. Arulanandam and K.S. Raman, Advanced Accountancy, Himalaya Publishing House, (Part-II).