

MASTER OF COMMERCE
SEMESTER-II



ADVANCE CORPORATE ACCOUNTING
MCM609

CHANDIGARH UNIVERSITY
Institute of Distance and Online Learning

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UNIT-I INTRODUCTION TO ADVANCE CORPORATE ACCOUNTING

Structure

- 1.0. Learning Objective
- 1.1. Introduction
- 1.2. Basic
- 1.3. Features
- 1.4. Importance of Advanced Corporate Accounting
- 1.5. Summary
- 1.6. Key words
- 1.7. Learning Activity
- 1.8. Unit -End Questions
- 1.9. Suggested Readings

1.0 LEARNING OBJECTIVE

After studying this unit, you will be able to:

- State the basics of advance corporate accounting
- Describe basic concepts of corporate accounting
- List features of advance corporate accounting

1.1 INTRODUCTION

This is a process of accounting that is dedicated to the operations of a single company. In this type of bookkeeping, the corporate accountant only concerns themselves with the financial records of one firm. More specifically, the accountant only focuses on the firm that has employed him or her. According to the corporate accounting definition, this activity is normally performed so as to ascertain the financial and operational status of a company. Investors are especially interested in knowing the financial strength of the firm in which they have purchased some stock. Therefore, corporate accounting is performed to communicate the assets and liabilities of the firm to them. Advanced Accounting provides usage-based information for a wide variety of system resources so that one can develop comprehensive charge-back strategies. Advanced Accounting also provides new statistics from previous accounting tools. Corporate Accounting is a special branch of accounting which deals with accounting for companies, preparation of their final accounts and cash flow statements, analysis and interpretation of company's financial results and accounting for specific events like amalgamation, absorption, preparation of consolidated balance sheets.

1.2 BASIC

According to R.N Anthony, “nearly every business enterprise has accounting system. It is a means of collecting, summarizing, analyzing and reporting in monetary terms, information’s about business”.

According to Smith and Ashburne, “accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events, which are, in part at least, of a financial character and interpreting the result thereof”.

Accountants maintain monetary records and may concentrate on one or many areas of accounting and finance. Corporate accountants concentrate on business accounting and maintain an organization’s financial records to confirm compliancy with laws, rules and also the organization’s policies. Much of the work of corporate accountants is employed internally to assist executives build financial decisions for the organization. These professionals are stated as management accountants.

This is a special branch of accounting which deals with the accounting of a specific or individual company. It includes preparation of final accounts, cash flow statements, for specific events like amalgamation, consolidated balance sheets, absorption, etc. Corporate accounting mainly focuses on analysing and interpreting the company’s financial results.

Corporate accounting revolves around maintaining an organization’s financial records in order to ensure that the directed rules are compliance effectively and working procedures are held within the limits of the organization’s rules regulations and policies. Corporate accounting not only benefits the company but also enables the executives in making financial decisions. The Corporate Accountants dealing with all this work are also often referred to as Management Accountants.

It practices the double-entry book-keeping system in which every transaction will be recorded in two accounts which means that the debit account is the one from which money is leaving, and the credit account is to which it is transferred. This branch of accounting requires preparing and consolidating an organization’s financial statements, and ledgers. Ledgers and financial reports are collected from various organizations’ divisions and further, corporate financial statements for company executives are prepared. It is ensured that each division of the organization is covered and they are contributing to the company’s revenues equally.

With the motive of meeting financial goals, every year, efficient planning and well-versed working structure must be established. This gets possible with Corporate Accounting. Budgets are prepared to adequately allocate the funds and resources for various expenses in the departments of the company.

Apart from the financial works, Corporate Accounting also includes Auditing which specifies clearly whether organizational goals are met each year or not.

Corporate accounting is for large organizations and partnerships, where the requirements and demands for filing accounts are less rigorous.

Thus, Corporate Accounting includes the elements of book-keeping, classification of transactions, analysis of reports in such a way that these reports can be further used for decision making.

Corporate Accounting clearly requires the knowledge of:

- Accounting Principles and Conventions
- Accounting Standards
- Shares and Debentures
- The issue of and Forfeiture of Shares
- Issue of Debentures
- Redemption of Preference Shares
- Redemption of Debentures
- Valuation of Goodwill
- Company Amalgamations,

1.3 FEATURES

Accountants who work in the corporate or private sphere are employed by non-accounting companies rather than accounting firms. They can work in small local offices, national corporations or international companies.

Typically, corporate accountants will work in a team or department under the direction of the CFO (Chief Financial Officer)—though you’ll occasionally see an accounting party of one.

Rather than helping a wide-range of clients, private accountants work for a single company, developing an impressive depth of knowledge into their industry or niche. They typically choose to stay in that specific industry, gaining specialized knowledge. Some corporate accountants even work their way up to CFO.

1. The shareholders of a corporation have limited liability.
2. A corporate entity can raise its amount by selling shares and issuing bonds.
3. A corporate company holder can transfer his ownership.
4. Since the ownership of a corporation can be transferred, it has a perpetual life.
5. Owners can also receive tax-free benefits.

Corporation Has Limited Liability

A corporation grants the owners limited liability against debts and lawsuits filed against the company. This means that any loans, credit cards, mortgages or revolving credit with vendors, are the sole responsibility of the company. The same is true for any lawsuits or insurance claims against the company.

This is best illustrated when a company goes into financial hardship and files for bankruptcy; payroll, taxes and debts are all paid before any shareholder gets paid from the remaining assets, but the shareholders are not liable to pay for any of these if the assets are not enough to pay everything off. All accounting is done for a corporation under its own unique Tax Identification Number obtained from the IRS.

Corporation is Owned by Shareholders

The corporation is owned by shareholders. When the corporation is formed, a fixed number of company stock shares are issued. Stock shares can be owned by one person or many shareholders. When you think of the public corporations that sell stock on the stock exchanges, there are potentially millions of owners to any given company. Shareholders are allowed to vote based on the number of shares they own; the more shares an owner has the more control he has over the company's decisions.

Consider Double Taxation

For a smaller corporation, double taxation is a significant consideration. The corporation is taxed on earning at the business level. When profits are distributed to shareholders, those are also taxed as dividends. Depending on the overall revenues and how much is distributed to the shareholders, this could have a significant financial impact on the owners. Keep in mind that there are two types of corporate structures, the C corporation and the S- corp. Smaller businesses may elect the S-corp to pass through revenues directly to owners to mitigate the double taxation.

Corporations Have Their Own Lifespan

A corporation is its own entity, meaning it has a lifespan that only ends when the board of directors and owners vote to dissolve the business. This means a corporation extends beyond the lifespan of its human owners. Stock shares are transferable upon death or have the ability to be sold and transferred from person to person. Transfers happen either through a public stock exchange or through private transactions for non-public entities.

The transfer of stock is why a large company like Ford Motor Company and many other major corporations still exist today, even though their founders died decades ago.

Corporations Have Professional Management

The owners of a corporation may be able to vote on decisions for the board of directors to make final directives on, but the shareholders are not necessarily the managers of the company. For many small businesses, the majority shareholder is the founder and main leader of the company. However, it is possible for any corporation to hire a company leadership, while also reaping the benefits of the profits. The board of directors votes on major budget items.

1.4 IMPORTANCE OF ADVANCED CORPORATE ACCOUNTING

Accounting is very important whether it is corporate or otherwise, it is a heart of your business where you are heading can be assessed by accounts. According to Chanakya you have to keep account for each and every penny you spend.

1. **Statutory requirements of Company law:**Corporate accounting is very important because of some statutory requirement of Company Law rules and regulation. You have to maintain certain Books of account Register either manually or computerized. If you have collected shareholder money publicly or privately you have to give account to stakeholders, Bankers, Borrowers etc. Auditor report is also depending on Accounts.

Without accounting you or outsider cannot judge financial health of the company you cannot raised the fund with proper accounting.

2. **To maintain financial approach:**The importance of corporate accounting can be observed majorly in the context of developing and maintaining the financial as well as accounting approaches for the global organizations. By investigating the definition of corporate accounting, it is acknowledged that the particular process is one of the broader areas of accounting responsible for dealing and controlling wide range of accounting practices for the companies. From the preparation of major financial statements to the analysis and interpretation of the financial results, the involvement of corporate accounting can be significantly found in the important events associated with the company, such as the amalgamation, absorption, or preparation of consolidated accounting statements (Ahmed & Henry, 2011).
3. **To form financial statement:**Corporate accounting plays the major roles in the formation of financial statements and relevant accounts associated with the operations of an organization. In addition, the companies are responsible for addressing the inclusion of different accounting concepts and standards in their operations as part of forming their annual reports. The overall process helps to extract significant sense about the company's operations and their compliance with the particular accounting board, i.e. AASB or IASB.

1.5 SUMMARY

- Corporate Accounting is a special branch of accounting which deals with the accounting for companies, preparation of their final accounts and cash flow statements, analysis and interpretation of companies' financial results and accounting for specific events like amalgamation, absorption, preparation of consolidated balance sheets.
- A public company usually refers to a company that is permitted to offer its registered securities (stock, bonds, etc.) for sale to the general public, typically through a stock exchange, but also may include companies whose stock is traded over the counter (OTC) via market makers who use non-exchange quotation services such as the OTCBB and the Pink Sheets.
- The term "public company" may also refer to a government-owned corporation. This meaning of a "public company" comes from the tradition of public ownership of assets and interests by and for the people as a whole (public ownership), and is the less-common meaning in the United States. Advantages it is able to raise funds and capital through the sale of its securities. This is the reason why public corporations are so important: prior to their existence, it was very difficult to obtain large amounts of capital for private enterprises.
- In addition to being able to easily raise capital, public companies may issue their securities as compensation for those that provide services to the company, such as their directors, officers, and employees. 21st century corporate world is not restricted to single business and national boundaries. The Corporate need to have a global perspective and grow accordingly.
- The objective of including corporate accounting is to give a clear understanding and knowledge to the students in the area of corporate accounting and other related matters.
- Advanced Corporate Accounting. Objectives of this note is to provide theoretical knowledge of International Financial Reporting Standards and to enable the students to gain ability to solve problems relating to Holding Company Accounts, Liquidation of Companies and various other Accounts.
- Accounting helps organization in taking management decisions, formation of planning and control system. It also helps expert advice in financial reporting with formulation and implementation of organizational strategies.
- A proper accounting system is essential to any business, whether big or small, in order to manage its daily functions and run it successfully.
- The main obligation of any business is to maximize profits, minimize losses and at the same time maintain its position as a responsible entity within the society.

1.6 KEY WORDS

- Accounting: An information system that measures, processes, and communicates financial information about an economic entity.
- Amortization: The periodic allocation of the cost of an intangible asset to the periods it benefits. (Chapter 9, LO1), and their notes present all information relevant to the users' understanding of the statements.
- Balance sheet: the financial statement that shows a business's assets, liabilities, and stockholders' equity as of a specific date. Also called the statement of financial position.
- Financial Accounting Standards Board (FASB): The most important body for developing rules on accounting practice; it issues Statements of Financial Accounting Standards.
- Generally accepted accounting principles (GAAP): The conventions, rules, and procedures that define accepted accounting practice at a particular time.

1.7 LEARNING ACTIVITY

1. Why need for valuation of shares arises? What are the methods for valuation of shares?

2. What is meant by purchase consideration?

1.8 UNIT-END QUESTIONS

A. Descriptive Questions

1. Explain the importance of reserve capital for Tata Steel
2. What is debenture for an organisation who wants to expand their business operations?
3. Explain the meaning of equity when an organisation needs funds for expansion
4. What are the features of corporate accounting to Kotak Mahindra Bank?
5. What is the importance of advance corporate accounting to make Reliance fresh to expand their business operations?

B. Multiple Choice Questions

1. The company formed by the special Act of ligatures of parliament is known as
 - a. Public Company
 - b. registered company
 - c. statutory company
 - d. chartered company

2. The amount of capital with which the company intends to get registered is known as
 - a. issued capital
 - b. subscribed capital
 - c. authorized capital
 - d. called-up capital

3. Advance payment of tax is in the nature of -----.
 - a. capital expenses
 - b. revenue expenses
 - c. pre-paid expenses
 - d. outstanding expenses

4. Private company has minimum-----.
 - a. 2 directors
 - b. 5 directors
 - c. 10 directors
 - d. 20 directors

5. In the balance sheet of a limited company, assets are arranged in the order of-----.
 - a. liquidity
 - b. permanence
 - c. neither of the two
 - d. either liquidity or permanence

Answer:

1.c 2.b 3.c 4.a 5.b

1.9 SUGGESTED READINGS

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UNIT II –ACCOUNTING FOR GROUP OF COMPANIES

Structure

- 2.0. Learning Objective
- 2.1. Introduction
- 2.2. Holding and amalgamation of Companies- Definition
 - 2.2.1 Holding of Companies
 - 2.2.2 Amalgamation of Companies
 - 2.2.3 Difference Between Mergers and Amalgamations
- 2.3. Accounts Consolidation
- 2.4. Preparation of Consolidated Balance Sheet
 - 2.4.1 Balance Sheet
- 2.5. Minority Interest
- 2.6. Preacquisition or Capital Profits
- 2.7. Inter-company Balance
- 2.8. Unrealized Inter-company profits
- 2.9. Revaluation of assets and liabilities
- 2.10. Bonus Shares
- 2.11. Summary
- 2.12. Key words
- 2.13. Learning Activity
- 2.14. Unit -End Questions
- 2.15. Suggested Readings

2.0 LEARNING OBJECTIVE

After studying this unit, you will be able to:

- Describe accounting for group of companies
- Explain consolidation of accounts
- Assess minority interest
- Analyse Preacquisition or capital profits
- Describe unrealised inter company profits

2.1 INTRODUCTION

Consolidated financial statements are the "financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent company and its subsidiaries are presented as those of a single economic entity", according to International Accounting Standard 27 "Consolidated and separate financial statements", and International Financial Reporting Standard 10 "Consolidated financial statements"

Accounting information relates to the financial or economic activities of a business or organisation. It needs to be identified and measured by way of a "set of accounts".

There are two broad types of accounting information:

Financial Accounts which are geared toward external users

Management Accounts which are aimed more at internal users.

The role of a director means there are responsibilities for the accurate maintenance of the Limited company accounts. Management accounts are key in making business decisions from day to day however; there is a legal obligation under the Companies act to produce a set of Year-End Accounts for external scrutiny.

2.2 HOLDING AND AMALGAMATION OF COMPANIES- DEFINITION

2.2.1 Holding of Companies

In the words of Haney, “a form of business organization which is created for the purpose of combining other corporations by owning a controlling amount of their stock”.

A holding company is a business entity—usually a corporation or limited liability company (LLC). Typically, a holding company doesn't manufacture anything, sell any products or services, or conduct any other business operations. Rather, holding companies hold the controlling stock in other companies.

Although a holding company owns the assets of other companies, it often maintains only oversight capacities. So, while it may oversee the company's management decisions, it does not actively participate in running a business's day-to-day operations of these subsidiaries.

A holding company is also sometimes called an "umbrella" or parent company.

A holding company typically exists for the sole purpose of controlling other companies. Holding companies may also own property, such as real estate, patents, trademarks, stocks, and other assets.

Businesses that are completely owned by a holding company are referred to as "wholly-owned subsidiaries." Although a holding company can hire and fire managers of the companies it owns, those managers are ultimately responsible for their own operations.

Benefits of Holding Companies

1. Ease of formation

It is quite easy to form a holding company. The promoters can buy the shares in the open market. The consent of the shareholders of the subsidiary company is not required.

2. Large capital

The financial resources of the holding and subsidiary companies can be pooled together. The company can undertake large scale projects to increase its profitability.

3. Avoidance of competition

Competition between holding and subsidiary companies can be avoided if they are in the same line of business.

4. Economies of large scale operations

The buying and selling of the holding company and the subsidiaries can be centralized. It can enjoy the advantage of quantity discount and better credit terms because of bulk purchases. It can also get better terms from buyers in case of sales.

5. Secrecy maintained

Secrecy can be maintained as the authority and decision making are centralized. It can protect itself from adverse publicity.

6. Risks avoided

In case the subsidiaries undertake risky business and fail, the loss does not affect the holding company. It can sell its stakes in the subsidiary company.

Holding companies enjoy the benefit of protection from losses. If a subsidiary company goes bankrupt, the holding company may experience a capital loss and a decline in net worth. However, the bankrupt company's creditors cannot legally pursue the holding company for remuneration.

Consequently, as an asset protection strategy, a parent corporation might structure itself as a holding company, while creating subsidiaries for each of its business lines. For example, one subsidiary may own the parent corporation's brand name and trademarks, while another subsidiary may own its real estate.

This tactic serves to limit the financial and legal liability exposure of the holding company (and of its various subsidiaries). It may also depress a corporation's overall tax liability by strategically basing certain parts of its business in jurisdictions that have lower tax rates.

Holding companies can also serve the purpose of protecting an individual's personal assets. With a holding company, those assets are technically held by the corporation, and not by the person, who is consequently shielded from debt liabilities, lawsuits, and other risks.

Holding companies support their subsidiaries by using their resources to lower the cost of much-needed operating capital. Using a downstream guarantee, the parent company can make a pledge on a loan on behalf of the subsidiary. Ultimately, this can help companies obtain lower-interest-rate debt financing than they otherwise would be able to source on their own. Once backed by the financial strength of the holding company, the subsidiary company's risk of defaulting on its debt drops considerably.

Example of a Holding Company

An example of a well-known holding company is Berkshire Hathaway, which owns assets in more than one hundred public and private companies, including Dairy Queen, Clayton Homes, Duracell, GEICO, Fruit of the Loom, RC Wiley Home Furnishings and Marmon Group. Berkshire likewise boasts minor holdings in The Coca-Cola Company, Goldman Sachs, IBM, American Express, Apple, Delta Airlines, and Kinder Morgan.

2.2.2 Amalgamation of Companies

In general, the definition of amalgamation can be stated as follows.

"Amalgamation is a union of two or more companies, made with an intention to form a new company."

In terms of finance, the definition of amalgamation can be given as under.

"Amalgamation is an agreement (deal) between two or more companies to consolidate (strengthen) their business activities by establishing a new company having a separate legal existence."

An amalgamation is a combination of two or more companies into a new entity. Amalgamation is distinct from a merger because neither company involved survives as a legal entity. Instead, a completely new entity is formed to house the combined assets and liabilities of both companies.

The term amalgamation has generally fallen out of popular use in the United States, being replaced with the term's merger or consolidation. But it is still commonly used in countries such as India.

Amalgamation typically happens between two or more companies engaged in the same line of business or those that share some similarity in operations. Companies may combine to diversify their activities or to expand their range of services.

Since two or more companies are merging together, an amalgamation results in the formation of a larger entity. The transferor company—the weaker company—is absorbed into the stronger transferee company, thus forming an entirely different company. This leads to a stronger and larger customer base, and also means the newly formed entity has more assets.

Amalgamations generally take place between larger and smaller entities, where the larger one takes over smaller firms.

The Pros and Cons of Amalgamation

The following are the advantages of opting for amalgamation.

1. The first and most important advantage of choosing for amalgamation is the elimination of competition in the market. When two or more competing companies come together, the competition automatically gets eliminated.
2. The operating cost of the business can be curtailed by opting amalgamation.
3. Research and development facilities can be improved.
4. The controlled price of goods in the market.
5. Diversification can be achieved.
6. Amalgamation is one of the best ways when a company wants to expand its business.
7. The goodwill of a company increases in the market when it associates with a more prominent company.
8. Managerial effectiveness can be achieved by opting for amalgamation.
9. Amalgamation results in an increased market share of the newly formed company.
10. Diversification can be achieved using amalgamation.
11. Amalgamation is the best solution for reviving the business of failing companies.
12. Amalgamation is an excellent way of creating a monopoly in the market.
13. The last but not least advantage of amalgamation is the tax advantage.

Cons

1. Amalgamation sometimes eliminates the healthy competition in the market.
2. Amalgamation can also result in increased debt.
3. Companies taking part in amalgamation lose their identity, which affects the goodwill of the company and its products.
4. The monopoly achieved through amalgamation is not always healthy for the market.

5. The amalgamation of two or more companies results in the reduction of the number of employees. That means employees working in the companies become unemployed, which is not healthy for the economy.
6. The management of newly formed companies becomes very complicated.

Amalgamation Procedure

The terms of amalgamation are finalized by the board of directors of each company. The plan is prepared and submitted for approval. For instance, the High Court and Securities and Exchange Board of India (SEBI) must approve the shareholders of the new company when a plan is submitted.

The new company officially becomes an entity and issues shares to shareholders of the transferor company. The transferor company is liquidated, and all assets and liabilities are taken over by the **transferee company**.

The following steps are involved in the procedure for Amalgamation:

The board of directors finalize the terms of amalgamation for the amalgamating companies.

1. Preparation of the scheme of amalgamation is to be conducted and later submitted for approval to the respective High Court.
2. Approval of the shareholders' of the constituent companies is to be obtained followed by approval of SEBI.
3. Formation of the new company takes place and shares are will be issued to the shareholders' of the transferor company.
4. The transferor company is then liquidated and all the assets and liabilities are taken over by the transferee company

Example of Amalgamation

In November 2015, drug firm Natco Pharma received shareholders' approval for the amalgamation of its subsidiary Natco Organics into the company. Results of postal ballots and e-voting showed the resolution passed with 99.94% of votes in favour with 0.02% opposed and 0.04% invalid.³

Types of Amalgamation

One type of amalgamation—similar to a merger—pools both companies' assets and liabilities, and the shareholders' interests together. All assets of the transferor company become that of the transferee company.

The business of the transferor company is carried on after the amalgamation. No adjustments are made to book values. Shareholders of the transferor company holding a minimum of 90% face value of equity shares become shareholders of the transferee company.

The second type of amalgamation is similar to a purchase. One company is acquired by another, and shareholders of the transferor company do not have a proportionate share in the equity of the combined company. If the purchase consideration exceeds the net asset value (NAV), the excess amount is recorded as goodwill. If not, it is recorded as capital reserves.

2.2.3 Difference Between Mergers and Amalgamations

Because companies typically don't want to join with their rivals, it often takes an outsider to put together an amalgamation. However, the surviving company is typically the one to take the lead in a merger and often doesn't need an outside promoter.

When a merger happens, the culture and identity of the target company is lost and swallowed up in the surviving company. Amalgamation blends multiple companies together into a single entity that takes part of each company's identity to create something new.

When companies merge, the assets and liabilities of the target company are joined with the assets and liabilities of the surviving company. Shareholders from both companies are merged with shareholders in the new company. During an amalgamation, shareholders of all companies involved receive new shares of the newly fused company.

2.3 ACCOUNTS CONSOLIDATION

Consolidation accounting is the process of combining the financial results of several subsidiary companies into the combined financial results of the parent company. This method is typically used when a parent entity owns more than 50% of the shares of another entity. The following steps document the consolidation accounting process flow:

1. **Record intercompany loans.** If the parent company has been consolidating the cash balances of its subsidiaries into an investment account, record intercompany loans from the subsidiaries to the parent company. Also record an interest income allocation for the interest earned on consolidated investments from the parent company down to the subsidiaries.
2. **Charge corporate overhead.** If the parent company allocates its overhead costs to subsidiaries, calculate the amount of the allocation and charge it to the various subsidiaries.
3. **Charge payables.** If the parent company runs a consolidated payables operation, verify that all accounts payable recorded during the period have been appropriately charged to the various subsidiaries.
4. **Charge payroll expenses.** If the parent company has been using a common paymaster system to pay all employees throughout the company, ensure that the proper allocation of payroll expenses has been made to all subsidiaries.

5. **Complete adjusting entries.** At the subsidiary and corporate levels, record any adjusting entries needed to properly record revenue and expense transactions in the correct period.
6. **Investigate asset, liability, and equity account balances.** Verify that the contents of all asset, liability, and equity accounts for both the subsidiaries and the corporate parent are correct, and adjust as necessary.
7. **Review subsidiary financial statements.** Print and review the financial statements for each subsidiary, and investigate any items that appear to be unusual or incorrect. Make adjustments as necessary.
8. **Eliminate intercompany transactions.** If there have been any intercompany transactions, reverse them at the parent company level to eliminate their effects from the consolidated financial statements.
9. **Review parent financial statements.** Print and review the financial statements for the parent company, and investigate any items that appear to be unusual or incorrect. Make adjustments as necessary.
10. **Record income tax liability.** If the company earned a profit, record an income tax liability. It may be necessary to do so at the subsidiary level, as well.
11. **Close subsidiary books.** Depending upon the accounting software in use, it may be necessary to access the financial records of each subsidiary and flag them as closed. This prevents any additional transactions from being recorded in the accounting period being closed.
12. **Close parent company books.** Flag the parent company accounting period as closed, so that no additional transactions can be reported in the accounting period being closed.
13. **Issue financial statements.** Print and distribute the financial statements of the parent company.

If a subsidiary uses a different currency as its operating currency, an additional consolidation accounting step is to convert its financial statements into the operating currency of the parent company.

Given the considerable number of steps, it is useful to convert them into a detailed procedure, which the accounting department should follow religiously as part of its closing process. Otherwise, a key step could be missed, which would throw off the financial statement results.

Some of the tasks noted here can be automated, or at least made simpler, in order to produce financial statements more quickly. However, to some degree, the higher level of precision required to produce more accurate financial statements requires additional consolidation effort, and therefore more time.

2.4 PREPARATION OF CONSOLIDATED BALANCE SHEET

What Is a Consolidated Balance Sheet?

The simplest way to showcase the company's financial information as one is to use a consolidated balance sheet. Typically, to create a consolidated balance sheet, you will need to start with a worksheet. This worksheet is usually presented as a chart, and it has columns for the parent company, each subsidiary, amounts to eliminate in both debits or credits and a total. The idea is that you should be able to get a very clear picture of the business's overall health with a simple chart like this. The numbers can then be transferred to an even simpler consolidated balance sheet.

The rows of your chart should list all debit accounts and total debits, and the parent company and subsidiary can split this. Also, you should list all credit accounts and total credits. If you have any accounts that overlap between the parent company and its subsidiaries, you will need to eliminate duplicates on your consolidated balance sheet.

When you own a subsidiary in its entirety, it is fairly straightforward to submit a consolidated balance sheet. It should show the credits and debits for both your parent company and the subsidiary. No additional calculations need to be done to determine the portion of the subsidiary's assets or liabilities that you must take ownership of.

In the case where a company does not own 100 percent of its subsidiary, this must be reflected on the consolidated balance sheet accordingly. If you own more than 50 percent but less than 100 percent of the subsidiary, you have what is known as minority interest in the company. To complete a consolidated balance sheet when you have a minority interest, your company should take ownership of all the subsidiary's debits and credits and then "return" the percentage you don't own in the owner's equity section. For instance, if your restaurant owns 75 percent of a small cafe, you would need to claim 75 percent of the cafe's credits and 75 percent of its debits on your company's consolidated balance sheet. You could do this by showing ownership of all the credits and debits, then by showing a return of 25 percent in the owner's equity section.

If your company owns less than half of its subsidiary, you should not use a consolidated balance sheet. For businesses in this situation, you should merely claim one line item on your balance sheet that represents the portion of the subsidiary you own. If the subsidiary's assets are equal to \$100,000 and you have a 40-percent stake, you would record an asset of \$40,000. This can become complicated, mainly when a business owns stakes in multiple subsidiary companies.

How to Prepare a Consolidated Balance Sheet

Consolidated balance sheets must be prepared according to the same rules and accounting methods used across the parent company and its subsidiaries. Generally accepted accounting principles, sometimes known as GAAP, must be adhered to at all times. Before proceeding with your consolidated balance sheet or a worksheet, you should carefully check all your reference information. The accuracy of your input is paramount in ensuring that the balance sheet itself is correct.

When preparing the consolidated balance sheet, it's important to adjust the figures related to the subsidiaries assets so that they reflect their fair market value. Also, revenue of the parent company that is also an expense of the subsidiary should be left out because the net change is \$0.

It may be helpful when preparing a consolidated balance sheet, to start with a worksheet. To create the worksheet, you will need the financials of the parent company and its subsidiary to be initially separate. Make a list of all the asset accounts and all the liability accounts including their values. Then, add together all the company's assets and all its liabilities. Follow this same procedure for the subsidiary business. You should have one column for each unit of the company.

Next, you will need two columns for assets and liabilities that can be eliminated due to duplication. The debits and credits you eliminate will need to balance out to zero. These eliminated figures are listed in the assets or liabilities for both the company and the subsidiary. Including both would create duplication in the consolidated balance sheet. For instance, if your business and subsidiary both make use of a particular machine for production, you should not include it as an asset twice. This amount would need to be removed from one location so as not to duplicate numbers and throw off your total.

In the right-hand column of your worksheet, you should list the consolidated trial balance for each category you've listed. In this column, find the sum of all amounts in that row, being sure to add and subtract debits and credits from your duplication column appropriately.

Once you've found the total of your consolidated trial balance by category, you are ready to move on to your consolidated balance sheet. The only numbers that you should transfer over are those that you listed in the right-hand column of your worksheet. These should represent the total numbers of assets, liabilities and owner's equity for both your parent company and its subsidiary.

To create a consolidated balance sheet, first document the name of the company, its subsidiary and the date at the top of your chart. In the left-hand column, you'll want a section for assets, liabilities and equity. The numbers that you include should match those from your worksheet's consolidated trial balances.

Once you have finished inputting the numbers from your worksheet, check your consolidated balance sheet. Your total assets, liabilities and equity should match those of your parent company plus those of your subsidiary, minus any duplicate items you eliminated.

Consolidated Balance Sheet Format				
	Particulars	Notes	Amount (CY)	Amount (PY)
I	<u>EQUITY AND LIABILITIES</u>			
A	<u>SHAREHOLDER'S FUND</u>			
(a)	Share Capital		H	
(b)	Reserves and Surplus		W.N.	
B	<u>MINORITY INTEREST</u>		W.N.	
C	<u>NON CURRENT LIABILITIES</u>			
(a)	Secured (Debentures)		H+S	
(b)	Unsecured		H+S	
D	<u>CURRENT LIABILITIES</u>			
(a)	Creditors		H+S	
(b)	Bills Payable		H+S	
(c)	Outstanding Expenses		H+S	
	Total		XX	XX
II	<u>ASSETS</u>			
A	<u>NON CURRENT ASSETS</u>			
(a)	Fixed Assets			
i)	Tangible Fixed Assets		H+S	
ii)	Intangible Fixed Assets		H+S	
(b)	Non-Current Investments		H+S	
B	<u>CURRENT ASSETS</u>			
(a)	Stock in Trade		H+S	
(b)	Sundry Debtors		H+S	
(c)	Bills Receivables		H+S	
(d)	Cash and Bank		H+S	
	Total		XX	XX

Advantages of a Consolidated Balance Sheet

A consolidated balance sheet has many advantages, not the least of which is ease of use. This method of financial documentation makes it simple for lending institutions, boards of directors and stockholders to see a clearly laid-out statement of the company's financial health.

This is preferable to a separate balance sheet for the parent company and its subsidiary for a variety of reasons. First of all, the parent company likely includes the purchase of the subsidiary among its liabilities and this could be confusing if it's included on a parent-company-only balance sheet. Secondly, the parent company and subsidiary may share various assets or liabilities, including office space, advertising and payroll. For instance, if some employees work part-time for the parent

company and part-time for its related subsidiary, showing the payroll liability on a consolidated balance sheet is essential. Overall, presenting the company's financials in this manner helps provide the clearest possible picture of its health and longevity.

Consolidated Balance Sheet Example

A consolidated balance sheet should always begin with a statement of the parent company name, the name of its subsidiary, the words "consolidated balance sheet" and the date.

You will then list your total assets, liabilities and equity. Say you have \$450,000 in total assets between your parent company and your subsidiary. Your liabilities are \$330,000, and you hold \$80,000 in equity. These should all be listed in one column. You may then add up your total liabilities and equity, for a total of \$450,000. As always, assets should be equal to your liabilities plus owner's equity.

You may use footnotes or other asides to explain anything that would be confusing to someone who might later look at the consolidated balance sheet. For instance, if you recently sold off a great deal of equipment or experienced a reduction in staffing, you might wish to note it so that parties who have viewed comparable financial statements from your company are not confused.

What is the Difference Between A Consolidated Balance Sheet and Traditional Balance Sheet?

2.4.1 Balance Sheet Format:

The balance sheet of a company will look like the image given below.

Balance Sheet of As at.....

Liabilities	Rs.	Assets	Rs.
Capital:		Fixed Assets:	
Opening Balance xxxx		Good will	
Add: Net Profit xxxx		Land	
(Less: Net Loss)		Building	
Less: Drawings xxxxx		Plant & Machinery	
Long-term Liabilities:		Furniture & Fixtures	
Loan		Investment:	
Current liabilities:		Current Assets:	
Income received-in-advance		Closing stock	
Sundry Creditors		Accrued income	
Outstanding Expenses		Prepaid expenses	
Bills Payable		Sundry Debtors	
Bank Overdraft		Bills Receivable	
		Cash at Bank	
		Cash in Hand	

You may be wondering what the key differences are between traditional balance sheets and consolidated balance sheets. Basically, both are a financial statement showing the relationship between a company's assets, liabilities and equity. You might choose to view a consolidated balance sheet as an extension of a traditional one. In this instance, the assets and liabilities of the subsidiary are included. A standalone balance sheet explicitly indicates which assets and liabilities belong to the parent company, whereas a consolidated balance sheet represents both the parent and subsidiary company.

A balance sheet is relatively straightforward as financial statements go. On the other hand, a consolidated balance sheet is among the most complex of financial statements due to the amount of information required for input and all of the parties and accounts involved. This is because a balance sheet requires information from only a trial balance, income statement and cash flow statement which is then summarized in two columns, one each for assets and liabilities.

Consolidated balance sheets, on the other hand, typically require a great deal of time and effort to put together because the parent company's balance sheet is needed in addition to that of the subsidiary. Also, depending on the ownership arrangement of the subsidiary, the nature of the consolidated balance sheet may differ. Careful, accurate accounting is essential throughout the year in both the parent company and subsidiary to ensure that, when it comes time to create a consolidated balance sheet, it is done correctly.

Balance sheets are generally a requirement for doing business. They are typically prepared quarterly and are important for strategic planning and protection from audits. Consolidated balance sheets, while challenging, are essential when you're operating a business and a subsidiary. This is especially true since the information contained within might overlap between the two entities and thus need to be eliminated to avoid duplication.

Both a traditional balance sheet and a consolidated balance sheet are essential to have on hand and be able to furnish to investors. These balance sheets can showcase the overall health of the company and impress investors in the ongoing benefits of their involvement. Showcasing the information in a clear-cut manner is critical, however, to avoid confusion.

Let us make an in-depth study of the miscellaneous adjustments in preparation of a consolidated balance sheet.

(a) Unrealised Inter-Company Profits:

An unrealised inter-company profit exists only when there is a sale of goods by one company in the group to another at a profit, and the same goods remain unsold and appear as an asset in the Balance Sheet.

This unrealised profit made by the selling company is to be eliminated at the time of preparing a Consolidated Balance Sheet since such profit is true from the individual point of view but not from the view of a group.

The Consolidated Balance Sheet shows an overall picture of the group and that is why such unrealised profit should be eliminated.

The following principles should be followed for the purpose:

(i) Ascertain the amount of profit on unsold stock supplied by the company in the group;

(ii) Share of minority interest should be deducted from such unrealised profit so calculated, and

(iii) The balance of unrealised profit (i.e., Holding Company's share or after deducting minority interest) is to be deducted from the profit of the company who is selling the goods and from the books of the company receiving those goods as well. In short, holding company's share of unrealised

profit should be deducted from the Consolidated Stock in the assets side of the Consolidated Balance Sheet and the same amount should also be deducted from the Profit and Loss Account in the Consolidated Balance Sheet.

There are some authorities who prefer to eliminate the whole of such unrealised profit in all cases since it represents the original cost of the asset in the group. Similarly, unrealised profit on fixed assets (i.e., if one company transfers a fixed asset at a profit to another company in the group) should also be adjusted. However, as per AS 21, Clause 16, Consolidated Financial Statements, Unrealised Profit must be deducted in full.

However, the elimination of inter-company profits is made only so long as such asset is held. On the disposal of the asset, the profit is treated for consolidation purposes as a realised profit.

Illustration 1:

H. Ltd. acquired 4,000 shares of S. Ltd. on 1.1.2000.

Their Balance Sheets as at 31.12.2000 stood as follows:

Balance Sheets
as at 31st December 2000

<i>Liabilities</i>	H. Ltd. Rs.	S. Ltd. Rs.	<i>Assets</i>	H. Ltd. Rs.	S. Ltd. Rs.
Share Capital :			Fixed Assets	80,000	45,000
10,000 Equity Shares of Rs. 10 each, fully paid	1,00,000	—	Investments :		
5,000 Equity Shares of Rs. 10 each, fully paid	—	50,000	4,000 shares in S. Ltd., as per	40,000	—
General Reserve (1.1.1983)	40,000	10,000	Stock	20,000	10,000
Profit & Loss A/c	20,000	10,000	Debtors	25,000	10,000
Creditors	10,000	5,000	Cash and Bank	5,000	10,000
	<u>1,70,000</u>	<u>75,000</u>		<u>1,70,000</u>	<u>75,000</u>

On 1.1.2000, the Profit and Loss Account of S. Ltd. showed a credit balance of Rs. 4,000. Stock of H. Ltd. includes Rs. 2,500 for goods at invoice price from S. Ltd. on which the latter company made a profit of 25% on cost.

Prepare a Consolidated Balance Sheet as at 31.12.2000.

Solution :

Workings :

1. Proportion of holding shares :	Rs.		2. Capital Profit :	Rs.
H. Ltd.'s share in S. Ltd.	=	$\frac{4,000}{5,000} = \frac{4}{5}$	General Reserve	10,000
S. Ltd.	=	$\frac{1,000}{5,000} = \frac{1}{5}$	Profit and Loss A/c	4,000
				<u>14,000</u>

3. Current Profits :	Rs.				
Profit & Loss A/c (10,000 – 4,000)			H. Ltd. Rs. 14,000 × $\frac{4}{5}$	=	11,200
	6,000		S. Ltd. Rs. 14,000 × $\frac{1}{5}$	=	2,800
	<u>6,000</u>				
H. Ltd. Rs. 6,000 × $\frac{4}{5}$	=	4,800	4. Minority Interest :		Rs.
S. Ltd. Rs. 6,000 × $\frac{1}{5}$	=	1,200	Share Capital (1,000 × Rs. 10)		10,000
5. Capital Reserve :		Rs.	Add : Capital Profit		2,800
Cost of shares		40,000	Add : Current Profit		1,200
Less : Nominal value of shares held		40,000			<u>14,000</u>
Capital Profit		<u>11,200</u>	6. Unrealised Profit on Stock		Rs.
		51,200	Invoice Value of goods taken from S. Ltd. Rs. 2,500		
		<u>11,200</u>	∴ Rs. 2,500 × $\frac{25}{125}$	=	500
			H. Ltd.'s share = Rs. 500 × $\frac{4}{5}$	=	400**

**H. Ltd. and its subsidiary S. Ltd.
Consolidated Balance Sheet
as at 31st December 2000**

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Share Capital :			Fixed Assets :		
Authorised			H. Ltd.	80,000	
Issued and Paid-up			S. Ltd.	45,000	
10,000 Equity shares of Rs. 10 each, fully paid		1,00,000			1,25,000
Reserve and Surplus			Investments		Nil
Capital Reserve			Current Assets, Loans and Advances		
General Reserve		11,200	Stock :		
Profit and Loss A/c :		40,000	H. Ltd.	20,000	
H. Ltd.	20,000		S. Ltd.	10,000	
S. Ltd.	4,800			<u>30,000</u>	
	<u>24,800</u>		Less : Unrealised Profit on stock	400	
Less : Unrealised Profit on stock	400				29,600
		24,400	Debtors :		
Minority Interest		14,000	H. Ltd.	25,000	
Secured Loan		Nil	S. Ltd.	10,000	
Unsecured loan		Nil			35,000
Current Liabilities and Provisions			Cash at Bank :		
Creditors :			H. Ltd.	5,000	
H. Ltd.	10,000		S. Ltd.	10,000	
S. Ltd.	5,000				15,000
		15,000	Misc. Expenditure		Nil
		<u>2,04,600</u>			<u>2,04,600</u>

(b) Issue of Bonus Shares:

When subsidiary company issues bonus shares, the same will increase only the number of shares in the hands of the holding company. The treatment, of course, depends on the sources from which such bonus shares are issued, i.e., whether the bonus shares are issued out of the Pre-acquisition Profit/Capital Profit or out of the Post-acquisition Profit/Revenue Profit.

(i) If Bonus Shares are Issued out of Capital Profit:

There will be no effect in Cost of Control or Goodwill Account and minority interest for this purpose since pre-acquisition profit is reduced in one hand and paid-up value of share held will increase on the other. As a result, there will be ultimately no effect for the purpose of issuing bonus shares out of Capital Profit in Goodwill Account or Capital Reserve or Minority Interest.

(ii) If Bonus Shares are Issued out of Current Profit:

When bonus shares are issued out of current or revenue profit, holding company's shares in current profit should be calculated only after making the proper adjustment for bonus issue from the said current profits, which will ultimately reduce the amount of holding company's share in current profits. Thus, Cost of Goodwill will be reduced by the amount of increased value of paid-up shares.

(a) Out of Capital Profit:

Illustration 2:

Parent Ltd. acquired 6,000 equity shares of Rs.10 each in Subsidiary Ltd. on Dec.31, 2000.

The summarised Balance Sheets of Parent Ltd. and Subsidiary Ltd. as on that date were:

Liabilities	Parent Ltd. Rs.	Sub. Ltd. Rs.	Assets	Parent Ltd. Rs.	Sub. Ltd. Rs.
<i>Capital Alc</i>			<i>Fixed Assets</i>	2,53,000	1,28,000
<i>Authorised</i>	4,00,000	1,20,000	Investment in		
<i>Issued and Paid-up :</i>			Subsidiary Ltd. at cost		
60,000 shares of Rs. 5 each	3,00,000	—	6,000 shares of Rs. 10 each	1,00,000	—
8,000 shares of Rs. 10 each	—	80,000	Stock in hand	30,000	10,000
Capital Reserve	—	34,000	Bills Receivable	2,000	—
General Reserve	20,000	10,000	(including Rs. 1,000 from		
Profit and Loss A/c	50,000	10,000	Subsidiary Ltd.)		
Bills Payable			Debtors and balance at Bank	20,000	17,000
(Including Rs. 1,000 to					
Parent Ltd.)	—	3,500			
Creditors	35,000	17,500			
	4,05,000	1,55,000		4,05,000	1,55,000

Note : (Re. : Balance Sheet of Parent Ltd.) Contingent Liability for Bills discounted Rs. 1,200.

On 1.1.2000 Subsidiary Ltd. utilised part of its Capital Reserve to make a Bonus issue of one share for every four shares held.

You are required to prepare the Consolidated Balance Sheet as on 1.1.2000, and show therein how your figures are made up.

Solution :

1. Proportion of holding shares :		Rs.	2. Capital Profit :		Rs.
Parent Ltd.'s share in S. Ltd.	=	$\frac{6,000}{8,000} = \frac{3}{4}$	Capital Reserve	34,000	
Sub. S. Ltd.	=	$\frac{2,000}{8,000} = \frac{1}{4}$	Less : Bonus Issue	<u>20,000</u>	
3. There will be no current profit			Revenue Reserves		14,000
since the shares are acquired at 31.12.2001, i.e., at the time of preparing final accounts.			Profit & Loss A/c		10,000
5. Capital Reserve :		Rs.			<u>34,000</u>
Cost of Shares		1,00,000	Parent Ltd. Rs. $34,000 \times \frac{3}{4} =$		25,500
Less : Face value of shares held (6,000 × Rs. 10)	60,000		Subsidiary Ltd. Rs. $34,000 \times \frac{1}{4} =$		8,500
Capital Profit	25,500		4. Minority Interest :		
F.V. of Bonus issue	<u>15,000</u>		Share Capital (2,000 × Rs. 10)		20,000
		1,00,500	Capital Profit		8,500
			F.V. of Bonus issue		
			(Rs. 20,000 × $\frac{1}{4}$)		5,000
Capital Reserve		<u>500</u>			<u>33,500</u>

**Parent Ltd. and its subsidiary Subs. Ltd.
Consolidated Balance Sheet
as at 1st January 2001**

<i>Liabilities</i>	Rs.	Rs.	<i>Assets</i>	Rs.	Rs.
Share Capital :			Fixed Assets :		
Authorised			Parent Ltd.	2,53,000	
Issued & Paid-up			Sub. Ltd.	<u>1,28,000</u>	
60,000 share of Rs. 5 each,					3,81,000
fully paid		3,00,000	Investments		Nil
Reserve & Surplus			Current Assets, Loans and		
General Reserve		20,000	Advances :		
Capital Reserve		500	Stock		
Profit & Loss A/c		50,000	Parent Ltd.	30,000	
Minority Interest		33,500	Sub. Ltd.	<u>10,000</u>	
Secured Loans		Nil			40,000
Unsecured Loans		Nil	Debtors & Bank Balances		
Current Liabilities & Provisions			Parent Ltd.	20,000	
Creditors :			Sub. Ltd.	<u>17,000</u>	
Parent Ltd.	35,000				37,000
Sub. Ltd.	<u>17,500</u>		Bills Receivable		
		52,500	Parent Ltd.	2,000	
Bills Payable :			Less : Acceptance by Sub. Ltd.		
Sub. Ltd.	3,500		per contra	<u>1,000</u>	
Less : Bills held by Parent					1,000
per contra	<u>1,000</u>		Misc. Expenditure		Nil
		2,500			
		<u>4,59,000</u>			<u>4,59,000</u>

(b) Out of Current Profit:

Illustration 3:

The Balance Sheets of H. Ltd. and S. Ltd. as at 19..... are:

Balance Sheets
as at 31st December 2000

Liabilities	H. Ltd. Rs.	S. Ltd. Rs.	Assets	H. Ltd. Rs.	S. Ltd. Rs.
Share Capital : (Rs. 10 each)	4,00,000	1,00,000	Fixed Assets	3,50,000	1,00,000
General Reserve	1,00,000	40,000	Investments : 8,000 shares in S. Ltd.	1,00,000	—
Profit and Loss A/c	50,000	30,000	Current Assets	1,50,000	80,000
Creditors	50,000	10,000			
	<u>6,00,000</u>	<u>1,80,000</u>		<u>6,00,000</u>	<u>1,80,000</u>

S. Ltd. has a credit balance of Rs. 40,000 in the General Reserve when H. Ltd. acquired share in S. Ltd. S. Ltd. capitalised Rs. 20,000 out of profits earned after the acquisition of its shares by H. Ltd. by making a bonus issue of one share for every five shares held. Prepare a consolidated Balance Sheet as at 19.....

Solution :

<p>1. Proportion of holding shares :</p> <p>H. Ltd.'s share in S. Ltd. = $\frac{8,000}{10,000} = \frac{4}{5}$</p> <p>S. Ltd. = $\frac{2,000}{10,000} = \frac{1}{5}$</p> <p>3. Current Profits :</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">Profit & Loss A/c</td> <td style="width: 10%; text-align: right;">30,000</td> <td style="width: 40%;"></td> </tr> <tr> <td>Less : Bonus Issue</td> <td style="text-align: right;">20,000</td> <td></td> </tr> <tr> <td></td> <td style="text-align: right; border-top: 1px solid black;">10,000</td> <td></td> </tr> <tr> <td></td> <td style="text-align: right; border-bottom: 3px double black;"><u>10,000</u></td> <td></td> </tr> <tr> <td>H. Ltd. Rs. 10,000 $\times \frac{4}{5}$</td> <td style="text-align: right;">8,000</td> <td></td> </tr> <tr> <td>S. Ltd. Rs. 10,000 $\times \frac{1}{5}$</td> <td style="text-align: right;">2,000</td> <td></td> </tr> </table> <p>5. Capital Reserve :</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">Cost of shares</td> <td style="width: 10%; text-align: right;">1,00,000</td> <td style="width: 40%;"></td> </tr> <tr> <td></td> <td style="text-align: right;">Rs.</td> <td></td> </tr> <tr> <td>Less : F. V. of shares</td> <td style="text-align: right;">80,000</td> <td></td> </tr> <tr> <td>Capital Profit</td> <td style="text-align: right;">32,000</td> <td></td> </tr> <tr> <td>F. V. of Bonus issue</td> <td style="text-align: right;">16,000</td> <td></td> </tr> <tr> <td></td> <td style="text-align: right; border-top: 1px solid black;">1,28,000</td> <td></td> </tr> <tr> <td></td> <td style="text-align: right; border-bottom: 3px double black;"><u>28,000</u></td> <td></td> </tr> </table>	Profit & Loss A/c	30,000		Less : Bonus Issue	20,000			10,000			<u>10,000</u>		H. Ltd. Rs. 10,000 $\times \frac{4}{5}$	8,000		S. Ltd. Rs. 10,000 $\times \frac{1}{5}$	2,000		Cost of shares	1,00,000			Rs.		Less : F. V. of shares	80,000		Capital Profit	32,000		F. V. of Bonus issue	16,000			1,28,000			<u>28,000</u>		<p>2. Capital Profit :</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">General Reserve</td> <td style="width: 10%; text-align: right;">40,000</td> <td style="width: 40%;"></td> </tr> <tr> <td></td> <td style="text-align: right; border-bottom: 3px double black;"><u>40,000</u></td> <td></td> </tr> <tr> <td>H. Ltd. Rs. 40,000 $\times \frac{4}{5} =$</td> <td style="text-align: right;">32,000</td> <td></td> </tr> <tr> <td>S. Ltd. Rs. 40,000 $\times \frac{1}{5} =$</td> <td style="text-align: right;">8,000</td> <td></td> </tr> </table> <p>4. Minority Interest :</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">Share Capital</td> <td style="width: 10%; text-align: right;">20,000</td> <td style="width: 40%;"></td> </tr> <tr> <td>Capital Profit</td> <td style="text-align: right;">8,000</td> <td></td> </tr> <tr> <td>Current Profit</td> <td style="text-align: right;">2,000</td> <td></td> </tr> <tr> <td>F. V. of Bonus issue</td> <td style="text-align: right;">4,000</td> <td></td> </tr> <tr> <td></td> <td style="text-align: right; border-top: 1px solid black; border-bottom: 3px double black;"><u>34,000</u></td> <td></td> </tr> </table>	General Reserve	40,000			<u>40,000</u>		H. Ltd. Rs. 40,000 $\times \frac{4}{5} =$	32,000		S. Ltd. Rs. 40,000 $\times \frac{1}{5} =$	8,000		Share Capital	20,000		Capital Profit	8,000		Current Profit	2,000		F. V. of Bonus issue	4,000			<u>34,000</u>	
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Cost of shares	1,00,000																																																																		
	Rs.																																																																		
Less : F. V. of shares	80,000																																																																		
Capital Profit	32,000																																																																		
F. V. of Bonus issue	16,000																																																																		
	1,28,000																																																																		
	<u>28,000</u>																																																																		
General Reserve	40,000																																																																		
	<u>40,000</u>																																																																		
H. Ltd. Rs. 40,000 $\times \frac{4}{5} =$	32,000																																																																		
S. Ltd. Rs. 40,000 $\times \frac{1}{5} =$	8,000																																																																		
Share Capital	20,000																																																																		
Capital Profit	8,000																																																																		
Current Profit	2,000																																																																		
F. V. of Bonus issue	4,000																																																																		
	<u>34,000</u>																																																																		

**H. Ltd. and its subsidiary S. Ltd.
Consolidated Balance Sheet
as at**

<i>Liabilities</i>	<i>Rs.</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>	<i>Rs.</i>
Share Capital :			Fixed Assets :		
<i>Authorised</i>			H. Ltd.	3,50,000	
<i>Issued and Paid-up</i>			S. Ltd.	1,00,000	
40,000 Equity Shares of Rs. 10 each		4,00,000			4,50,000
Reserves and Surplus			Investments		Nil
General Reserve		1,00,000	Current Assets, Loans and Advances		
Capital Reserve		28,000	Current Assets		
Profit and Loss A/c			H. Ltd.	1,50,000	
—Balance	50,000		S. Ltd.	80,000	
Add : Current Profit for S. Ltd.	8,000				2,30,000
		58,000	Misc. Expenditures		Nil
Minority Interest		34,000			
Secured Loans		Nil			
Unsecured Loans		Nil			
Current Liabilities & Provisions					
Creditors					
H. Ltd.	50,000				
S. Ltd.	10,000				
		60,000			
		<u>6,80,000</u>			<u>6,80,000</u>

(c) Revaluation of Fixed Assets:

Sometimes fixed assets of the subsidiary company are revalued at the time of acquisition of shares. If, as a result of revaluation, profit or loss on fixed assets takes place, such profit or loss should be treated as capital profit or capital loss. Since the capital profit cannot be utilised for the purpose of declaring dividend the same is shown in the Liability side of the Balance Sheet of the subsidiary company under the head 'Capital Reserve' or may be written-off against Goodwill. Therefore, the profit made on revaluation of fixed asset should be treated as Capital Profit and, hence, it will be distributed between holding company and minority interest according to their ratio as usual.

It should be remembered in this respect that depreciation should also be provided on the increased or decreased value of fixed asset against the revenue profit as well. In other words, in case of profit on revaluation or under-valuation of assets, additional provision for depreciation should be made, i.e., it will be deducted from the current/revenue profit and, in the case of loss on revaluation or over-valuation of assets, provision for depreciation should be written-back, i.e., it will be added with the amount of current/revenue loss.

Illustration 4:

From the following Balance Sheets of H. Ltd. and its subsidiary S. Ltd. drawn up at 31.12.1999, prepare a Consolidated Balance Sheet as at that date, having regard to the following:

- (i) Reserve and Profit and Loss Account (Cr.) of S. Ltd. stood at Rs. 25,000 and Rs. 15,000, respectively, on the date of acquisition of its 80% shares held by H. Ltd. on 1.1.1999, and'

(ii) Machinery (Book value Rs. 1,00,000) and Furniture (Book value Rs. 20,000) of S. Ltd. were revalued at Rs. 1,50,000 and Rs. 15,000, 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. and S. Ltd.
as at 31st December 1999

<i>Liabilities</i>	H. Ltd. Rs.	S. Ltd. Rs.	<i>Assets</i>	H. Ltd. Rs.	S. Ltd. Rs.
Share Capital :			Machinery	3,00,000	90,000
Shares of Rs. 100 each	5,00,000	1,00,000	Furniture	50,000	17,000
Reserves	2,00,000	75,000	Other Assets	4,40,000	1,43,000
Profit and Loss A/c	1,00,000	25,000	(Current)		
Creditors	1,50,000	50,000	Shares in S. Ltd.		
			800 at Rs. 200 each	1,60,000	—
	<u>9,50,000</u>	<u>2,50,000</u>		<u>9,50,000</u>	<u>2,50,000</u>

Solution :

Workings

1. Proportion of holding shares :	Rs.	2. Capital Profit	Rs.
H. Ltd.'s share in S. Ltd.	= $\frac{800}{1,000} = \frac{4}{5}$ (i.e., 80%)	Reserve	25,000
S. Ltd.	= $\frac{200}{1,000} = \frac{1}{5}$ (i.e., 20%)	Profit and Loss	15,000
			<u>40,000</u>
 3. Current Profit :	 Rs.	Add : Undervaluation of Machinery (1,50,000 – 1,00,000)	 50,000
Reserve (75,000 – 25,000)	50,000		<u>90,000</u>
Profit & Loss A/c (25,000 – 15,000)	10,000	Less : Overvaluation of Furniture (20,000 – 15,000)	5,000
	<u>60,000</u>		<u>85,000</u>
Less : Depreciation on Machinery undercharged @ 10%		H. Ltd. Rs. 85,000 $\times \frac{4}{5}$	68,000
(Rs. $\frac{10,000}{1,00,000} \times 100$) on Rs. 50,000	5,000	S. Ltd. Rs. 85,000 $\times \frac{1}{5}$	17,000
	<u>55,000</u>	4. Minority Interest :	Rs.
Less : Dep. overcharged on Furniture @ 15%		Share Capital (200 \times Rs. 100)	20,000
(Rs. $\frac{3,000}{20,000} \times 100$) on Rs. 5,000	750	Add : Capital Profit	17,000
	<u>55,750</u>	Add : Current Profit	11,150
H. Ltd. Rs. 55,750 $\times \frac{4}{5}$	44,600		<u>48,150</u>
S. Ltd. Rs. 55,750 $\times \frac{1}{5}$	11,150	5. Cost of Control/Goodwill :	Rs.
		Cost of Shares	1,60,000
		Less : Nominal value of	
		Shares held	Rs. 80,000
		Cap. Profit	Rs. 68,000
			<u>1,48,000</u>
		Goodwill	<u>12,000</u>

H. Ltd. and its subsidiary S. Ltd.
Consolidated Balance Sheet
as at 31st December 1999

<i>Liabilities</i>	Rs.	Rs.	<i>Assets</i>	Rs.	Rs.
Share Capital :			Fixed Assets :		
Authorised		Goodwill		12,000
Issued and Paid-up			Machinery		
5,000 Equity Shares			H. Ltd.	3,00,000	
of Rs. 100 each, fully paid		5,00,000	S. Ltd.	90,000	
Reserve and Surplus :			Add : Under-		
Reserve :			valuation	50,000	
H. Ltd.	2,00,000			1,40,000	
S. Ltd. (50,000 × $\frac{4}{5}$)	40,000	2,40,000	Less : Depreciation	5,000	
Profit & Loss A/c :				1,35,000	4,35,000
H. Ltd.	1,00,000		Furniture :		
S. Ltd. (44,600 – 40,000)	4,600	1,04,600	H. Ltd.	50,000	
Minority Interest :		48,150	S. Ltd.	1,7000	
Secured Loan :		Nil	Less : Overvaluation	5,000	
Unsecured Loan :		Nil		12,000	
Current Liabilities and Provisions :			Add : Depreciation	750	
Creditors :				12,750	62,750
H. Ltd.	1,50,000		Investments :		Nil
S. Ltd.	50,000	2,00,000	Current Assets, Loans and Advances :		
			Current Assets		
			H. Ltd.	4,40,000	
			S. Ltd.	1,43,000	5,83,000
		<u>10,92,750</u>	Misc. Expenditure		Nil
					<u>10,92,750</u>

(d) Debentures of Subsidiary Company:

Sometimes Debentures of subsidiary company are held by holding company which are shown under the head 'Investments' in the Balance Sheet of holding company. These are to be eliminated while preparing Consolidated Balance Sheet. But if there is any difference between the cost price and paid-up value of Debentures, the same will, however, be adjusted against Cost of Control or Goodwill Account. Similarly, if there is any outstanding Debenture Interest, the same also will be adjusted.

Consider the following examples:

Balance Sheet
as at 31st December, 2000

<i>Liabilities</i>	H. Ltd. Rs.	S. Ltd. Rs.	<i>Assets</i>	H. Ltd. Rs.	S. Ltd. Rs.
6% Debentures, Rs. 1,000 each	—	20,000	Current Assets	30,000	20,000
Outstanding Debenture Interest		1,200	Investments :		
			6%, 5 Debentures of S. Ltd.	5,000	—

Now, the position will be :

Consolidated Balance Sheet
as at

	Rs.	Rs.		Rs.	Rs.
6% Debentures	20,000		Current Assets		
Less : Held by H. Ltd.	5,000			H. Ltd.	30,000
		15,000	S. Ltd.	20,000	
Outstanding Debenture Interest	1,200			50,000	
Less : Held by H. Ltd.	300		Less : Accrued Interest on Debentures	300	
		900			49,700

(e) Preference Shares of Subsidiary Company

(1) When Preference Shares are Held by Outsiders:

If preference shares are held by outsiders, the same will be included with minority interest by the amount of paid-up value of shares held (including the arrear dividend, if any). But a proper provision should be made against existing reserves which is to be added with minority interest if the profit of the subsidiary company becomes insufficient to pay cumulative dividend on preference shares.

Illustration 5:

The following are the Balance Sheets of H. Ltd. and its subsidiary S. Ltd. as at 31.12.1999

Balance Sheets
as at 31st December 1999

<i>Liabilities</i>	H. Ltd. Rs.	S. Ltd. Rs.	<i>Assets</i>	H. Ltd. Rs.	S. Ltd. Rs.
Share Capital :			Fixed Assets	8,00,000	1,20,000
10,000 Equity Shares of Rs. 100 each	10,00,000	—	Investments :		
10,000 Equity shares of Rs. 10 each, fully paid	—	1,00,000	8,000 Equity Shares in S. Ltd.	1,00,000	—
					<i>Contd</i>
	Rs.	Rs.	Current Assets	Rs.	Rs.
5,000, 8% Preference shares of Rs. 10 each, fully paid	—	50,000		2,50,000	65,000
General Reserve	1,00,000	20,000			
Sundry Creditors	50,000	10,000			
Dividend due on Preference Shares	—	5,000			
	<u>11,50,000</u>	<u>1,85,000</u>		<u>11,50,000</u>	<u>1,85,000</u>

S. Ltd. had Rs. 15,000 in General Reserve as on 1.1.1999. No dividend has been declared by S. Ltd. in 1999.

Prepare a Consolidated Balance Sheet as at 31st Dec. 1999.

Solution :

Workings :

1. Proportion of Holding Shares :	Rs.		2. Capital Profit :	Rs.
H. Ltd.'s share in S. Ltd.	=	$\frac{8,000}{10,000} = \frac{4}{5}$	General Reserve	15,000
S. Ltd.	=	$\frac{2,000}{10,000} = \frac{1}{5}$	H. Ltd. Rs. 15,000 $\times \frac{4}{5} =$	12,000
3. Current Profits :	Rs.		S. Ltd. Rs. 15,000 $\times \frac{1}{5} =$	3,000
General Reserve	<u>5,000</u>			

H. Ltd. Rs. 5,000 × $\frac{4}{5}$	4,000	4. Goodwill	Rs.
S. Ltd. Rs. 5,000 × $\frac{1}{5}$	1,000	Cost of Shares	1,00,000
5. Minority Interest :	Rs.	Less : Face value	80,000
Equity Share Capital (2,000 × 10)	20,000	Cap. Profit	<u>12,000</u>
Pref. Share Capital	50,000		92,000
Capital Profit	3,000	Goodwill	<u>8,000</u>
Current Profit	1,000		
Dividend due on Pref. Shares	5,000		
	<u>79,000</u>		

H. Ltd. and its subsidiary S. Ltd.—Consolidated B/S
Balance Sheet
as at 31st December 1999

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
<i>Share Capital :</i>			<i>Fixed Assets :</i>		
<i>Authorised</i>			H. Ltd.	8,00,000	
<i>Issued & Paid-up</i>			S. Ltd.	<u>1,20,000</u>	9,20,000
10,000 Equity shares of		10,00,000	Goodwill :		8,000
Rs. 100 each, fully paid			<i>Investment :</i>		Nil
<i>Reserve & Surplus :</i>			<i>Current Assets,</i>		
General Reserve	1,00,000		<i>Loans & Advances :</i>		
Profit of S. Ltd.	<u>4,000</u>		H. Ltd.	2,50,000	
		1,04,000	S. Ltd.	<u>65,000</u>	3,15,000
<i>Minority Interest</i>		79,000	<i>Misc. Expenditure</i>		Nil
<i>Secured Loans</i>		Nil			
<i>Unsecured Loans</i>		Nil			
<i>Current Liabilities and</i>					
<i>Provisions :</i>					
Sundry Creditors :					
H. Ltd.	50,000				
S. Ltd.	<u>10,000</u>	60,000			
		<u>12,43,000</u>			<u>12,43,000</u>

(2) When Preference Shares are Held by the Holding Company:

When preference shares of subsidiary company are held by the holding company, the treatment will be the same as in the case of equity shares, i.e., the paid-up value will be deducted from the cost of shares. The difference (between the cost price and paid-up value), if any, will represent cost of control which will be added with cost of control that is derived from the equity shares. But if the subsidiary company issues these shares either at a discount or at a premium, the same will not be adjusted against Cost of Control/Goodwill but will be incorporated with the cost of preference shares.

The preference dividend accrued to the date of acquisition will be adjusted against Goodwill/Cost of Control. But the dividend which has accrued from the date of acquisition to the date of preparation of accounts will, however, be considered as revenue profit and the same will be included with the share of profit of holding company in the Liability side of the Balance Sheet.

Illustration 6:

H. Ltd. acquires 80% of both classes of shares of S. Ltd., on 1.1.2001, at a total cost of Rs. 1,00,000.

The Balance Sheets of the two companies as on that date are:

<i>Liabilities</i>	H. Ltd. Rs.	S. Ltd. Rs.	<i>Assets</i>	H. Ltd. Rs.	S. Ltd. Rs.
Share capital :			Fixed Assets	2,50,000	1,40,000
40,000 Equity Shares of Rs. 10 each, fully-paid	4,00,000	—	Investments		
5,000 Equity Shares of Rs. 10 each, fully paid	—	50,000	in share of S. Ltd.	1,00,000	
5,000, 8% Pref. Shares of Rs. 10 each, fully paid	—	50,000	Current Assets	1,50,000	20,000
General Reserve (1.1.2001)	50,000	30,000			
Profit & Loss A/c	20,000	10,000			
Sundry Creditors	30,000	20,000			
	<u>5,00,000</u>	<u>1,60,000</u>		<u>5,00,000</u>	<u>1,60,000</u>

S. Ltd. had Rs. 5,000 in Profit and Loss Account as on 1.1.2001. The dividend in respect of Preference shares for 2001 is still payable.

Prepare a Consolidated Balance Sheet as at 31.12.2001.

Solution :

Workings :

1. Proportion of holding shares :	Rs.	2. Capital Profit :	Rs.
H. Ltd.'s share in S. Ltd.	= 80% (i.e., $\frac{4}{5}$)	Profit and Loss A/c	5,000
		General Reserve	30,000
			<u>35,000</u>
S. Ltd.	= 20% (i.e., $\frac{1}{5}$)	H. Ltd. Rs. 35,000 $\times \frac{4}{5}$ =	28,000
		S. Ltd. Rs. 35,000 $\times \frac{1}{5}$ =	7,000
3. Current Profits :	Rs.	4. Minority Interest :	Rs.
Profit and Loss A/c		Equity Share Capital	
(Rs. 10,000 - Rs. 5,000)	5,000	(50,000 $\times \frac{1}{5}$)	10,000
Less : Preference Dividend		Preference share capital	
(8% on Rs. 50,000)	4,000	(Rs. 50,000 $\times \frac{1}{5}$)	10,000
	<u>1,000</u>	Capital Profit	7,000
H. Ltd. Rs. 1,000 $\times \frac{4}{5}$ =	800	Current Profit	200
S. Ltd. Rs. 1,000 $\times \frac{1}{5}$ =	200	Preference Dividend	800
		(Rs. 4,000 $\times \frac{1}{5}$)	
5. Capital Reserve :	Rs.		<u>28,000</u>
Cost of Shares	1,00,000		
Less : Face value of			
Equity shares 40,000			
Pref. shares 40,000			
Capital Profit <u>28,000</u>	1,08,000		
Capital Reserve :	<u>8,000</u>		

H. Ltd. and its subsidiary S. Ltd.
Consolidated Balance Sheet
as at 31st December 2001

<i>Liabilities</i>	Rs.	Rs.	<i>Assets</i>	Rs.	Rs.
Share Capital :			Fixed Assets :		
Authorised			H. Ltd.	2,50,000	
Issued and Paid-up			S. Ltd.	1,40,000	
40,000 Equity shares					3,90,000
of Rs. 10 each, fully paid		4,00,000	Investment :		Nil
Reserve and Surplus :			Current Assets,		
Capital Reserve		8,000	Loans & Advances :		
General Reserve		50,000	H. Ltd.	1,50,000	
Profit and Loss A/c			S. Ltd.	20,000	
H. Ltd.	20,000				1,70,000
S. Ltd.	800		Misc. Expenditure		Nil
Pre. Dividend					
(Rs. 4,000 × $\frac{4}{5}$)	3,200				
		24,000			
Minority Interest :		28,000			
Secured Loan :		Nil			
Unsecured Loan :		Nil			
Current Liabilities and Provision :					
Sundry Creditors :					
H. Ltd.	30,000				
S. Ltd.	20,000				
		50,000			
		<u>5,60,000</u>			<u>5,60,000</u>

(f) Dividends:

(i) Ordinary:

It is quite natural that the holding company will receive dividend from the subsidiary company since the former has acquired the major portion of shares. It may be stated that such dividend may be paid by the subsidiary company out of (i) Pre-acquisition Profit, or (ii) Post-acquisition Profit.

(a) If dividends are paid out of Pre-acquisition Profit:

If the dividend has been distributed out of Capital Profit/Pre-acquisition Profit and has already been credited by the Profit and Loss Account of holding company, in that case, Profit and Loss Account should be debited and Investment Account should be credited in order to make proper reconciliation for the Consolidated Balance Sheet. In short, such dividend (only holding company's share) will be adjusted against Goodwill or Capital Reserve and the same also will be deducted from the Consolidated Profit and Loss Account in the Consolidated Balance Sheet.

To Sum up:

1. Deduct the amount of dividend (holding company's share) while computing Goodwill or Capital Reserve; and

2. Deduct the same also from Consolidated Profit and Loss Account in the Consolidated Balance Sheet, which appears in the Liability side.

Note: There will be no adjustment if the same has correctly been recorded in the books by the holding company.

Consider this illustration:

Illustration 7:

Holders Ltd. acquired 4,000 shares of Rs. 10 each, on 30.6.2000, for Rs. 52,000 in Subs. Ltd. Holders Ltd. received 10% dividend for 1999, but the dividends, as received, has been credited to Profit and Loss Account of Holders Ltd.

The following are the Balance Sheets as at 31.12.2000:

<i>Liabilities</i>	Holders Ltd. Rs.	Subs. Ltd. Rs.	<i>Assets</i>	Holders Ltd. Rs.	Subs. Ltd. Rs.
Share Capital in Rs. 10 Shares	60,000	50,000	Investments in Subs. Ltd. (4,000 shares)	52,000	—
General Reserve (1.1.2000)	12,000	10,000	Sundry Assets	64,000	96,000
Profit and Loss A/c :					
Balance on 1.1.2000	4,000	8,000			
Balance of 2000					
Profit	30,000	20,000			
Sundry Creditors and Provisions	10,000	8,000			
	<u>1,16,000</u>	<u>96,000</u>		<u>1,16,000</u>	<u>96,000</u>

Prepare a Consolidated Balance Sheet as at 31.12. 2000.

Solution :

Workings :

1. Proportion of holding shares :	Rs.	2. Capital Profit :	Rs.
H. Ltd.'s share in Subs. Ltd.	= $\frac{4,000}{5,000} = \frac{4}{5}$	General Reserve	10,000
S. Ltd.	= $\frac{1,000}{5,000} = \frac{1}{5}$	Profit and Loss A/c	8,000
			<u>18,000</u>
3. Current Profit :	Rs.	Add : Profit and Loss A/c	
Profit & Loss A/c		(profit for 1.1.2,000 to	
(Rs. 20,000 - Rs. 10,000)	10,000	30.6.2000 (Rs. 20,000 \times $\frac{1}{2}$)	10,000
Holders Ltd. Rs. 10,000 \times $\frac{4}{5}$	<u>8,000</u>		<u>28,000</u>
Subs. Ltd. Rs. 10,000 \times $\frac{1}{5}$	2,000	H. Ltd. Rs. 28,000 \times $\frac{4}{5}$ =	22,400

4. Minority Interest :	Rs.	S. Ltd. Rs. 28,000 × $\frac{1}{5}$ =	5,600
Share Capital (1,000 × Rs. 10)	10,000		
Add : Capital Profit	5,600	5. Capital Reserve :	Rs.
Add : Current Profit	2,000	Cost of Shares	52,000
	<u>17,600</u>	Less : Nominal value of	
		Shares held	40,000
		Capital Profit	22,400
		Dividend for 1999	<u>4,000</u>
			66,400
		Capital Reserve	<u>14,400</u>

Holders Ltd. and its subsidiary Subs. Ltd.
Consolidated Balance Sheet
as at 31st December 2000

<i>Liabilities</i>	Rs.	Rs.	<i>Assets</i>	Rs.	Rs.
Share Capital :			Sundry Assets		
Authorised			Holders Ltd.	64,000	
Issued and Paid-up			Subs. Ltd.	<u>96,000</u>	
6,000 Equity shares					1,60,000
of Rs. 10 each, fully paid		60,000			
Reserve and Surplus :					
Capital Reserve		14,400			
General Reserve		12,000			
Profit and Loss A/c :					
Holders Ltd. balance on 1.1.2000	4,000				
Profit for the year 2000	30,000				
	<u>34,000</u>				
Less : Dividend received					
from Subs. Ltd.	4,000				
	<u>30,000</u>				
Add : Current Profit of Subs. Ltd.	8,000				
		38,000			
Minority Interest					
Sundry Creditors :		17,600			
Holders Ltd.	10,000				
Subs Ltd.	<u>8,000</u>				
		18,000			
		<u>1,60,000</u>			<u>1,60,000</u>

(b) If dividends are paid out of Post-acquisition Profit:

If dividend has been paid by the subsidiary company out of current profit and is received by the holding company, the same will be treated as an income from investment and should be credited to Profit and Loss Account of holding company.

2.5 MINORITY INTEREST

A minority interest is ownership or interest of less than 50% of an enterprise. The term can refer to either stock ownership or a partnership interest in a company. The minority interest of a company is held by an investor or another organization other than the parent company. Minority interests generally come with some rights for the stakeholder such as the participation in sales and certain audit rights.

A minority interest shows up as a noncurrent liability on the balance sheet of companies with a majority interest in a company. This represents the proportion of its subsidiaries owned by minority shareholders.

Minority interests are the portion of a company or stock not held by the parent company, which has a majority interest. Most minority interests range between 20% and 30%.

While the majority stakeholder—in most cases, the parent company—has voting rights to set policy and procedures, the minority stakeholders generally have very little say or influence in the direction of the company. That's why it's also referred to as non-controlling interests (NCIs).

In some cases, a minority may have some rights such as the ability to take part in sales. There are laws that also allow minority interest holders to certain audit rights. They also may be able to attend shareholder or partnership meetings.

In the world of private equity, companies and investors with a minority interest may be able to negotiate control rights. For example, venture capitalists may ask to negotiate for a seat on the board of directors in exchange for his investment in a start-up.

In the corporate world, a corporation lists minority ownership on its balance sheet. In addition to being reflected on the balance sheet, a minority interest is reported on the consolidated income statement as a share of profit belonging to minority equity holders.

Example of Minority Interest

ABC Corporation owns 90% of XYZ Inc., which is a \$100 million company. ABC records a \$10 million minority interest as a noncurrent liability to represent the 10% of XYZ Inc. it does not own.

XYZ Inc. generates \$10 million in net income. As a result, ABC recognizes \$1 million—or 10% of \$10 million—of net income attributable to minority interest on its income statement. Correspondingly, ABC marks up the \$10 million minority interest by \$1 million on the balance sheet. The minority interest investors do not record anything unless they receive dividends, which are booked as income.

Types of Minority Interests

A minority interest can either be passive or active. Passive minority interests, where a company owns 20% or less, are those in which a company has no material influence on the company in which it maintains a minority interest. In accounting terms, only the dividends received from the minority interest are recorded for those with minority passive interests. This is referred to as the cost method—the ownership stake is treated as an investment at cost, and any dividends received are treated as dividend income.

Active minority interests—owning 21% to 49%—are those in which a company has the ability to materially influence the company in which it holds a minority interest. Unlike passive interests, dividends received and a percentage of income is recorded for those with active minority interests. This is referred to as the equity method.

Dividends are treated as a return of capital, decreasing the value of the investment on the balance sheet. The percentage of income the minority interest is entitled to is added to the investment account on the balance sheet as this effectively increases its equity share in the company.

The Majority Stakeholder: The Parent Company

The parent company is a majority stakeholder in the subsidiary. It owns more than 50% but less than 100% of a subsidiary's voting shares and recognizes a minority interest in its financial statements.

The parent company consolidates the financial results of the subsidiary with its own, and as a result, a proportional share of income shows up on the parent company's income statement attributable to the minority interest. Likewise, a proportional share of equity in the subsidiary company shows up on the parent's balance sheet attributable to the minority interest.

The minority interest can be found in the noncurrent liability section or equity section of the parent company's balance sheet under the generally accepted accounting principles (GAAP) rules. Under International Financial Reporting Standards (IFRS), however, the minority interest must be recorded in the equity section of the balance sheet. (For related reading, see "How To Calculate Minority Interest")

2.6 PREACQUISITION OR CAPITAL PROFITS

The retained earnings of one company before it is taken over by another company. Preacquisition profits should not be distributed to the shareholders of the acquiring company by way of dividend, as such profits do not constitute income to the parent company but a partial repayment of its capital outlay on the acquisition of the shares.

2.7 INTER-COMPANY BALANCE

Intercompany Balances means, as of any date, all balances as of such date between Seller and the Non-Company Affiliates, on the one hand, and the Company and the Company Subsidiaries, on the other hand, including intercompany accounts receivable and intercompany accounts payable. Intercompany Balances means any and all intercompany balances (including, without limitation, Indebtedness and all other liabilities) between the Company or any Subsidiary, on the one hand, and the Seller and its Affiliates (other than the Company and the Subsidiaries), on the other hand, arising from transactions of any kind between or among the Company or the Subsidiaries and any of their respective Affiliates, whether shown on the Balance Sheet or arising after the date of the

Balance Sheet. Such intercompany balances are reflected in the Intercompany Accounts. Intercompany Balances means as of any date, all balances as of such date between Seller or any of its Subsidiaries (other than the Transferred Entities or the JV Entities), on the one hand, and the Transferred Entities or the JV Entities, on the other hand, including intercompany accounts receivable and intercompany accounts payable.

2.8 UNREALIZED INTER-COMPANY PROFITS

Intercompany sales (and selling prices) do affect the allocation of profits to the controlling and noncontrolling interests, once the profit is realized through sales to outsiders. Thus, intercompany profit needs to be eliminated only if assets are still on the books of the consolidated entity (one of the members of the affiliated group). In such cases, the amount of profit to be eliminated may be calculated using the selling affiliate's gross profit rate, which may be stated as a percentage of either sales or costs. (The amount of profit to be eliminated is the same, regardless of how the percentage is stated.)

Proponents of 100% elimination regard all the intercompany profit associated with assets remaining in the affiliated group to be unrealized. Proponents of partial elimination regard only the parent company's share of the profit recognized by the selling affiliate to be unrealized. Both current and past GAAP require 100% elimination of intercompany profit in the preparation of consolidated financial statements.

Sales from a parent company to one or more of its subsidiaries are referred to as downstream sales. Sales from subsidiaries to the parent company are referred to as upstream sales.

For downstream sales, no modification to the calculation of the noncontrolling interest in consolidated income is needed. For upstream or horizontal sales, however, the noncontrolling interest in income must be adjusted. The reported income of the subsidiary (the selling affiliate) is reduced by the amount of gross profit remaining in ending inventory of the purchasing affiliate before multiplying by the noncontrolling percentage interest; it is increased for gross profit realized from beginning inventory.

In the consolidated workpapers, eliminating and adjusting entries serve to eliminate intercompany sales and adjust both beginning and ending inventories for the effects of any gross profit included from intercompany sales. The noncontrolling interest in consolidated income reflects the adjustment described in the preceding learning objective for upstream (or horizontal) sales. The final column of the workpapers is identical, regardless of whether the parent uses the cost, partial equity, or complete equity method for consolidated investments.

Generally accepted accounting standards are silent as to the appropriate treatment of unrealized profit on assets that result from sales between companies prior to affiliation (pre affiliation profit). The question is whether pre-affiliation profit should be eliminated in consolidation. In our opinion, workpaper entries eliminating pre-affiliation profit are inappropriate.

2.9 REVALUATION OF ASSETS AND LIABILITIES

A Revaluation account is opened to record the increase or decrease in assets and liabilities. Revaluation account is also called Profit and loss adjustment account. It is a nominal account. Revaluation account is credited with increase in value of assets and decrease in the value of liabilities. It is debited with decrease in value of assets and increase in the value of liabilities. Unrecorded assets if any are credited and unrecorded liabilities if any are debited to the revaluation account. The profit or loss arising therefrom is transferred to the capital accounts of the old partners in the old profit-sharing ratio. If the total of the credit side of the revaluation account exceeds the total of the debit side, the difference is profit on revaluation. If the total of the debit side of the revaluation account exceeds the total of the credit side, the difference is loss on revaluation.

Following are the journal entries to be passed to record the revaluation of assets and liabilities:

Date	Particulars	L.F.	Debit ₹	Credit ₹
	1. For increase in the value of asset			
	Concerned asset A/c To Revaluation A/c	Dr.	xxx	xxx
	2. For decrease in the value of asset			
	Revaluation A/c To Concerned asset A/c	Dr.	xxx	xxx
	3. For increase in the amount of liabilities			
	Revaluation A/c To Concerned liability A/c	Dr.	xxx	xxx
	4. For decrease in the amount of liability			
	Concerned liability A/c To Revaluation A/c	Dr.	xxx	xxx
	5. For recording an unrecorded asset			
	Concerned asset A/c To Revaluation A/c	Dr.	xxx	xxx
	6. For recording an unrecorded liability			
	Revaluation A/c To Concerned liability A/c	Dr.	xxx	xxx
	7. For transferring the balance in revaluation A/c			
	(a) If there is profit on revaluation			
	Revaluation A/c To Old partners' capital A/c (individually in old ratio)	Dr.	xxx	xxx
	(b) If there is loss on revaluation			
	Old partners' capital A/c (individually in old ratio) To Revaluation A/c	Dr.	xxx	xxx

Format of Revaluation Account:

Dr.		Revaluation Account		Cr.	
Particulars	₹	Particulars	₹		
To Concerned asset A/c (net decrease)	xxx	By Concerned asset A/c (net increase)	xxx		
To Concerned liability A/c (net increase)	xxx	By Concerned liability A/c (net decrease)	xxx		
To Old partners' capital A/c (profit on revaluation shared in old ratio)*	xxx	By Old partners' capital A/c (loss on revaluation shared in old ratio)*	xxx		
	xxx		xxx		

*There will be either profit or loss on revaluation.

*There will be either profit or loss on revaluation.

Illustration

Rajesh and Ramesh are partners sharing profits in the ratio 3:2. Raman is admitted as a new partner and the new profit-sharing ratio is decided as 5:3:2. The following revaluations are made. Pass journal entries and prepare revaluation account.

- a) The value of building is increased by ₹ 15,000.
- b) The value of the machinery is decreased by ₹ 4,000.
- c) Provision for doubtful debt is made for ₹ 1,000.

Solution

Journal entries

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Buildings A/c Dr. To Revaluation A/c (Appreciation in value of buildings recorded)		15,000	15,000
	Revaluation A/c Dr. To Machinery A/c To Provision for doubtful debts A/c (Decrease in assets recorded and provision made)		5,000	4,000 1,000
	Revaluation A/c Dr. To Rajesh's capital A/c To Ramesh's capital A/c (Profit on revaluation transferred)		10,000	6,000 4,000

Dr.		Revaluation Account		Cr.	
Particulars	₹	₹	Particulars	₹	
To Machinery A/c		4,000	By Buildings A/c	15,000	
To Provision for doubtful debts A/c		1,000			
To Profit on revaluation transferred to					
Rajesh's capital A/c (3/5)	6,000				
Ramesh's capital A/c (2/5)	4,000	10,000			
		15,000			15,000

2.10 BONUS SHARES

Bonus shares are additional shares given to the current shareholders without any additional cost, based upon the number of shares that a shareholder owns. These are company's accumulated earnings which are not given out in the form of dividends, but are converted into free shares. The basic principle behind bonus shares is that the total number of shares increases with a constant ratio of

number of shares held to the number of shares outstanding. For instance, if Investor A holds 200 shares of a company and a company declares 4:1 bonus, that is for every one share, he gets 4 shares for free. That is total 800 shares for free and his total holding will increase to 1000 shares.

Companies issue bonus shares to encourage retail participation and increase their equity base. When price per share of a company is high, it becomes difficult for new investors to buy shares of that particular company. Increase in the number of shares reduces the price per share. But the overall capital remains the same even if bonus shares are declared.

WHY COMPANIES ISSUE BONUS SHARES?

Bonus shares are issued by a company when it is not able to pay a dividend to its shareholders due to shortage of funds in spite of earning good profits for that quarter. In such a situation, the company issues bonus shares to its existing shareholders instead of paying dividend. These shares are given to the current shareholders on the basis of their existing holding in the company. Issuing bonus shares to the existing shareholders is also called capitalization of profits because it is given out of the profits or reserves of the company.

Let us now learn about how the bonus shares calculation is done.

BONUS SHARES CALCULATION

The bonus shares are given to the existing shareholders according to their existing stake in the company. Like for example, a company declaring one for two bonus shares would mean that an existing shareholder would get one bonus share of the company for every two shares held. Suppose a shareholder holds 1,000 shares of the company. Now when the company issues bonus shares, he will receive 500 bonus shares ($1,000 * 1/2 = 500$).

When the company issues bonus shares, the term “record date” is used along with it. Let us now learn about the term record date.

WHAT IS RECORD DATE?

Record date is a cut-off date set by the company. If you are the owner of the shares of the company on this cut-off date then you are eligible to receive the bonus shares. The record date is set by the company so that they can find the eligible shareholders and distribute bonus shares to them.

Let us now learn about the advantages of bonus shares.

ADVANTAGES OF BONUS SHARES

- There is no need for investors to pay any tax on receiving bonus shares.

- It is beneficial for the long-term shareholders of the company who want to increase their investment.
- Bonus shares enhance the faith of the investors in the operations of the company because the cash is used by the company for business growth.
- When the company declares a dividend in the future, the investor will receive higher dividend because now he holds larger number of shares in the company due to bonus shares.
- Bonus shares give positive sign to the market that the company is committed towards long term growth story.
- Bonus shares increase the outstanding shares which in turn enhances the liquidity of the stock.
- The perception of the company's size increases with the increase in the issued share capital.

Since there are many advantages of bonus shares, let us now learn the conditions for the issue of bonus shares.

CONDITIONS FOR ISSUE OF BONUS SHARES

- The issue of bonus shares must be authorized by the Articles of the company.
- The issue of bonus shares must be recommended by the resolution of the Board of Directors. Also, this recommendation must be later approved by the shareholders of the company in the general meeting.
- The Controller of Capital Issues must give permission to the issue.

The above mentioned are the conditions that a company must fulfil to issue bonus shares. To be eligible for the different types of bonus shares you must hold the shares of the company in the demat account. If you want to open a demat account, you can consider Kotak Securities. We are the leading broking firm of India that provides premium services to the clients at the most affordable rates.

2.11 SUMMARY

- While preparing a consolidated financial statement, there are two basic procedures that need to be followed: first, cancel out all the items that are accounted as an asset in one company and a liability in another, and then add together all uncanceled items.
- There are two main type of items that cancel each other out from the consolidated statement of financial position.

1. "Investment in subsidiary companies" which is treated as an asset in the parent company will be cancelled out by "share capital" account in subsidiary's statement. Only the parent company's "share capital" account will be included in the consolidated statement.
2. If trading between different companies in one group happen, then the payables of one company will be cancelled by the receivables of another company.
 - In corporate finance, an amalgamation is the combination of two or more companies into a larger single company.
 - In accounting an amalgamation, or consolidation, refers to the combination of financial statements. For example, a group of companies reports their financials on a consolidated basis, which includes the individual statements of several smaller businesses.
 - Amalgamation is an arrangement where two or more companies consolidate their business to form a new firm or become a subsidiary of any one of the companies.
 - A bonus issue is an offer of free additional shares to existing shareholders. A company may decide to distribute additional shares as an alternative to dividend pay-out. For example, a company may give one bonus share for every 2 shares held.
 - You will be eligible for bonus shares if you've purchased the stocks before the ex-date. If you've purchased the shares on or after the ex-date, you will not be eligible for the dividend. Refer to this article for more info on eligibility.
 - **Minority interest** is an accounting concept that deals with the part of a subsidiary corporation's stock which is not owned by the parent corporation. Moreover, the enormity of the minority interest in the subsidiary company is usually less than 50% of outstanding shares, or the corporation would normally stop being a subsidiary of the parent corporation.
 - To define in a more elaborate manner, minority interest can be explained as a significant but non-controlling ownership of less than 50% of the voting shares of a company by an investor or another company. Also, it can be referred as a non-current obligation which can be found on the balance sheet of the parent company which represents the amount of subsidiaries owned by minority shareholders.
 - If minority interest is owned by a company in another but is not able to exert influence, i.e. holds a minority passive position, then all the info recorded from this investment includes dividends obtained from the minority interest. Moreover, if the company is capable of exerting influence, i.e. holds a minority active position, then the dividends as well as a percent of income are recorded on the books of the company.
 - A capital gain refers to profit that results from a sale of a capital asset, such as stock, bond or real estate, where the sale price exceeds the purchase price. The gain is the difference between a higher selling price and a lower purchase price.

- Intercompany Balances means as of any date, all balances as of such date between Parent or any Non-Business Subsidiaries, on the one hand, and the Business Entities, on the other hand, including intercompany accounts receivable and intercompany accounts payable.
- A Revaluation account is opened to record the increase or decrease in assets and liabilities. Revaluation account is also called Profit and loss adjustment account. It is a nominal account. Revaluation account is credited with increase in value of assets and decrease in the value of liabilities.

2.12 KEY WORDS

- Authorized shares the maximum number of shares a corporation can issue without a change in its state charter.
- Bond issue the total value of bonds issued at one time.
- Bond A security, usually long term, representing money that a corporation or other entity borrows from the investing public.
- Consolidated financial statements Financial statements that reflect the combined operations of a parent company and its subsidiaries.
- Minority interest an amount recorded on a consolidated balance sheet that represents the holdings of owners of less than 50 percent of a subsidiary's voting stock.

2.13 LEARNING ACTIVITY

1. Sriram and Raj are partners sharing profits and losses in the ratio of 2:1. Nelson joins as a partner on 1st April 2017. The following adjustments are to be made:

- i. Increase the value of stock by ₹ 5,000
- ii. Bring into record investment of ₹ 7,000 which had not been recorded in the books of the firm.
- iii. Reduce the value of office equipment by ₹ 10,000
- iv. A provision would also be made for outstanding wages for ₹ 9,500.

Give journal entries and prepare revaluation account.

2.

Balance Sheets
as at 31st December 2001

<i>Liabilities</i>	H. Ltd. Rs.	S. Ltd. Rs.	<i>Assets</i>	H. Ltd. Rs.	S. Ltd. Rs.
Share Capital of Rs. 10 each	1,00,000	50,000	Sundry Assets	60,000	63,000
Reserve	10,000	5,000	Investments:		
Profit and Loss A/c	10,000	4,000	4,000 shares in S. Ltd.	65,000	—
Sundry Liabilities	5,000	4,000			
	<u>1,25,000</u>	<u>63,000</u>		<u>1,25,000</u>	<u>63,000</u>

H. Ltd. acquired the shares of S. Ltd. on 1st Jan. 2001. On that date the Profit and Loss Account of S. Ltd. had a credit balance of Rs. 1,000 and in Reserve Rs. 3,000.

Prepare a Consolidated Balance Sheet.

2.14 UNIT-END QUESTIONS

A. Descriptive Questions

1. Explain minority interest if you are a shareholder of SBI Bank?
2. What are importance of bonus shares if you are shareholder of Wipro?
3. What are the types of minority interest in an organisation of your choice?
4. How to revalue assets and liabilities when Company A is acquiring Company B?
5. What is consolidated balance sheet when TCS is issuing annual report to its shareholders?

B. Multiple Choice Questions

1. Preparation of consolidated Balance Sheet of Holding Co. and its subsidiary company as per
 - a. As 11
 - b. AS – 22
 - c. AS 21
 - d. AS – 23

2. The share of outsiders in the Net Assets in subsidiary company is known as under:
 - a. outsider's liability
 - b. Assets
 - c. subsidiary company's liability
 - d. Minority Interest

3. Pre-acquisition profit in subsidiary company is considered as:
 - a. Revenue profit
 - b. Capital profit
 - c. Goodwill

d. None of the above

4. Excess of cost of investment over paid up value of the shares is considered as:

- a. Goodwill
- b. Capital Reserve
- c. Minority Interest
- d. None of above

5. Excess of paid up value of the shares over cost of investment is considered as:

- a. Goodwill
- b. Capital Reserve
- c. Minority Interest
- d. None of above

Answer:

1. c 2. d 3. b 4. a 5. b

2.15 SUGGESTED READINGS

- Hanif, M. & Mukherjee, A. (2015). *Corporate Accounting*. South West: Thomson.
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UNIT III –SHARE CAPITAL

Structure

- 3.0. Learning Objective
- 3.1. Introduction
- 3.2. Introduction and Issue of Shares
- 3.3. Buy Back of Shares
- 3.4. Redemption of Preference Share
- 3.5. Summary
- 3.6. Key words
- 3.7. Learning Activity
- 3.8. Unit -End Questions
- 3.9. Suggested Readings

3.0 LEARNING OBJECTIVE

After studying this unit, you will be able to:

- Describe issue of shares
- Assess preference shares
- Explain buyback of shares

3.1 INTRODUCTION

A corporation's share capital or capital stock is the portion of a corporation's equity that has been obtained by the issue of shares in the corporation to a shareholder, usually for cash. "Share capital" may also denote the number and types of shares that compose a corporation's share structure. Share capital is reported by a company on its balance sheet in the shareholder's equity section. The information may be listed in separate line items depending on the source of the funds. These usually include a line for common stock, another for preferred stock, and a third for additional paid-in capital.

Common stock and preferred stock shares are reported at their par value at the time of sale. In modern business, the "par" or face value is a nominal figure. The actual amount received by a company in excess of par value is reported as "additional paid-in capital."

3.2 INTRODUCTION AND ISSUE OF SHARES

Issue of Shares is the process in which companies allot new shares to shareholders. Shareholders can be either individuals or corporates. The company follows the rules prescribed by Companies Act 2013 while

issuing the shares. Issue of Prospectus, Receiving Applications, Allotment of Shares are three basic steps of the procedure of issuing the shares. The process of creating new shares is known as Allocation or allotment. Let us see the two types of shares of a company and the procedure for issue of shares that a company must follow.

Nature and Classes of Shares

A share of a company is one of the units into which the capital of a company is divided. So, if the total capital of a company is 5 lakhs, and such capital is divided into 5000 units of Rs 100/- each, then this one unit of amount 100 is a share of the company.

Thus, a share is the basis of ownership of the company. And the person who holds such shares and is thus a member of the company is known as a shareholder.

Now the Articles of Association will contain some essential information about shares and share capital, like the classes of shares to be prescribed. In all, there are two types of shares a company can allot according to the Companies Act 2013. They have different natures, rights, and obligations.

Difference between Equity Shares and Preference Shares

Preference Shares

A preference share is one which carries two exclusive preferential rights over the other type of shares, i.e. equity shares. These two special conditions of preference shares are

1. A preferential right with respect to the dividends declared by a company. Such dividends can be at a fixed rate on the nominal value of the shares held by them. So, the dividend is first paid to preference shareholders before equity shareholders.
2. Preferential right when it comes to repayment of capital in case of liquidation of the company. This means that the preference shareholders get paid out earlier than the equity shareholders.

Other than these two rights, preference shares are similar to equity shares. The holders of preference shares can vote in any matters directly affecting their rights or obligations.

Preference shares can actually be of various types as well. They can be redeemable or irredeemable. They can be participating (participate in further profits after a dividend is paid out) or non-participating. And they may be cumulative (arrears in demand will cumulate) or non-cumulative.

Equity Shares

Equity share is a share that is simply not a preference share. So shares that do not enjoy any preferential rights are thus equity shares. They only enjoy equity, i.e. ownership in the company.

The dividend given to equity shareholders is not fixed. It is decided by the Board of Directors according to the financial performance of the company. And if in a given year no dividend can be declared, the shareholders lose the dividend for that year, it does not cumulate.

Equity shareholders also have proportional voting rights according to the paid-up capital of the company. Essentially it is one share one vote system. A company cannot issue non-voting equity shares, they are illegal. All equity shares must come with full voting rights.

Issue of Shares

When a company wishes to issue shares to the public, there is a procedure and rules that it must follow as prescribed by the Companies Act 2013. The money to be paid by subscribers can even be collected by the company in instalments if it wishes. Let us take a look at the steps and the procedure of issue of new shares.

Procedure of Issue of New Shares

1] Issue of Prospectus

Before the issue of shares, comes the issue of the prospectus. The prospectus is like an invitation to the public to subscribe to shares of the company. A prospectus contains all the information of the company, its financial structure, previous year balance sheets and profit and Loss statements etc.

It also states the manner in which the capital collected will be spent. When inviting deposits from the public at large it is compulsory for a company to issue a prospectus or a document in lieu of a prospectus.

2] Receiving Applications

When the prospectus is issued, prospective investors can now apply for shares. They must fill out an application and deposit the requisite application money in the schedule bank mentioned in the prospectus. The application process can stay open a maximum of 120 days. If in these 120 days minimum subscription has not been reached, then this issue of shares will be cancelled. The application money must be refunded to the investors within 130 days since issuing of the prospectus.

3] Allotment of Shares

Once the minimum subscription has been reached, the shares can be allotted. Generally, there is always oversubscription of shares, so the allotment is done on pro-rata bases. Letters of Allotment are sent to those who have been allotted their shares. This results in a valid contract between the company and the applicant, who will now be a part owner of the company.

If any applications were rejected, letters of regret are sent to the applicants. After the allotment, the company can collect the share capital as it wishes, in one go or in instalments.

3.3 BUY BACK OF SHARES

A buyback, also known as a share repurchase, is when a company buys its own outstanding shares to reduce the number of shares available on the open market. Companies buy back shares for a number of reasons, such as to increase the value of remaining shares available by reducing the supply or to prevent other shareholders from taking a controlling stake. A buyback allows companies to invest in themselves. Reducing the number of shares outstanding on the market increases the proportion of shares owned by investors. A company may feel its shares are undervalued and do a buyback to provide investors with a return. And because the company is bullish on its current operations, a buyback also boosts the proportion of earnings that a share is allocated. This will raise the stock price if the same price-to-earnings (P/E) ratio is maintained.

The share repurchase reduces the number of existing shares, making each worth a greater percentage of the corporation. The stock's earnings per share (EPS) thus increases while the price-to-earnings ratio (P/E) decreases or the stock price increases. A share repurchase demonstrates to investors that the business has sufficient cash set aside for emergencies and a low probability of economic troubles.

Another reason for a buyback is for compensation purposes. Companies often award their employees and management with stock rewards and stock options. To offer rewards and options, companies buy back shares and issue them to employees and management. This helps avoid the dilution of existing shareholders.

How Companies Perform a Buyback

Buybacks are carried out in two ways:

- Shareholders might be presented with a tender offer, where they have the option to submit, or tender, all or a portion of their shares within a given time frame at a premium to the current market price. This premium compensates investors for tendering their shares rather than holding onto them.

- Companies buy back shares on the open market over an extended period of time and may even have an outlined share repurchase program that purchases shares at certain times or at regular intervals.

A company can fund its buyback by taking on debt, with cash on hand, or with its cash flow from operations.

An expanded share buyback is an increase in a company's existing share repurchase plan. An expanded share buyback accelerates a company's share repurchase plan and leads to a faster contraction of its share float. The market impact of an expanded share buyback depends on its magnitude. A large, expanded buyback is likely to cause the share price to rise.

The buyback ratio considers the buyback dollars spent over the past year, divided by its market capitalization at the beginning of the buyback period. The buyback ratio enables a comparison of the potential impact of repurchases across different companies. It is also a good indicator of a company's ability to return value to its shareholders since companies that engage in regular buybacks have historically outperformed the broad market.

Example of a Buyback

A company's stock price has underperformed its competitor's stock even though it has had a solid year financially. To reward investors and provide a return to them, the company announces a share buyback program to repurchase 10% of its outstanding shares at the current market price.

The company had \$1 million in earnings and 1 million outstanding shares before the buyback, equating to earnings per share (EPS) of \$1. Trading at a \$20 per share stock price, its P/E ratio is 20. With all else being equal, 100,000 shares would be repurchased and the new EPS would be \$1.11, or \$1 million in earnings spread out over 900,000 shares. To keep the same P/E ratio of 20, shares would need to trade up 11% to \$22.22.

Criticism of Buybacks

A share buyback can give investors the impression that the corporation does not have other profitable opportunities for growth, which is an issue for growth investors looking for revenue and profit increases. A corporation is not obligated to repurchase shares due to changes in the marketplace or economy.

Repurchasing shares puts a business in a precarious situation if the economy takes a downturn or the corporation faces financial issues it cannot cover. Others allege that sometimes buybacks are used to inflate share price artificially in the market, which can also lead to higher executive bonuses.

3.4 REDEMPTION OF PREFERENCE SHARE

Redemption of preference shares means returning the preference share capital to the preference shareholders either at a fixed date or after a certain time period during the life time of the company provided company must complied certain conditions.

According to Section 100 of the **Companies Act 1956**, a company is not allowed to return to its shareholders the share money without the permission of the court. A refund of money to shareholders on capital account, while the company is in existence, requires court's sanction in addition to the special procedure. But Section 80 of the Companies Act allows a company, if authorized by its articles to issue preference shares which at the option of the company may be redeemed, if the conditions as laid down under this Section are to be satisfied.

The following are the important provisions regarding the redemption of preference shares which are given under Section 80 of the Companies Act:

- (1) Company must be authorized by its articles of association.
- (2) No such shares shall be redeemed unless they are fully paid up. The partly paid up shares cannot be redeemed. If they are partly paid in that case a final call be made to convert them from partly paid to fully paid only then redemption can be carried out.
- (3) Such shares can be redeemed
 - (a) Out of the profit of the company which would otherwise be available for the dividend; or
 - (b) Out of the proceeds of a fresh issue of shares made for the purpose of redemption.
- (4) If the shares are redeemed out of profits available for the distribution for dividend, a sum equal to the nominal amount of the shares so redeemed must be transferred to reserve account to be called 'Capital Redemption Reserve Account'
- (5) If preference shares are redeemed at premium, then such premium must be provided either out of the profits of the company or out of the company's security premium account.
- (6) The Capital Redemption Reserve Account can be utilized for the issue of fully paid bonus shares to the shareholders.

Redemption of preference shares by a company is not taken as reducing the amount of its authorized share capital and as such provisions of the act with regard to reduction of capital are not required to be complied with. Shares already issued of other type cannot be converted into redeemable preference shares.

No company limited by shares shall, after the commencement of the companies (amendment Act, 1996), issue irredeemable preference shares or redeemable preference shares which are Redeemable after 20 years of its issue.

If company fails to comply with these provisions, the company and every officer of the company who is in default shall be punishable with fine which may extend to Rs. 10,000. Redemption of redeemable preference shares shall be notified to the registrar of companies within one month of redemption.

Profits available for dividend or the profit out of which the Capital Redemption Reserve Account is allowed:

The Companies Act permits the redemption of shares from out of the profits, which are otherwise available for dividend. In case the redemption is out of profits, the company is expected to transfer an equal amount to an account called 'Capital Redemption Reserve Account' out of divisible profits. The following are the profits which are available for dividend.

Table showing profits available/not for redemption.

Profits available for redemption (Transfer to capital redemption reserve is allowed from these profits)	Profits not available for redemption. (Transfer to capital redemption reserve account is not allowed from these profits)
<ol style="list-style-type: none"> 1. Reserves 2. General reserve 3. Reserve fund 4. Dividend equalisation fund 5. Insurance fund 6. Workmen's compensation fund 7. Workmen's accident fund 8. Voluntary debenture redemption A/c 9. Debenture sinking fund A/c 10. Profit and loss A/c (cr.) 	<ol style="list-style-type: none"> 1. Security premium account 2. Share forfeited account. 3. Profit prior to incorporation. 4. Capital reserve 5. Development rebate reserve.

Figure 3.1

Central Idea:

Whatever be the source of funds for redemption, the original paid up capital of the company must not be reduced by a single rupee. Redemption should not affect adversely the interests of the creditors.

It can happen as follows:

If a company redeems preference shares and soon after, it goes into liquidation, if the amount available is not sufficient in that case though preference shareholders got their full dues whereas the creditors suffered. It is not allowed under law. Creditors must get priority over the shareholders. Therefore, the Companies Act has laid down manifold conditions for the redemption of preference shares.

3.5 SUMMARY

- Share capital is the money a company raises by issuing common or preferred stock. The amount of share capital or equity financing a company has can change over time with additional public offerings.
- The term share capital can mean slightly different things depending on the context. Accountants have a much narrower definition and their definition rules on the balance sheets of public companies. It means the total amount raised by the company in sales of shares.
- A buyback allows companies to invest in themselves. By reducing the number of shares outstanding on the market, buybacks increase the proportion of shares a company owns. Buybacks can be carried out in two ways:
 - Shareholders may be presented with a tender offer whereby they have the option to submit (or tender) a portion or all of their shares within a certain time frame and at a premium to the current market price. This premium compensates investors for tendering their shares rather than holding on to them.
 - Companies buy back shares on the open market over an extended period of time.
- Preference shares are shares which are preferred over common or equity shares in payment of surplus. Owners of preference shares get fixed dividend. However, in the event of liquidation of the company they are paid after bond holders and creditors, but before equity holders. Preference Shares mean and includes that part of the share capital the holders of which have a preferential right overpayment of dividend (fixed amount or rate) and repayment of share capital in the event of winding up of the company. Companies Act, 2013 permits for redemption of preference share with fresh issue of Equity shares or Preference shares.
- To simplify, when you buy shares from the company you become part-owner of the company, you are common shareholder or equity shareholder. One cannot directly own preference shares as it is for only Board of Directors, promoters of the company or financial institutions. They are still not offered to retail-investors.
- Preference shares are not liquid shares as they are not traded on stock exchanges. The other disadvantage is they don't have voting rights.
- Source for Premium on Redemption 1. Certain class of Companies whose financial statements comply with the Accounting Standards as prescribed under Section 133 of the Companies Act, 2013, it must be out of profits of the company and cannot use existing Security premium or security premium collected on fresh issue for the purpose of redemption. 2. Companies issued shares before the date of commencement of the Companies Act, 2013 or the class of Companies whose financial statements do not comply with the Accounting Standards as prescribed under Section 133 of the Companies Act, 2013 can be made from securities premium or profits of the company.

3.6 KEY WORDS

- Book value per share the equity of the owner of one share of stock in a corporation's net assets.
- Equity: A description applied to the ordinary share capital of an entity.
- rights issue: A company gives its existing shareholders the right to buy more shares in proportion to those already held.
- working capital: Finance provided to support the short-term assets of the business (stocks and debtors) to the extent that these are not financed by short-term creditors. It is calculated as current assets minus current liabilities.
- listed company: A company whose shares are listed by the Stock Exchange as being available for buying and selling under the rules and safeguards of the Exchange.

3.7 LEARNING ACTIVITY

1. Pass the required journal entries for redemption of preference shares.

2. Know the Provisions of the Company's Act relating to issue and redemption of redeemable preference shares.

3.8 UNIT-END QUESTION

A. Descriptive Questions

1. What are equity shares when ABC Ltd is listing their shares in stock exchange?
2. What are preference shares when company wants to expand their business operations and needs funds
3. Explain buy back of shares if you're are a shareholder of TCS?
4. What is redemption of preference shares when a shareholder has bought preference shares of Tata Steels
5. Understand and apply the logical sequence involved in redemption of preference shares.

B. Multiple Choice Questions

1. Under which section of Companies Act 2013, a company can buy back its own shares?
 - a) 68
 - b) 81

- c) 62
- d) none of these

2. As per section 77A (1) of the companies act,1956, a company can buy back its own shares out of:

- a) Reserves which are available for distribution as dividend
- b) Securities premium account
- c) Proceeds of fresh issue of shares or other specified securities
- d) All of the above.

3. Redeemable Preference shares can be redeemed out of _____

- a) The sale proceeds of Investments
- b) The proceeds of a fresh issue of shares
- c) Share premium
- d) The proceeds of issue of debentures

4. When Redeemable Preference shares are due for redemption, the entry passed is

- a) Debit redeemable Preference Share capital a/c; Credit cash a/c
- b) Debit Redeemable Preference share capital a/c; credit Preference shareholders a/c
- c) Debit preference shareholders a/c; credit cash a/c
- d) Debit preference shareholders a/c; credit capital reduction a/c

5. If the whole of the issue of shares or debentures is underwritten it is known as-----

- a) partial underwriting
- b) Incomplete underwriting
- c) Complete underwriting
- d) Firm underwriting

Answer

1. a; 2. d; 3. b; 4. b; 5. c

3.9 SUGGESTED READINGS

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UNIT IV- DEBENTURES

Structure

- 4.0. Learning Objective
- 4.1. Introduction
- 4.2. Issue of Debentures
- 4.3. Redemption of Debentures
- 4.4. Underwriting of Shares and Debentures.
- 4.5. Summary
- 4.6. Key words
- 4.7. Learning Activity
- 4.8. Unit -End Questions
- 4.9. Suggested Readings

4.0 LEARNING OBJECTIVE

After studying this unit, you will be able to:

- Discuss about debentures
- Explain redemption of debenture
- State underwriting of shares

4.1 INTRODUCTION

Debentures are a debt instrument used by companies and government to issue the loan. The loan is issued to corporates based on their reputation at a fixed rate of interest. Debentures are also known as a bond which serves as an IOU between issuers and purchaser. A debenture is a medium to long-term debt format that is used by large companies to borrow money. Debentures are typically loans that are repayable on a fixed date, but some debentures are irredeemable securities (these are sometimes called perpetual bonds), which means that they do not have a fixed date of expected return of the funds. Debenture holders (investors) do not have any rights to vote in the company's general meetings of shareholders, but they are allowed separate meetings or votes e.g. on changes to the rights attached to the debentures.

The interest paid to debenture holders is calculated as a charge against profit in the company's financial statements.

Definition: A medium- or long-term debt format that large companies use to borrow money.

In corporate finance, a debenture is a medium- to long-term debt instrument used by large companies to borrow money, at a fixed rate of interest. The legal term "debenture" originally referred to a document that either creates a debt or acknowledges it, but in some countries the term is now used interchangeably with bond, loan stock or note. A debenture is thus like a certificate of loan or a loan bond evidencing the fact that the company is liable to pay a specified amount with interest. Although the money raised by the debentures becomes a part of the company's capital structure, it does not become share capital. Senior debentures get paid before subordinate debentures, and there are varying rates of risk and payoff for these categories.

4.2 ISSUE OF DEBENTURES

The word 'debenture' itself is a derivation of the Latin word 'debere' which means to borrow or loan. Debentures are written instruments of debt that companies issue under their common seal. They are similar to a loan certificate.

Debentures are issued to the public as a contract of repayment of money borrowed from them. These debentures are for a fixed period and a fixed interest rate that can be payable yearly or half-yearly. Debentures are also offered to the public at large, like equity shares. Debentures are actually the most common way for large companies to borrow money.

Let us look at some important features of debentures that make them unique,

1. Maturity:

Although debentures provide long-term funds to a company, they mature after a specific period. Generally, the debentures are to be repaid at a definite time as stipulated in the issue. The company must pay back the principal amount on these debentures on the given date otherwise the debenture-holders may force winding up of the company as creditors.

However, a company may issue irredeemable or perpetual bonds or debentures which have no maturity date. The effect of issuing irredeemable debentures is that they do not have any fixed time limit within which the company must pay back the principal amount of debentures and hence the holders cannot compel the company to pay them.

But, it does not mean that the company can never redeem these debentures. In that sense, all debentures are redeemable or mature at one time or the other. The various methods for redemption of debentures have been discussed separately under the heading of Extinction of Bonded Indebtedness in this very chapter.

2. Claims on Income:

A fixed rate of interest is payable on debentures. Unlike shares, a company has a legal obligation to pay the interest on due dates irrespective of its level of earnings. Even if a company makes no earnings or incurs loss, it is under an obligation to pay interest to its debenture-holders.

The default in payment of interest may cause winding up of company because the debenture-holders may take recourse to law for the same. In any case, bond holders have priority of claim on income of the company over equity and preference shareholders.

3. Claims on Assets:

Even in respect of claim on assets, debenture-holders have priority of claim on assets of the company. They have to be paid first before making any payment to the preference or equity shareholders in the event of liquidation of the company. However, they have a claim for the principal amount and interest due only and do not have any share in the surplus assets of the company, if any. Further, debentures may provide for a charge on the assets of the company as a security to its holders.

The debenture-holders may have either specific charge on the assets of the company or a floating charge over all the assets of the company. The secured debentures entitle its holders to have a priority over other unsecured creditors of the company, against the assets mortgaged to them.

If the assets pledged to them are not sufficient to satisfy their claims, they rank *pari passu* with the other unsecured creditors for the balance.

4. Control:

Since, debenture-holders are creditors of the company and not its owners; they do not have any control over the management of the company. They do not have any voting rights to elect the directors of the company or on any other matters. But, at the time of liquidation of the company they have prior claim over shareholders and if remain unpaid, they may take control over the company.

5. Call Feature:

Issue of debentures sometimes provides a call feature which entitles the company to redeem its debentures at a certain price before the maturity date. Since, the call feature provides advantages to the company at the expense of its debenture-holders, the call price is usually more than the issue price.

Advantages of Debentures

- One of the biggest advantages of debentures is that the company can get its required funds without diluting equity. Since debentures are a form of debt, the equity of the company remains unchanged.
- Interest to be paid on debentures is a charge against profit for the company. But this also means it is a tax-deductible expense and is useful while tax planning
- Debentures encourage long-term planning and funding. And compared to other forms of lending debentures tend to be cheaper.
- Debenture holders bear very little risk since the loan is secured and the interest is payable even in the case of a loss to the company
- At times of inflation, debentures are the preferred instrument to raise funds since they have a fixed rate of interest

Disadvantages of Debentures

1. The interest payable to debenture holders is a financial burden for the company. It is payable even in the event of a loss
2. While issuing debentures help a company trade on equity, it also makes it too dependent on debt. A skewed Debt-Equity Ratio is not good for the financial health of a company
3. Redemption of debentures is a significant cash outflow for the company which can imbalance its liquidity
4. During a depression, when profits are declining, debentures can prove to be very expensive due to their fixed interest rate

Types of Debentures

There are various types of debentures that a company can issue, based on security, tenure, convertibility etc. Let us take a look at some of these types of debentures.

- **Secured Debentures:** These are debentures that are secured against an asset/assets of the company. This means a charge is created on such an asset in case of default in repayment of such debentures. So, in case, the company does not have enough funds to repay such debentures, the said asset will be sold to pay such a loan. The charge may be fixed, i.e. against a specific assets/asset or floating, i.e. against all assets of the firm.
- **Unsecured Debentures:** These are not secured by any charge against the assets of the company, neither fixed nor floating. Normally such kinds of debentures are not issued by companies in India.

- **Redeemable Debentures:** These debentures are payable at the expiry of their term. Which means at the end of a specified period they are payable, either in the lump sum or in instalments over a time period. Such debentures can be redeemable at par, premium or at a discount.
- **Irredeemable Debentures:** Such debentures are perpetual in nature. There is no fixed date at which they become payable. They are redeemable when the company goes into the liquidation process. Or they can be redeemable after an unspecified long-time interval.
- **Fully Convertible Debentures:** These shares can be converted to equity shares at the option of the debenture holder. So if he wishes then after a specified time interval all his shares will be converted to equity shares and he will become a shareholder.
- **Partly Convertible Debentures:** Here the holders of such debentures are given the option to partially convert their debentures to shares. If he opts for the conversion, he will be both a creditor and a shareholder of the company.
- **Non-Convertible Debentures:** As the name suggests such debentures do not have an option to be converted to shares or any kind of equity. These debentures will remain so till their maturity, no conversion will take place. These are the most common type of debentures.

What is the Issue of Debentures?

The issue of Debentures seems to be much alike to the issue of shares by an enterprise. Here, the money can be accumulated either in lump sum or in instalments. The accounting treatment of the 2 is quite alike. Now, the debentures can be either issued for some other considerations or cash. Often issue or circulation of debentures is done as collateral security.

(A) MEANING OF DEBENTURE	<ul style="list-style-type: none"> • Debenture is a written instrument acknowledging a debt under the common seal of the company • It contains a contract for repayment of principal after a specified period and for payment of interest at a fixed rate
(B) CHARACTERISTICS OF A DEBENTURE	
(i) LOAN	<ul style="list-style-type: none"> • Debenture is an instrument of loan.
(ii) FIXED RATE	<ul style="list-style-type: none"> • Interest is paid at a fixed rate every year and debentures are known as “fixed cost bearing capital”.
(iii) COMMON SEAL	<ul style="list-style-type: none"> • Debenture has a common seal of the company.

(iv) REDEMPTION	<ul style="list-style-type: none"> • Debenture is redeemable at a fixed and specified time.
(v) CREDITORS	<ul style="list-style-type: none"> • Debenture-holders are the creditors of the company, not owners.
(vi) VOTING POWER	<ul style="list-style-type: none"> • Debenture-holders have no right to cast vote in the company's general meeting.
(vii) PRIORITY	<ul style="list-style-type: none"> • At the time of liquidation, the first priority is given to debenture-holders at the time of repayment.

(C) KINDS OF DEBENTURES

1. FROM THE POINT OF VIEW OF 'SECURITY'

(i) SECURED DEBENTURES	<ul style="list-style-type: none"> • The debentures which are secured by a charge on the assets or property of the company are known as secured debentures. • It is a Debt security backed by a specific asset of the issuer • If the company fails to pay the interest or principal amount, then debenture holders can sell the assets in order to satisfy their claims. They are known as Mortgage Debentures.
(ii) UNSECURED DEBENTURES	<ul style="list-style-type: none"> • The debentures which do not carry any charge or security on the assets of the company, are known as unsecured debentures • In case of any default in payment, debenture holders can only file a suit for recovery of money. They are also known as Naked Debentures.

2. FROM THE POINT OF VIEW OF 'TIME'

(i) REDEEMABLE DEBENTURES	<ul style="list-style-type: none"> • These are those debentures which are repayable at the end of the specified period, either in lump-sum or in instalments during the lifetime of the company
(ii) IRREDEEMABLE DEBENTURES	<ul style="list-style-type: none"> • These are those debentures which are not repayable during the lifetime of the company and are repaid only on the winding up of a company

3. FROM THE POINT OF VIEW OF 'CONVERTIBILITY'

(i) CONVERTIBLE DEBENTURES	<ul style="list-style-type: none">The debentures which can be converted into equity shares after the expiry of a specified period, are known as convertible debentures
(ii) NON-CONVERTIBLE DEBENTURES	<ul style="list-style-type: none">The debentures which cannot be converted into equity shares, are known non-convertible debentures

4. FROM THE POINT OF VIEW OF 'COUPON RATE'

(i) SPECIFIC COUPON RATE DEBENTURES	<ul style="list-style-type: none">These debentures are issued with a specific rate of interest, which is called as the Coupon rateThis rate may be fixed or floating
(ii) ZERO COUPON RATE DEBENTURES	<ul style="list-style-type: none">These debentures don't carry a specific rate of interest.In order to compensate the investors, such debentures are issued at a substantial discount

5. FROM THE POINT OF VIEW OF 'REGISTRATION'

(i) REGISTERED DEBENTURES	<ul style="list-style-type: none">The debentures in which the names of debenture holders are duly recorded in the register maintained by the company are known as registered debentures
(ii) BEARER DEBENTURES	<ul style="list-style-type: none">The debentures which can be transferred by mere delivery are known as bearer debentures.

6. FROM THE POINT OF VIEW OF 'PRIORITY'

(i) FIRST DEBENTURES	<ul style="list-style-type: none">Debentures which are repaid before other debentures are repaid.
(ii) SECOND DEBENTURES	<ul style="list-style-type: none">Debentures which are paid after the other debentures are paid.

The issue of Debentures for Cash

Debentures in accustomed progress of the business concern are circulated for cash. Circulation of debentures that occurs can be categorised into 3 types, like the issue of shares at a discount, at a premium and at par.

The issue of Debentures at Discount

When the debentures are circulated below the face value, this type of circulation of debentures is called a discount issue. Say, for instance, the debenture possesses a nominal value of 200/- but is issued for 190/-. This type of debentures is known to be issued at a discount.

The issue of Debentures at Premium

The issue of debentures at a premium is when the money is charged more than the nominal value. The premium amount charged to a special a/c is known as Securities Premium Reserve A/c. This account shall be depicted on the liabilities side of the Balance Sheet below the heading Reserves and Surplus. So, if a debenture with a face value of 200/- is sold at 210/- then it is circulated at a premium.

4.3 REDEMPTION OF DEBENTURES

Redemption of debentures refers to the repayment of these debentures by the company to the debenture holders. So, the company will discharge its liability and remove it from the balance sheet. This is a major transaction for the company since the amount of money involved tends to be quite significant.

There are a few ways in which this redemption of shares can take place. These methods all have different accounting treatment as well. So, let us take a look at the various methods of redemption of debentures.

Lump Sum Method

This method as the name suggests is a one-time payment method. Here the company will repay the whole amount in one lump sum payment to the debenture holders. The amount and the date of the payment will be according to the terms of issue.

Since the company knows the date of the repayment in advance, they can plan their finances accordingly. So, they make provisions to pay the debenture holders. So as per the provisions of the Companies Act and the SEBI guidelines the company has to make provisions for such a debenture. And hence the company sets up a special account known as the Debenture Redemption Reserve.

This debenture redemption reserve is a capital reserve account. It is funded by the divisible profits of each year, i.e. a portion of the profits are set aside for this purpose. This account can only be utilized for the purpose of redemption of debentures and for no other purpose.

Accounting Treatment

The entries passed in the first year of the debentures is as follows

Sr No	Particulars		Amount	Amount
1	Profit & Loss Appropriation A/c	Dr	xxx	
	To Debenture Redemption Fund A/c			xxx
	(Being appropriation of profit to DRF A/c)			
2	DRF Investment A/c	Dr	xxx	
	To Bank A/c			xxx
	(Being amount invested in securities)			

The entries passed in the subsequent years are as follows

Sr No	Particulars		Amount	Amount
1	Bank A/c	Dr	xxx	

	To Interest on DRF Investment A/c			xxx
	(Being interest received on investment made)			
2	Interest on DRF Investment A/c	Dr	xxx	
	To Debenture Redemption Fund A/c			xxx
	(Being interest credited to DRF account)			
3	Profit & Loss Appropriation A/c	Dr	xxx	
	To Debenture Redemption Fund A/c			xxx
	(Being appropriation of profit to DRF A/c)			
4	DRF Investment A/c	Dr	xxx	
	To Bank A/c			xxx

	(Being amount invested in securities)			
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And now finally the entries passed in the last year, i.e. the year of redemption

Sr No	Particulars		Amount	Amount
1	Bank A/c	Dr	xxx	
	To Debenture Redemption Fund Investment, A/c			xxx
	(Being investment sold)			
2	Profit & Loss Appropriation A/c	Dr	xxx	
	To Debenture Redemption Fund A/c			xxx
	(Being amount of profit transferred)			
3	Debenture Redemption Fund A/c	Dr	xxx	

	To General Reserve A/c			xxx
	To Capital Reserve A/c			xxx
	(Profit on sale of investment)			

Instalment Method

This is also known as the drawing of lots method. Here the company will start redeeming debentures in lots or instalments from one particular year as agreed by the terms of issue. Let us see the accounting entries for the same.

If the Debentures are redeemed from profits

Sr No	Particulars		Amount	Amount
1	Profit & Loss Appropriation A/c	Dr	xxx	
	To Debenture Redemption Fund A/c			xxx
2	Debentures A/c	Dr	xxx	
	To Debenture Holders A/c			xxx

3	Debenture Holders A/c	Dr	xxx	
	To Bank A/c			xxx

Conversion Method

A company may opt to not pay the debenture holders at the time of redemption. Instead of that, it can convert the debentures into a new class of debentures or even equity shares. Such debentures are known as convertible debentures. Such new debentures or shares can be issued at par, premium or even discount. Let us see the accounting treatment for these scenarios.

Debentures converted to a new class of debentures

Sr No	Particulars		Amount	Amount
1	8 % Debentures A/c (old)	Dr	xxx	
	To 9% Debentures A/c (New)			xxx
	(Being debentures converted to new debentures)			

Debentures converted to Equity Shares

Sr No	Particulars		Amount	Amount
1	8 % Debentures A/c (old)	Dr	xxx	
	To Equity Share Capital			xxx
	(Being debentures converted to new shares)			

Debentures converted to shares at a premium

Sr No	Particulars		Amount	Amount
1	8 % Debentures A/c (old)	Dr	xxx	
	To Equity Share Capital			xxx
	To Securities Premium A/c			
	(Being debentures converted to new shares)			

Purchasing Method

In this method, the company will buy its debentures from the open market and then immediately cancel them. This is known as the purchase from the open market. This way the company can defer the redemption till it is suitable to them. Also, if they buy the debentures for a discount, they can make additional benefits/profits as well.

When debentures are purchased for a premium

Sr No	Particulars		Amount	Amount
1	Debentures A/c	Dr	xxx	
	Loss on Redemption A/c	Dr	xxx	
	To Bank A/c			xxx
2	Profit and Loss A/c	Dr	xxx	
	To Loss on Redemption A/c			xxx

When debentures are purchased at a discount

Sr	Particulars		Amount	Amount
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No				
1	Debentures A/c	Dr	xxx	
	To Profit on Redemption A/c	Dr	xxx	
	To Bank A/c			xxx
2	Profit on Redemption A/c	Dr	xxx	
	To Capital Reserve A/c			xxx

4.4 UNDERWRITING OF SHARES AND DEBENTURES

Meaning of Underwriting:

We know that a 'Certificate of Commencement of Business' will not be granted to a public company until it receives the minimum subscriptions from the public. Moreover, when a company wants to raise funds by the issue of shares or debentures, it should raise at least 90% of the issue within a time limit of 120 days from the date of opening the issue.

In order to avoid that risk, the public companies enter into underwriting arrangements. Underwriting means guaranteeing to subscribe to an agreed number of shares or debentures for a certain consideration.

In other words, the company will pay anyone a certain percentage of commission on all shares or debentures issued to the public if the person guarantees that he will take the remaining shares which are not taken up by the public.

As such, the person or institution who underwrites the issue is called 'underwriters' and the commission so paid is known as 'Underwriting Commission'. In order to avoid the risk arising from certain unforeseen contingencies it is better, on the part of a company, to get the shares or debentures underwritten.

In our country, underwriting is done by the Industrial Development Bank of India, Industrial Finance Corporation of India, Life Insurance Corporation of India, The Industrial Credit and Investment Corporation of India, Commercial Banks, Investment Trust, etc.

The usual contents of underwriting agreements are:

- i. The underwriters must agree to underwrite a certain number of shares or debentures;
- ii. All the shares are to be offered to the public according to the specified prospectus of the company;
- iii. The undertaking agreement must also contain an authority for the company to allot balance of the shares which are not taken up by the public;
- iv. It is an undertaking on the part of the company to pay the commission to the underwriters.

SEBI Guidelines 2000: Regarding Underwriting:

Some Important Guidelines:

- (a) The underwriting of shares or debentures is optional, i.e., Not Mandatory.
- (b) The lead merchant bankers must satisfy themselves relating to the ability of the underwriters to perform their underwriting obligations.
- (c) The lead merchant banker must take consent of the underwriter in writing before recording the same to the offer document.
- (d) The lead merchant bank should undertake a minimum underwriting obligation of 5% of the total commitment or Rs. 25 lakhs, whichever is less, at any point of time.
- (e) The outstanding underwriting commitment of a merchant banker should not exceed 20 times its net worth.
- (f) The lead merchant banker must see that the relevant details of the underwriters are recorded in the offer document.

Underwriting Commission:

According to Sec. 76 of the Companies Act, 1956, the payment of underwriting commission is made if the following conditions are satisfied:

- (i) The payment of commission is possible only when the same is authorised by the Articles;
- (ii) The commission paid or agreed to be paid does not exceed
 - (a) In case of shares, 5% of the price at which the shares are issued or the amount or rate authorised by the Articles, whichever is less, and
 - (b) In case of debentures, 2½% of the price at which the debentures are issued or this amount or rate authorised by the Articles, whichever is less;
- (iii) Underwriting commission may be paid in cash or in kind or lump sum as per respective percentage mentioned above and the same cannot exceed the said percentage in any case;
- (iv) No underwriting commission shall be paid to any person which are not offered for public subscription;
- (v) The commission paid or agreed to be paid is disclosed in the prospectus or statement in lieu of prospectus, as the case may be;
- (vi) The number of underwriting shares or debentures must also be disclosed in the prospectus or in the statement in lieu of prospectus;
- (vii) While delivering the prospectus or the statement in lieu of prospectus to the Registrar of Companies a copy of the contract against the underwriting commission must be delivered to the Registrar of Companies of the concerned State;
- (viii) Underwriting commission should always be calculated on the issue price of shares or debentures of the guaranteed issue;
- (ix) There may be sub-underwriters who work under the main/original underwriter;
- (x) The underwriter has to take some specified shares/debentures in case of Firm Underwriting, whereas, in case of conditional underwriting, the underwriter acquires those shares which are not taken up by the public.

Important Points:

- (a) Underwriting Commission at the specific rate is payable on the whole issue of shares or debentures that are underwritten by the underwriters—whether they have to take up or not any shares or debentures.

(b) If any share or debenture is taken up by the promoter, directors, employees etc., no underwriting commission is payable on such shares or debentures.

(c) No commission shall be paid on shares or debentures which are not offered to the public for subscription—except where they were subscribed or agreed to be subscribed before the issue of the prospectus or statement in lieu of prospectus.

(d) As per SEBI Guidelines, no person can act as underwriter unless and until he gets a certificate from SEBI; other than a share broker or Merchant banker.

Tutorial Note:

According to SEBI Guidelines, underwriting is not mandatory. It depends on the company but where the minimum subscriptions of 90% of the offer to the public are not received within the stipulated date, the entire amount should be refunded in full.

Rate/Percentage of Underwriting Commission:

It has already been stated above that the maximum rate of commission on the issue of shares is 5% and on the issue of Debentures @ 2½% at which the shares or debentures are issued.

But as per the guidelines issued by the Stock Exchange Division, Department of Economic Affairs, Ministry of Finance [vide: No F14/1/SE/85 dated 7.5.1985] the rates of underwriting commission are:

	On amount devolving on underwriters (%)	On amounts subscribed by the public (%)
A. Equity share	2.5	2.5
B. Preference share/Convertible or Non-convertible Debentures		
(i) For amounts not exceeding Rs. 5,00,000	2.5	1.5
(ii) For amount exceeding Rs. 5,00,000	2	1

Needless to say, that the above rate of underwriting commission is the maximum rate. It may be given at a lower rate if possible. As per SEBI Guidelines also, rate of underwriting commission must not exceed @ 2.5% of issue price.

Underwriting Agreement:

Underwriting agreement is of two types:

(a) Pure Underwriting/Conditional Underwriting:

Under this type of underwriting, underwriters undertake to subscribe for shares to a certain limit only when the offer which is made to the public is not fully subscribed for, i.e., the balance of shares to be taken over by them. For example, if the underwriters underwrite 20,000 shares, and if the public takes up only 12,000 shares, the balance will have to be undertaken by the underwriters.

(b) Firm Underwriting:

Under this type of underwriting, the underwriters agree to make an outright purchase of shares. Therefore, under this type, the underwriters stipulate that they must be allowed a given number of shares whether the issue is oversubscribed or not. Of course, if there is any oversubscription of shares, they will get the priority over the general public regarding allotment of shares.

Marked and Unmarked Applications:

Underwriters issue application forms to the public for subscription which carry the stamp of the particular underwriter. If the shares are underwritten by different underwriters, each underwriter will use his own seal/stamp out of his holding which enables the company to identify the name of the underwriter among them.

This is very important in order to ascertain the amount of commission as well to ascertain the liability of the underwriters for unsubscribed shares/debentures.

In short, a company can ascertain how much shares/debentures are issued by a particular underwriter. Similarly, an underwriter can also assess his own liability and the amount of underwriting commission to which he is entitled. The application forms which carry any seal or stamp of any underwriter is called Marked Application.

Similarly, the application forms which do not carry any seal or stamp of any underwriter is called Unmarked Application. It is particularly applicable where a shareholder directly gets the application from the company. It may be mentioned here that if a single underwriter underwrites the whole issue then the question of difference between marked and unmarked applications does not arise.

Full Underwriting and Partial Underwriting:

Full Underwriting:

When the underwriter(s) guarantees the whole issues the same is known as Full Underwriting.

Partial Underwriting:

When the underwriter(s) guarantees a part or a portion of the whole issue, (say, 80% of the whole issue) the same is known as Partial Undertaking. In that case, the company has to take the responsibility to underwrite the balance of shares.

Joint Underwriting:

When there is more than one underwriter, the same is known as 'Joint Underwriting' and the underwriters are called joint underwriters. Suppose, X and Y underwrite 5,000 shares of a company in 3: 2 (viz. X 3,000 shares and Y 2,000 shares), the so-called underwriting will be termed as joint underwriting.

Needless to say, that, under the circumstances, unmarked forms to be given to them as per their gross liability ratio (i.e., 3: 2). Thereafter, they will be given the marked forms. If there are any surplus, the same should be “distributed between the others as per their gross liability ratio.

Firm Underwriting:

When the underwriters commit to take a specified number of share(s)/debenture(s) of a company—whether the same share(s) or debenture(s) are subscribed by the public or not—the same is known as Firm Underwriting.

Example:

X, Y and Z underwrite to subscribe for 5,000 shares, 3,000 shares and 2,000 shares, respectively. Of which the firm underwriting is 2, 000,1000 and 500 shares of X, Y and Z, respectively. In other words, only 6,500 shares (i.e., 5000 + 3,000 + 2,000 shares – 2,000 – 1,000 – 500) may be issued to the public.

If there is oversubscription of shares, say, in the above case, if application is received for 7,000 shares, the allotment to be made for public only 6,500 shares. In short, if the issue is oversubscribed, only agreed number of shares/debentures can be taken up—in case of firm underwriting.

Accounting Entries:

The following entries are to be made in the books of the company:

(a) For Commission or Brokerage due:

Commission/Brokerage on Issue of Shares/Debentures A/c Dr.

To Underwriter’s/Broker’s A/c

(b) For Commission/or Brokerage paid:

Underwriter’s/Broker’s A/c Dr.

To Cash/Bank/Shares/Debentures A/c

(c) For acquiring any liability in case of under-subscription:

Underwriter’s A/c Dr.

To Share Capital/Debentures A/c

(d) For receiving payment:

Bank A/c Dr.

To Underwriter’s A/c,

General Illustrations:

Firm underwriting treated as marked applications:

Illustration 1:

The following underwriting took place for a company:

X 6,000 shares; Y 2,500 shares; Z 1,500 shares.

In addition, there were firm underwriting as:

X 800 shares; Y 300 shares; Z 1,000 shares.

The share issue was 10,000 shares. Total subscriptions including firm underwriting was 7,100 shares and the forms included the following marked forms:

X 1000 shares; Y 2000 shares; and Z 500 shares.

Show the allocation of the liability of the underwriters.

Solution

Calculation of Unmarked Applications

Underwriters	Marked Applications	Firm Applications	Total
X	1,000	800	1,800
Y	2,000	300	2,300
Z	500	1,000	1,500
	<u>3,500</u>	<u>2,100</u>	<u>5,600</u>

∴ Unmarked application = 7,100 – 5,600 = 1,500 shares

Statement showing the Liabilities of Underwriters

Name of the Underwriters:		X	Y	Z	Total
		Shares	Shares	Shares	Shares
	Gross Liability	6,000	2,500	1,500	10,000
Less:	Marked Application (including firm underwriting)	<u>1,000</u>	<u>2,000</u>	<u>500</u>	<u>3,500</u>
		5,000	500	1,000	6,500
		Shares	Shares	Shares	Shares
Less:	Unmarked Application 1,500 shares divided as per ratio of gross liabilities 12 : 5 : 3	(-) 900	(-) 375	(-) 225	(-) 1,500
		<u>4,100</u>	<u>125</u>	<u>775</u>	<u>5,000</u>
Less:	Firm Underwriting	(-) 800	(-) 300	(-) 1,000	(-) 2,100
	Balance	<u>3,300</u>	<u>-175</u>	<u>-225</u>	<u>2,900</u>
	Adjustment of Negative balance	- 175	+ 175		—
		<u>-225</u>		<u>+225</u>	
		<u>2,900</u>	<u>—</u>	<u>—</u>	<u>2,900</u>
	Firm Liability	800	300	1,000	2,100
		<u>3,700</u>	<u>300</u>	<u>1,000</u>	<u>5,000</u>

Illustration 2:

X. Ltd. issued 10,000 shares of Rs. 100 each at a premium of Rs. 15 each. Ninety per cent of the issue was underwritten by M/s Broker and Co. at a commission of 1% on the nominal face value.

Applications were received for 8,000 shares and allotment was fully made. All the money due from allottees was received in one instalment. The accounts with Broker & Co. were settled.

(a) Show the Journal entries to record the transactions.

(b) What would be the liability of M/s Broker & Co. if applications were received for 12,000 shares but marked applications were 8,000 shares?

Solution

(a)

**In the books of X Ltd.
Journal**

Date	Particulars	L.F.	Debit	Credit
?	Bank A/c Dr. To Share Application & Allotment A/c (Application & Allotment money received on 8,000 shares @ Rs. 115.)		Rs. 9,20,000	Rs. 9,20,000
?	Share Application & Allotment A/c Dr. To Share Capital A/c " Securities Premium A/c (Share Application & Allotment money on 8,000 shares @ Rs. 100 transferred to Share Capital A/c and Premium being transferred to Securities Premium A/c as per Board's Resolution dated)		9,20,000	8,00,000 1,20,000
?	M/s Broker & Co A/c Dr.* To Share Capital A/c (1,800 × 100) " Securities Premium A/c (Share taken by Broker & Co. for underwriting)		2,07,000	1,80,000 27,000
?	Underwriting Commission A/c Dr. To Broker & Co. A/c (Underwriting commission payable to M/s Broker & Co. on good shares)		9,000	9,000
?	Bank A/c Dr. To M/s Broker & Co. (Balance amount review from M/s Broker & Co.)		1,98,000	1,98,000

	Broker & Co.	X Ltd. (assumed @ 10% of the shares are taken by the company itself)
Gross Liability	9,000	1,000
Less: Applications received in the share 9 : 1	7,200	800
Net Liability	1,800	200

(b) Gross liability of the underwriter is 9,000 shares (i.e., 10,000 shares × 90%)

Marked Application 8,000 shares.

Since applications have been received for 12,000 shares, net liability of the Broker & Co. is Nil.

(b) Gross liability of the underwriter is 9,000 shares (i.e., 10,000 shares × 90%) Marked Application 8,000 shares.

Since applications have been received for 12,000 shares, net liability of the Broker & Co. is Nil.

Illustration 3:

Sardar Limited issued to public 1,50,000 equity shares of Rs. 100 each at par. Rs. 60 per share was payable along with application and the balance on allotment. This issue was underwritten equally by Ali, Bali and Charlie for a commission of 2.5 per cent.

Applications for 1,40,000 shares were received as per details:

Underwriter	Firm Application	Marked Application	Total
Ali	5,000	40,000	45,000
Bali	5,000	46,000	51,000
Charlie	3,000	34,000	37,000
Unmarked Applications			7,000
Total			1,40,000

It was agreed to credit the unmarked applications equally to Ali and Charlie. Sardar Limited accordingly made the allotment and received the amounts due from the public. The underwriters settled their accounts.

You are required to:

- (i) Prepare a statement showing the liability of the underwriters; and
- (ii) Journalize the above transactions (including cash) in the books of Sardar Ltd.

Solution

**In the books of Sardar Ltd.
Statement showing Number of Shares to be taken up
and Commission Receivable by each Underwriter**

Name of the Underwriters :	Ali	Bali	Charlie	Total
	No. of Shares	No. of Shares	No. of Shares	No. of Shares
Gross Liability (1,50,000 shares equally)	50,000	50,000	50,000	1,50,000
Less: Marked Application (excluding firm underwriting)	40,000	46,000	34,000	1,20,000
	10,000	4,000	16,000	30,000
Less: Unmarked Application (1,27,000 – 1,20,000)	3,500	—	3,500	7,000
	6,500	4,000	12,500	23,000
Less: Firm Underwriting	5,000	5,000	3,000	13,000
	1,500	(-) 1,000	9,500	10,000
Excess of Bali's Surplus to Ali and Charlie in 1 : 1	- 500	+ 1,000	- 500	—
	1,000	—	9,000	10,000
Add: Firm Underwriting	5,000	5,000	3,000	13,100
Gross Liability	6,000	5,000	12,000	23,000

Net Amount Due from/Due to Underwriters

Name of the underwriters :	Ali	Bali	Charlie
No. of shares subscribed	6,000	5,000	12,000
Amount due @ Rs. 60 per share	3,60,000	3,00,000	7,20,000
Less: Amount already paid on firm applications	3,00,000	3,00,000	1,80,000
	60,000	—	5,40,000
Less: Underwriting Commission @ 2.5% on issue price	1,25,000	1,25,000	1,25,000
	(-) 65,000	(-) 1,25,000	4,15,000

Journal

Date	Particulars	L.F.	Debit	Credit
			Rs.	Rs.
?	Bank A/c Dr. To Share Application A/c (Application money received on 1,40,000 shares @ Rs. 60 per share)		84,00,000	84,00,000
?	Share Application A/c Dr. To Share Capital A/c (Share Application money of 1,40,000 shares of Rs. 60 each transferred to Share Capital A/c, as per Board's Resolution dated...)		84,00,000	84,00,000
?	Ali A/c Dr. Charlie A/c Dr. To Equity Share Capital A/c (Allotment of shares made to Ali & Charlie as per Board's Resolution dated)		60,000 5,40,000	6,00,000
?	Underwriting Commission A/c Dr. To Ali A/c " Bali A/c " Charlie A/c (Underwriting Commission @ 2.5% payable to Ali, Bali and Charlie)		3,75,000	1,25,000 1,25,000 1,25,000
"	Bank A/c Dr. To Charlie A/c (Amount received from Charlie after adjusting underwriter commission)		4,15,000	4,15,000
?	Ali A/c Dr. Bali A/c Dr. To Bank A/c (Amount paid to Ali & Bali after adjusting underwriting commission.)		65,000 1,25,000	1,90,000
?	Share Allotment A/c (1,50,000 × Rs. 40) Dr. To Share Capital A/c (Share allotment money of 1,50,000 shares of Rs. 40 each transferred to Share Capital A/c as per Board's resolution dated ...)		60,00,000	60,00,000
?	Bank A/c Dr. To Share Allotment A/c (Amount received on allotment of 1,50,000 shares of Rs. 40 each)		60,00,000	60,00,000

Calculation of Settlement with Underwriters:

Illustration 4:

Libra Ltd. came up with an issue of 20,00,000 equity shares of Rs. 10 each at par. 5,00,000 shares were issued to the promoters and the balance to the public was underwritten by three underwriters—Anand, Vijay and Ashoke equally, with firm underwriting of 50,000 shares each.

Subscriptions totalled 12,97,000 shares including the marked forms which were:

Anand 4,25,000 shares

Vijay 4,50,000 shares

Ashoke 3,50,000 shares

The underwriters had applied for shares covered by firm underwriting. The amount payable on application and allotment were Rs. 2.50 and Rs. 2, respectively. The agreed commission was 2.5%.

Pass necessary journal entries for:

(a) The allotment of shares to the underwriters;

(b) The commission due to each of them; and

(c) The net cash paid and/or received.

Note:

Unmarked applications are to be credited to the underwriters equally.

Solution

**In the books of Libra Ltd.
Statement showing Liability of the Underwriters**

Name of the Underwriters:	Anand	Vijay	Ashoke	Total
	Shares	Shares	Shares	Shares
No. of shares underwritten	5,00,000	5,00,000	5,00,000	15,00,000
Less: Marked Application	4,25,000	4,50,000	3,50,000	12,25,000
	75,000	50,000	1,50,000	2,75,000
Less: Firm Application	Shares 50,000 25,000	Shares 50,000 —	Shares 50,000 1,00,000	Shares 1,50,000 1,25,000
Less: Unmarked Applications (equally) (12,97,000 – 12,25,000)	36,000 (–) 11,000	—	36,000 64,000	72,000 53,000
Less: Anand's Surplus to Ashoke Net Liability	11,000 —	—	(–) 11,000 53,000	— 53,000
Add: Firm Underwriting ∴ Gross Liability	50,000 <u>50,000</u>	50,000 <u>50,000</u>	50,000 <u>1,03,000</u>	

Statement showing the Amount to be Received/Paid by the Underwriters

Name of the Underwriters:	Anand	Vijay	Ashoke
Underwriters' liability (calculated as above)	50,000	50,000	1,03,000
	Rs.	Rs.	Rs.
Amount to be paid by them @ Rs.4.50 per share =	2,25,000	2,25,000	4,63,500
Less: Amount paid on firm applications @ Rs. 2.50 on 50,000 shares	1,25,000	1,25,000	1,25,000
	1,00,000	1,00,000	3,38,500
Less: Commission to be received on underwriting shares @ 2.5% on 50,000 shares each	1,25,000	1,25,000	1,25,000
Amount Paid	25,000	25,000	—
Amount Received	—	—	<u>1,13,500</u>

Journal

Date	Particulars	L.F.	Debit Rs.	Credit Rs.
?	Bank A/c Dr. To Share Application A/c (Amount received from the underwriters for 50,000 shares each @ Rs. 2.50.)		3,75,000	3,75,000
?	Share Application A/c Dr. To Share Capital A/c (Share application money of 1,50,000 shares @ Rs. 2.50 transferred to Share Capital A/c)		3,75,000	3,75,000
?	Anand A/c Dr. Vijay A/c Dr. Ashoke A/c Dr. To Equity Share Capital A/c (Allotment of shares to Anand, Vijay and Ashoke of 50,000, 50,000, and 1,03,000, respectively, transferred to Share Capital.)		1,00,000 1,00,000 3,38,500	5,38,500
?	Underwriting Commission A/c Dr. To Anand A/c " Vijoy A/c " Ashoke A/c (Amount payable to underwriters for their commission @ 2.5%)		3,75,000	1,25,000 1,25,000 1,25,000
?	Bank A/c Dr. To Ashoke A/c (Amount received from Ashoke after adjusting the underwriting commission.)		1,13,500	1,13,500
?	Anand A/c Dr. Vijoy A/c Dr. To Bank A/c (Amount paid to the underwriters after adjusting the payment on their holdings.)		25,000 25,000	50,000

Illustration 5:

Chaitanya Chemicals Ltd. planned to set up a unit for manufacture of bulk drugs. For the purpose of financing the unit, the Board of Directors have issued 15,00,000 equity shares of Rs. 10 each, 30% of the issue was reserved for promoters and the balanced was offered to the public. Aditya, Diwan and Anoop have come forward to underwrite the public issue in the ratio of 3:1: 1 and also agreed for

firm underwriting of 30,000; 20,000 and 10,000 shares, respectively. The underwriting commission was fixed at 2.5%. The amount payable on application was Rs. 2.50 per share.

The details of subscriptions are:

Marked forms of Aditya 50,000 shares

Marked forms of Diwan 20,000 shares

Marked forms of Anoop 1,50,000 shares

Unmarked forms 50,000 shares

- (a) You are required to show the allocation of liability among underwriters with workings.
- (b) Pass journal entries in the books of Chaitanya Chemicals Ltd.:
 - (i) For underwriters' net liability and the receipt or payment of cash to or from underwriters.
 - (ii) Determining the liability towards the payment of commissions to the underwriters.

Solution

Statement showing the Allocation of Liability of the Underwriters

Name of the Underwriters:	Aditya	Diwan	Anoop	Total
	Shares	Shares	Shares	Shares
No. of shares underwritten (70% of 15,00,000 in 3:1:1)	6,30,000	2,10,000	2,10,000	10,50,000
Less: Marked Application	5,50,000	2,00,000	1,50,000	9,00,000
	80,000	10,000	60,000	1,50,000
Less: Firm Application	30,000	20,000	10,000	60,000
	50,000	(-)10,000	50,000	90,000
Less: Unmarked Application (3 : 1 : 1)	30,000	10,000	10,000	50,000
	20,000	(-)20,000	40,000	40,000
Less: Excess of Diwan's surplus between Aditya and Anoop in (3 : 1)	15,000	20,000	5,000	—
Net Liability	5,000	—	35,000	40,000
Add: Firm Underwriting	30,000	20,000	10,000	60,000
	35,000	20,000	45,000	1,00,000

Statement showing the Amount to be Received/Paid by the Underwriters

Name of the Underwriters:	Aditya	Diwan	Anoop
Underwriters' liability (calculated as above)	35,000	20,000	45,000
Less: Firm Underwriting	30,000	20,000	10,000
	5,000	—	35,000
Amount to be paid by them @ Rs. 2.50 per share	12,500	—	87,500
Less: Commission to be received on underwriting shares @ 2.5%	1,57,500	52,500	52,500
Amount Paid	1,45,000	52,500	—
Amount Received	—	—	35,000

In the books of Chaitanya Chemicals Journal

Date	Particulars	L.F.	Debit	Credit
?	Aditya A/c Dr. Anoop A/c Dr. To Equity Share Capital A/c (Allotment of shares to Aditya & Anoop 5,000 and 35,000, respectively, transferred to share capital.)		Rs. 12,500 87,500	Rs. 1,00,000
?	Underwriting Commission A/c Dr. To Aditya A/c " Diwan A/c " Anoop A/c (Amount payable to underwriter for their commission @ 2.5%)		2,62,500	1,57,500 52,500 52,500
?	Bank A/c Dr. To Anoop A/c (Amount received from Anoop after adjusting his commission.)		Rs. 35,000	Rs. 35,000
?	Aditya A/c Dr. Diwan A/c Dr. To Bank A/c (Amount paid to the underwriters after adjusting their commission.)		1,45,000 52,500	1,97,500

4.5 SUMMARY

- A debenture is a type of bond or other debt instrument that is unsecured by collateral. Since debentures have no collateral backing, debentures must rely on the creditworthiness and

reputation of the issuer for support. Both corporations and governments frequently issue debentures to raise capital or funds. A debenture is one of the capital markets instruments which is used to raise medium- or long-term funds from public. A debenture is essentially a debt instrument that acknowledges a loan to the company and is executed under the common seal of the company. The debenture document, called Debenture deed contains provisions as to payment, of interest and the repayment of principal amount and giving a charge on the assets of a such a company, which may give security for the payment over the some or all the assets of the company. Issue of Debentures is one of the most common methods of raising the funds available to the company. It is an important source of finance. In a sense, all debentures are bonds, but not all bonds are debentures. Whenever a bond is unsecured, it can be referred to as a debenture.

- Debentures generally have a more specific purpose than other bonds. While both are used to raise capital, debentures typically are issued to raise capital to meet the expenses of an upcoming project or to pay for a planned expansion in business. These debt securities are a common form of long-term financing taken out by corporations.
- Debentures carry either a floating or a fixed-interest coupon rate return to investors and will list a repayable date. When the interest payment is due, the company will, most often, pay the interest before they pay shareholder dividends.
- On the due date, the company has two general choices of repayment of principal. They may pay in one lump sum or make instalment payments. The instalment plan is known as a debenture redemption reserve, and the company will pay a set amount each year to the investor until maturity. The terms of the debenture will be listed in the underlying documentation.
- Debentures are sometimes called revenue bonds because the issuer expects to repay the loans from the proceeds of the business project they helped finance. Physical assets or collateral do not back debentures. They are backed solely by the full faith and credit of the issuer.
- Some debentures, like other bonds, are convertible, meaning they can be converted into company stock, while others are non-convertible. Generally, investors prefer convertibles and will accept a slightly lower return to get them.
- Like any bond, debentures can be purchased through a broker.
- To complicate matters, this is the American definition of a debenture. In British usage, a debenture is a bond that is secured by company assets. In some countries, the terms are interchangeable.
- The issue of Debentures is very similar to the issue of shares by a company. Here to the money can be collected lump sum or in instalments. The accounting treatment of the two is also quite similar. Now debentures can be issued for cash or some other consideration. At times issue of debentures is also done as a collateral security. Debentures in the general course of business are issued for cash. This issue of debentures that happens can be of three kinds, just like an issue of shares, at par, at a discount, and at a premium. So let us take a look at all three and their respective

accounting entries as well. Section 2 (30) of the Companies Act, 2013 defines the term Debentures as “debenture includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not;

- Debenture is a debt acknowledged by a Company whether constituting a charge on the assets of the Company or not, whether convertible into shares at a later stage or not. Which means that a Debenture can be Secured or Unsecured, it can be Convertible (either wholly or partly) or Non-convertible. As Debentures are in the form of debt, unlike shares they don't carry voting rights.
- Underwriting (issue of shares or debentures) is a contract between a company and another party called underwriter, where by, in the event of the shares or debentures not being subscribed fully by the public, the underwriter agrees to take up the balance.
- Underwriting commission:-in consideration of service rendered by underwriter, the underwriter paid a commission. Maximum commission paid to underwriter at a rate authorized by the articles, not exceeding 2.5% of the issue price of debentures and 5% of issue of shares. Underwriting of shares and debentures is a contract between company and second party. Second party is called underwriters. They promise to sell all the shares of company to public, if any shares or debentures will be unsold, they will buy all these shares or debentures. For this service, they get underwriting commission.
- Underwriting commission is payment which is given by company to underwriters for their services of underwriting. Actually, contract of underwriting is same as the contract of insurance. Company gives maximum 5% commission to underwriter for selling his shares. Underwriter will take the risk of takeover the shares which will not be subscribed by public.

4.6 KEY WORDS

- Unsecured Debt: debt which is not covered by specific assets in the event of a default.
- Secured Debt: debt which is covered by specific assets in the event of a default.
- Redemption: Repayment of a debt security or preferred stock issue by payment of the principal at maturity, or at an earlier date if the issuer calls the security and pays a premium to debt security holders.
- Par Value: stated value of a share of stock – usually a minimal value
- Book Value: a company's total assets minus intangible assets and liabilities.

4.7 LEARNING ACTIVITY

1. Explain underwriting commission?

2. What are the types of underwriting?

4.8 UNIT-END QUESTIONS

A. Descriptive Questions

1. What do you mean by debenture? State the features of debenture when a company is raising funds through debt securities?
2. Raghav Limited purchased a running business from Krishna traders for a sum of ₹15,00,000 payable ₹3,00,000 by cheque and for the balance issued 9% debentures of ₹100 each at par. The assets and liabilities consisted of the following: Plant and Machinery ₹4, 00,000 Building ₹6, 00,000 Stock ₹5,00,000 Debtors ₹3, 00,000 Creditors ₹2,00,000. Calculate amount of capital reserve
3. AB Ltd. purchased assets worth Rs. 6, 80,000 and took over liabilities of Rs. 80,000. It was agreed to pay the purchase price of Rs. 6,40,000 by issuing debentures valued Rs. 4,40,000 of Rs. 100 each at a premium of 10% and balance in cash. Journalise the transaction in the books of purchasing company.
4. Know the different types of underwriting when Infosys is issuing debenture
5. You are required to pass journal entries for the issue of following debentures:
 - (a) 120 10% Rs. 1,000 Debentures are issued at 5% discount and are repayable at par.
 - (b) Another 150 7% Rs. 1,000 Debentures are issued at 5% discount and repayable at 10% premium.
 - (c) Further 80 9% Rs. 1,000 Debentures are issued at 5% premium.
 - (d) In addition, another 400 8% Rs. 100 Debentures are issued as collateral security against a loan of Rs. 40,000.

B. Multiple Choice Questions

1. Debentures contain the contract of repayment of:
 - a. Interest
 - b. Principal
 - c. Both(a)&(b)
 - d. None of the above
2. Debentures are _____ for the company.
 - a. Assets
 - b. Liabilities
 - c. Contingent liability
 - d. Intangible liability
3. From the point of view of TENURE debentures can be classified into-
 - a. Redeemable

- b. Non- redeemable
- c. Both (a)&(b)
- d. First debenture

4. Debentures which do not carry a specific rate of interest:

- a. Specific debentures
- b. Bonds
- c. Zero-coupon rate debentures
- d. Second debentures

5. The debentures, in which the names of debenture holders are duly recorded in the register maintained by the company are known as:

- a. bonds
- b. registered debentures
- c. specific-coupon rate debentures
- d. Second debentures

6. Debenture holders are

- a. Debtors of the Company
- b. Creditors of the Company
- c. Debtors of the Company
- d. Owners of the Company

7. Debentures indicate the

- a. Short-term Borrowings of a Company
- b. Directors' shares in a company
- c. The Investment of Equity-Shareholders
- d. Long-term Borrowings of a Company

8. In debenture, interest payable is

- a. Transferred to general reserve
- b. Transferred to falling fund investment account
- c. Charged against the firm's profits
- d. Appropriation of the company's profits

9. The owner of the debenture is qualified for

- a. Fixed-rate interest

- b. Company's voting rights
- c. Firm's Profits share
- d. Fixed dividend

10. On company liquidation, the principal amount of debentures is returned

- a. After Equity Capital
- b. Before Equity Capital
- c. Last of All
- d. First of All

Answer:

1. c 2. b 3. c 4. c 5. b 6. b 7. d 8. c 9. a 10. b

4.9 SUGGESTED READINGS

- Hanif, M. & Mukherjee, A. (2015). *Corporate Accounting*. South West: Thomson.
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UNIT V- ACCOUNTING FOR CORPORATE RESTRUCTURE

Structure

- 5.0. Learning Objective
- 5.1. Introduction
- 5.2. Internal and External
- 5.3. Merger and acquisition
- 5.4. Accounting for liquidation of companies
- 5.5. Preparation of Statement of Affairs
- 5.6. Deficiency/Surplus Account: Liquidator's Final Statement of Account
- 5.7. Receiver's Statement of Accounts.
- 5.8. Summary
- 5.9. Key words
- 5.10. Learning Activity
- 5.11. Unit -End Questions
- 5.12. Suggested Readings

5.0 LEARNING OBJECTIVE

After studying this unit, you will be able to:

- Discuss corporate restructuring
- Explain merger & acquisition
- Outline accounting for liquidation of companies
- Outline liquidator's final statement of account

5.1 INTRODUCTION

Restructuring is the corporate management term for the act of reorganizing the legal, ownership, operational, or other structures of a company for the purpose of making it more profitable, or better organized for its present needs. Corporate restructuring becomes a buzzword during economic downturns. A company going through tough financial scenario needs to understand the process of corporate restructuring thoroughly. Although restructuring is a generic word for any changes in the company, this word is generally associated with financial troubles.

Restructuring is the corporate management term for the act of reorganizing the legal, ownership, operational, or other structures of a company for the purpose of making it more profitable, or better

organized for its present needs. Other reasons for restructuring include a change of ownership or ownership structure, demerger, or a response to a crisis or major change in the business such as bankruptcy, repositioning, or buyout. Restructuring may also be described as corporate restructuring, debt restructuring and financial restructuring.

Executives involved in restructuring often hire financial and legal advisors to assist in the transaction details and negotiation. It may also be done by a new CEO hired specifically to make the difficult and controversial decisions required to save or reposition the company. It generally involves financing debt, selling portions of the company to investors, and reorganizing or reducing operations.

The basic nature of restructuring is a zero-sum game. Strategic restructuring reduces financial losses, simultaneously reducing tensions between debt and equity holders to facilitate a prompt resolution of a distressed situation.

Corporate debt restructuring is the reorganization of companies' outstanding liabilities. It is generally a mechanism used by companies which are facing difficulties in repaying their debts. In the process of restructuring, the credit obligations are spread out over longer duration with smaller payments. This allows company's ability to meet debt obligations. Also, as part of process, some creditors may agree to exchange debt for some portion of equity. It is based on the principle that restructuring facilities available to companies in a timely and transparent matter goes a long way in ensuring their viability which is sometimes threatened by internal and external factors. This process tries to resolve the difficulties faced by the corporate sector and enables them to become viable again.

Steps:

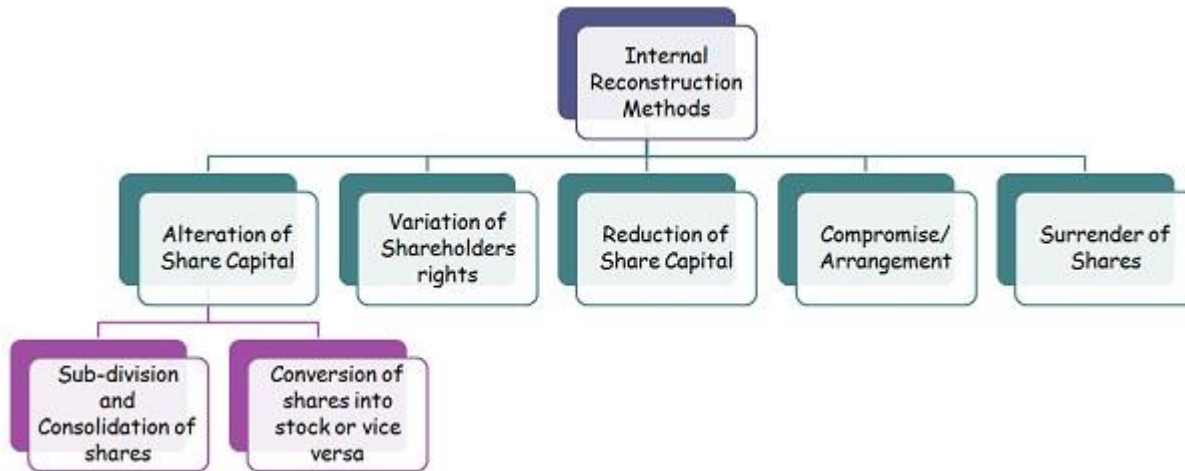
- Ensure the company has enough liquidity to operate during implementation of a complete restructuring
- Produce accurate working capital forecasts
- Provide open and clear lines of communication with creditors who mostly control the company's ability to raise financing
- Update detailed business plan and considerations

5.2 INTERNAL AND EXTERNAL

Definition of Internal Reconstruction

A recourse undertaken by the enterprise, in which substantial changes are made in the company's capital structure, without resorting to the liquidation of the existing company, is called internal reconstruction. In finer terms, it is the inner rearrangement of the company's financial structure, in which the company undergoing reconstruction continues to exist.

Internal Reconstruction focuses on relieving the company from debts and losses by negotiating with the creditors and reducing the outstanding amount towards them, so as to reach a favourable position. The methods given below are generally employed to affect the internal reconstruction process:



- Alteration of Share Capital
- Sub-division and Consolidation of Shares
- Conversion of shares into stock or stock into shares.
- Variation of Shareholder's rights
- Reduction of Share Capital
- Compromise/Arrangement
- Surrender of Shares.

In this process, the assets are restated, to represent fair values, and liabilities are restated to show the settable amount, and thus the balance sheet shows a true picture. In this scheme, trading losses and fictitious assets are written off, against the claim sacrificed by the debenture holders, creditors, etc.

Definition of External Reconstruction

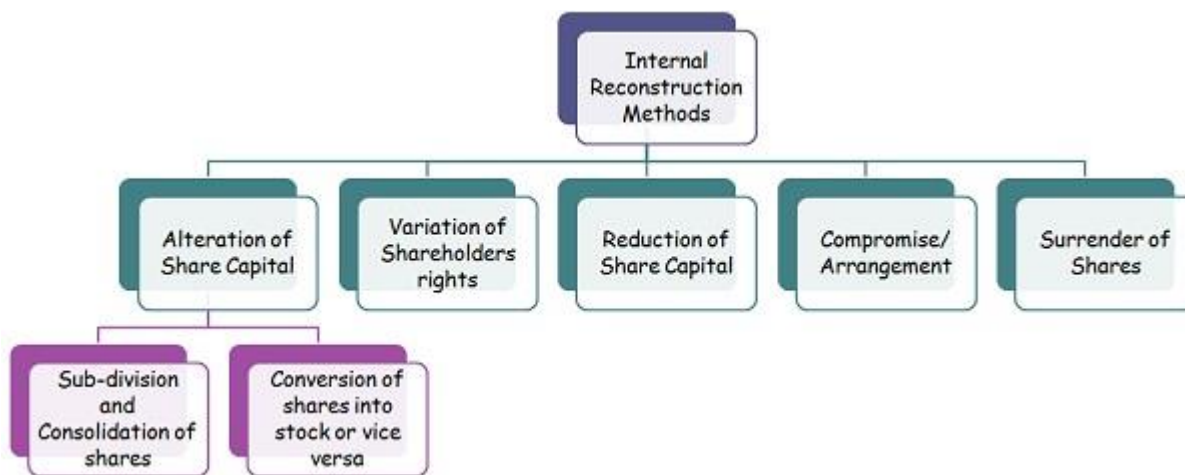
External Reconstruction is a process in which the company's financial affairs are wound up, and a new company is formed to take over the assets and liabilities of the existing company, after the reorganization of the financial position. It requires the approval of shareholders, creditors and National Company Law Tribunal (NCLT).

In external reconstruction, the undertaking is being continued by the company but is in substance transferred to a company which is not an external one, but another entity that comprises of almost same shareholders, to be carried on by the transferee company. The accounting treatment of external reconstruction is same as the amalgamation in the nature of the purchase.

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BASIS FOR COMPARISON	INTERNAL RECONSTRUCTION	EXTERNAL RECONSTRUCTION
Meaning	Internal reconstruction refers to the method of corporate restructuring wherein existing company is not liquidated to form a new one.	External reconstruction is one in which the company undergoing reconstruction is liquidated to take over the business of existing company.
New company	No new company is formed.	New company is formed.
Use of specific terms in Balance Sheet	Balance Sheet of the company contains "And Reduced".	No specific terms are used in the Balance sheet.
Capital reduction	Capital is reduced and the external liability holders waive their claims.	No reduction in the capital
Approval of court	Approval of court is must.	No approval of court is required.
Transfer of Assets and Liabilities	No such transfer takes place.	Assets and liabilities of existing company are transferred to the new company.

5.3 MERGER AND ACQUISITION

Merger

The term 'merger' is used to mean the unification of two or more business houses to form an entirely new entity. It leads to the dissolution of more or more entities, to get absorbed into another undertaking, which is relatively bigger in size.

A merger definition in business often refers to a corporate strategy where different companies will combine into one company, either to strengthen their financial or operational position. Companies may also try to merge to increase their scale and productivity. Mergers can drastically affect stock before the merger of businesses occurs.

Merger is an agreement or a voluntary fusion whereby two existing entities that are equal in terms of size, scale of operations, customers, etc decides to amalgamate to form into a new entity with an agenda to expand its reach into newer markets, lower operational costs, increase revenues, earn greater control over market share, etc.

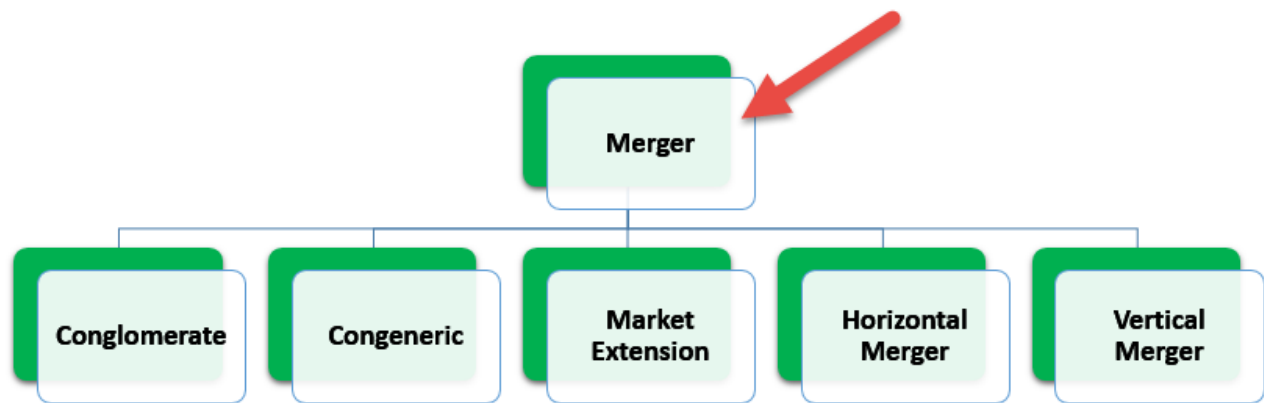
In simple words, it means an agreement in which two companies settle into an agreement to form a new third company or legal entity. In this, merged companies are usually of equal size and have a similar number of customers. On the other hand, in acquisition acquirer company is bigger in nature as compared to an acquired company. A new legal entity is being created while this is not the case in an acquisition.

It can be cash or stock merger or both. In a cash deal, the acquiring company will pay the target group with cash for their stocks. In an all-stock deal, the acquiring company will offer stocks instead of cash to the target company.

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Types of Mergers



1 – Conglomerate

A conglomerate is a type of merger, in which companies are not engaged in related business. This will involve companies which are having no business in common. Usually, these are done keeping in mind shareholding values. It refers to the combination of two firms operating in industries unrelated to each other. In this case, the business of the target company is entirely different from those of the acquiring company. For e.g., a watch manufacturer acquiring a cement manufacturer, a steel manufacturer acquiring a software company etc. The main objective of a conglomerate merger is to achieve a big size.

#2 – Congeneric

Here, the companies are in a similar market but having overlapping technologies. In this, one company can add its product line to another company line. With this, companies can get a larger number of customers and they can benefit from the knowledge transfer of technologies.

#3 – Market Extension

Here, the companies sell similar products but are in different geography or areas. With a market extension, companies try to gain access to a larger market group. A market extension merger takes place between two companies that deal in the same products but in separate markets. The main purpose of the market extension merger is to make sure that the merging companies can get access to a bigger market and that ensures a bigger client base.

Example

A very good example of market extension merger is the acquisition of Eagle Bancshares Inc by the RBC Centura. Eagle Bancshares is headquartered at Atlanta, Georgia and has 283 workers. It has almost 90,000 accounts and looks after assets worth US \$1.1 billion.

Eagle Bancshares also holds the Tucker Federal Bank, which is one of the ten biggest banks in the metropolitan Atlanta region as far as deposit market share is concerned. One of the major benefits of this acquisition is that this acquisition enables the RBC to go ahead with its growth operations in the North American market.

With the help of this acquisition RBC has got a chance to deal in the financial market of Atlanta, which is among the leading upcoming financial markets in the USA. This move would allow RBC to diversify its base of operations.

#4 – Horizontal

In this Horizontal Merger, the companies are in the same product line and in a similar industry. It is processed can be a part of the consolidation process. This is a common type of merger between the companies and the objective is to gain larger market share, cost-cutting, and have economies of scale. It refers to two firms operating in same industry or producing ideal products combining together. For e.g., in the banking industry in India, acquisition of Times Bank by HDFC Bank, Bank of Madura by ICICI Bank, Nedungadi Bank by Punjab National Bank etc. in consumer electronics, acquisition of Electrolux's Indian operations by Videocon International Ltd., in BPO sector, acquisition of Daksh by IBM, Spectra mind by Wipro etc. The main objectives of horizontal mergers are to benefit from economies of scale, reduce competition, achieve monopoly status and control the market.

#5 – Vertical

When 2 companies are at a different level in a product line and are trying to merge them, then it is known as a vertical merger. For example, a tire manufacturing company is merging with an auto manufacturing company. It is mainly done to reduce inventory costs and have cost synergies in a merger. A vertical merger can happen in two ways. One is when a firm acquires another firm which produces raw materials used by it. For e.g., a tyre manufacturer acquires a rubber manufacturer, a car manufacturer acquires a steel company, a textile company acquires a cotton yarn manufacturer etc.

Another form of vertical merger happens when a firm acquires another firm which would help it get closer to the customer. For e.g., a consumer durable manufacturer acquiring a consumer durable dealer, an FMCG company acquiring an advertising company or a retailing outlet etc.

What are Mergers & Acquisitions?

Mergers and acquisitions (M&A) are defined as consolidation of companies. Differentiating the two terms, Mergers is the combination of two companies to form one, while Acquisitions is one company taken over by the other. M&A is one of the major aspects of corporate finance world. The reasoning behind M&A generally given is that two separate companies together create more value compared to being on an individual stand. With the objective of wealth maximization, companies keep evaluating different opportunities through the route of merger or acquisition.

Mergers & Acquisitions can take place:

- by purchasing assets
- by purchasing common shares
- by exchange of shares for assets
- by exchanging shares for shares

Types of Mergers and Acquisitions:

Merger or amalgamation may take two forms: merger through absorption or merger through consolidation. Mergers can also be classified into three types from an economic perspective depending on the business combinations, whether in the same industry or not, into horizontal (two firms are in the same industry), vertical (at different production stages or value chain) and conglomerate (unrelated industries). From a legal perspective, there are different types of mergers like short form merger, statutory merger, subsidiary merger and merger of equals.

Reasons for Mergers and Acquisitions:

- Financial synergy for lower cost of capital
- Improving company's performance and accelerate growth
- Economies of scale
- Diversification for higher growth products or markets
- To increase market share and positioning giving broader market access
- Strategic realignment and technological change
- Tax considerations
- Undervalued target
- Diversification of risk

Principle behind any M&A is 2+2=5

There is always synergy value created by the joining or merger of two companies. The synergy value can be seen either through the Revenues (higher revenues), Expenses (lowering of expenses) or the cost of capital (lowering of overall cost of capital).

Three important considerations should be taken into account:

- The company must be willing to take the risk and vigilantly make investments to benefit fully from the merger as the competitors and the industry take heed quickly
- To reduce and diversify risk, multiple bets must be made, in order to narrow down to the one that will prove fruitful
- The management of the acquiring firm must learn to be resilient, patient and be able to adopt to the change owing to ever-changing business dynamics in the industry

Stages involved in any M&A:

Phase 1: Pre-acquisition review: this would include self-assessment of the acquiring company with regards to the need for M&A, ascertain the valuation (undervalued is the key) and chalk out the growth plan through the target.

Phase 2: Search and screen targets: This would include searching for the possible apt takeover candidates. This process is mainly to scan for a good strategic fit for the acquiring company.

Phase 3: Investigate and valuation of the target: Once the appropriate company is shortlisted through primary screening, detailed analysis of the target company has to be done. This is also referred to as due diligence.

Phase 4: Acquire the target through negotiations: Once the target company is selected, the next step is to start negotiations to come to consensus for a negotiated merger or a bear hug. This brings both the companies to agree mutually to the deal for the long term working of the M&A.

Phase 5: Post merger integration: If all the above steps fall in place, there is a formal announcement of the agreement of merger by both the participating companies.

Reasons for the failure of M&A – Analysed during the stages of M&A:

Poor strategic fit: Wide difference in objectives and strategies of the company

Poorly managed Integration: Integration is often poorly managed without planning and design. This leads to failure of implementation

Incomplete due diligence: Inadequate due diligence can lead to failure of M&A as it is the crux of the entire strategy

Overly optimistic: Too optimistic projections about the target company leads to bad decisions and failure of the M&A

Example: Breakdown in merger discussions between IBM and Sun Microsystems happened due to disagreement over price and other terms.

5.4 ACCOUNTING FOR LIQUIDATION OF COMPANIES

The liquidation of company accounting occurs in businesses that are ending operations. Liquidation is the process of settling any liabilities, selling all assets of an entity, taking the remaining funds and distributing them to shareholders, and closing the legal entity down. Since a business is created by law, it can't die on its own, so it must be ended through a liquidation. The liquidation of a company, also known as winding up, is defined as the method where the business's affairs are stopped so a liquidator can be in charge of all liabilities and assets.

What Does a Liquidator Do?

A liquidator, also known as an administrator, gets appointed to take over the company. They'll collect the assets, pay any debts, and distribute the remaining surplus among members based on their rights. This happens when the business is dissolved in compliance with the formalities stated in the company's ordinance. Part of the role of a liquidator is to look into any company affairs in case they need to recover the assets of a business that have been sold or misplaced at a price that's less than market value.

Reasons Why a Company Would Liquidate

The main reason a company decides to liquidate their assets is because of insolvency. This means a company gets to a point where it can't make necessary payments on time. Liquidation converts all business assets to cash, and payments can then be made with this. You might be forced to go through liquidation if the company isn't solvent anymore. If it stays solvent, it can be controlled by the company's directors. When it's insolvent, a liquidator is put in charge of the business.

They'll then be responsible for the details of winding up the company or the liquidation. If a company is considered insolvent, all assets that remain are sold off so the remaining creditors can be paid. Any amount that's left over after the required payments have been made will be distributed among the shareholders.

Three Kinds of Liquidation

It may seem like a liquidation is fairly straightforward, but there are three types of circumstances where a company gets sent into liquidation. For each type, a certain process must be followed. The first type is compulsory by the court. If a company is established and registered under an ordinance, it might get wound up by the court. This is also known as compulsory winding up. The following are other reasons this might happen:

- If a company passes a special resolution

- If the company can't fully pay its debts and the director applies to the court to ask that the liquidation process is started
- If a company does any illegal business
- If accounts aren't maintained
- If a statutory report isn't submitted to the registrar
- If the company can't start after a year of being incorporated

Sometimes, a business owner might decide to end the company for certain reasons. The company might still be able to make its payments by the deadline due to voluntary liquidation. It's up to the business partners or owners to wind up. This happens when the company's director recognizes that the business won't be able to pay off its debts and can start the liquidation process after they hold a vote among the shareholders. If more than 75 percent of the shareholders decide to liquidate, the process may begin.

The main point of a voluntary winding is the creditors and the company will settle their problems without taking it to court. However, they may apply for directions to the court and order if it's necessary. This can also happen when a certain period of time for the company expires or if the business passes a resolution voluntarily. Sometimes the company's Articles of Incorporation will state that when a specific event occurs, the business must close.

The third reason for liquidation can be when there is winding up that happens under a court's supervision. If a company passes an extraordinary or special resolution for the winding up or liquidation, the court passes an order on the creditors' or contributors' applications for closing a business under a court's supervision.

Compulsory Liquidation

When a business is not able to pay the debts it owes, its creditors may decide to petition for a winding up order.

If the debts cannot be paid back before the court date and the application is successful and the order made, the business accounts are frozen. Any assets would be liquidated and divided between creditors.

Voluntary Liquidation

When a business is not able to pay the debts it owes and the owner/directors/shareholders recognise this, they can instruct an insolvency practitioner to close the business.

The liquidator takes control of the company and oversees the liquidation process. This is the most favoured route of liquidation.

Company Liquidation

This is a formal binding arrangement which is agreed with your creditors. Not all creditors may agree, but a 75% majority vote (by value of the amount owed to them) will secure the deal.

Even if some creditors do not vote they are still bound to it. This becomes a legally binding contract which will stop any interest on monies owed and will pay back creditors a proportionate amount of what they are owed.

5.5 PREPARATION OF STATEMENT OF AFFAIRS

According to Sec. 454, within 21 days of the date of the winding-up order to the appointment of the official liquidator as provisional liquidator, the company has to submit a statement to the official liquidator as to the affairs of the company unless the Court otherwise orders. The statement must be in the prescribed form.

It must be verified by affidavit and must contain the following particulars:

- (i) The assets of the company, stating separately the cash in hand and cash at bank and negotiable securities.
- (ii) The debts and liabilities of the company;
- (iii) Names and addresses of its creditors, stating separately the amount of secured and unsecured debts;
- (iv) In the case of secured debts, particularly of the securities held by the creditors, their value and dates on which they were given;
- (v) The debts due to the company and names and addresses of the persons from whom they are due and the amount likely to be realized;
- (vi) Such further information as may be required by the official liquidator.

Prescribed Form of Statement of Affairs- [Form 57 of the Companies (Court) Rules, 1959] is given:

Form No. 57

In the High Court at
[(Or) In the District Court of

Original Jurisdiction

In the matters of Companies Act, 1956

and

In the matter of (Give the name of the Company)(In liquidation)

Company Petition no. of 20 —

Statement of Affairs (u/s 454)

Statement of Affairs of the above named company as on the day of 20—, the date of the winding-up order [or the order appointing Provisional Liquidator or the date directed by the Official Liquidator].

I/We of do solemnly affirm and say that the statement made overleaf and the several lists hereunto annexure marked 'A' to 'T', are to the best of my/our knowledge and belief a full, true and complete statement as to the affairs of the above named company on the day of 20....., the date of the winding-up order (or the order appointing Provisional Liquidator or the date directed by the official liquidator), and that the said company carries/carried on the following business:

[Here, set out the nature of Company's business]

Solemnly affirmed at this day of20.....

Before me
Commissioner for Oaths

Form of Statement of Affairs:

Statement as to the affairs of..... Ltd. on the..... day of 20...; being the date of winding-up order appointing provisional liquidator, or the date directed by the official liquidator as the case may be, showing assets of estimated realisable values and liabilities expected to rank.

Assets not specially pledged (as per list 'A')—	Estimated realisable values Rs.
Balance at Bank	
Cash in Hand	
Marketable Securities	
Bills Receivable	
Trade Debtors	
Loans and Advances	
Unpaid Calls	
Stock-in-trade	
Work-in-Progress	
.....	
.....	
Freehold Property, Land and Building	
Leasehold Property	
Plant and Machinery	
Furniture, Fittings and Utensils	
Investments other than Marketable Securities	
Livestock	
Other Properties, viz.	
.....	
.....	

Assets specially pledged (as per list 'B')				
(a)	(b)	(c)	(d)	
Estimated Realisable Values Rs.	Due to Secured Creditors Rs.	Deficiency ranking as Unsecured Rs.	Surplus carried to Last Column Rs.	
Freehold Property				
.....				
.....				
Estimated surplus from assets specially pledged				
Estimated Total Assets available for Preferential Creditors, Debentureholders secured by Floating Charges and Unsecured Creditors.				
Summary of Gross Assets				
Gross realisable value of assets specially pledged				Rs.
Other Assets				Rs.
Gross Assets				Rs.
Gross Liabilities Rs.	Liabilities (To be deducted from surplus or added to deficiency as the case may be)			Rs.
	Secured Creditors (as per list 'B') to the extent to which claims are estimated to be covered by assets specially pledged item (A) or (Insert in gross liabilities column only).			
			
			
	Preferential Creditors (as per list 'C')			
	Estimated balance of assets available for Debentureholders secured by floating charge and unsecured creditors			Rs.
	Debentureholders secured by a floating charge (as per list 'D')			
	Estimated Surplus/Deficiency as regards debenture- holders, unsecured creditors (as per list 'E')			Rs.
	Estimated unsecured balance of claims of creditors partly secured on specific assets, brought from preceding page			
	Trade Accounts			
	Bills Payable			
	Outstanding Expenses			
			
	Contingent Liabilities (state nature)			
			
	Estimated Surplus/Deficiency as regards creditors (being difference between Gross Assets brought from preceding page and liabilities)			
Rs.				Rs.

Issued and Paid-up Capital Preference Share of Rs.each Called-up (as per list 'G') Equity Shares of Rs. each Called-up (as per list 'G') Estimated Surplus/Deficiency as regards members (as per list 'H')	Rs.
--	-----

LIST 'A'—ASSETS NOT SPECIFICALLY PLEDGED

Statement of Affairs—List 'A'

Full particulars of every description of property not specifically pledged and not included in any other List are to be set forth in this list

	Full Statement and nature of Property	Book value		Estimated to produce	
		Rs.	P.	Rs.	P.
State name of bankers	Balance at Bank.....				
	Cash in Hand.....				
	Marketable Securities, viz.,				
	Bills Receivable (as per Schedule I).....				
	Trade Debtors (as per Schedule II).....				
	Loans & Advances (as per Schedule III)				
	Unpaid Calls (as per Schedule IV).....				
State nature	Stock-in-Trade (as per Schedule V).....				
State nature	Work-in-Progress.....				
	Freehold Property, viz.				
	Leasehold Property, viz.				
	Plant and Machinery, viz.				
	Furniture, Fittings, Utensils, etc.				
	Patents, Trade Marks, etc., viz.				
	Investments other than Marketable Securities				
	Livestock, Vehicles, etc.				
	Other Property, viz.				

Signature

Dated 20

LIST 'B'—ASSETS SPECIFICALLY PLEDGED AND CREDITORS FULLY OR PARTLY SECURED

(Not including Debentureholders secured by a floating charge)

The names of the secured creditors are to be shown against the assets on which their claims are secured, numbered consecutively, and arranged in alphabetical order as far as possible

Statement of Affairs—List 'B'

Particulars of assets specifically pledged*	Date when security given	Estimated value of security	No.	Name of creditor	Address & occupation	Amount of debt	Date when contracted	Consideration	Balance of + debt unsecured carried to list 'E'	Estimated surplus from security
		Rs.				Rs.			Rs.	Rs.

Signature

Dated 20

**LIST 'C'—PREFERENTIAL CREDITORS FOR RATES, TAXES, SALARIES,
WAGES AND OTHERWISE**

The names to be arranged in alphabetical order and numbered consecutively

Statement of Affairs—List 'C'

No.	Name of creditor	Address & occupation	Nature of claim	Period during which claim accrued due	Date when due	Amount of claim	Amount payable in full	Balance not preferential carried to List 'E'

Signature

Dated 20

LIST 'D'—LIST OF DEBENTUREHOLDERS SECURED BY A FLOATING CHARGE

The names to be arranged in alphabetical order and numbered consecutively. Separately Lists must be furnished of holders of each issue of Debentures, should more than one issue have been made

Statement of Affairs—List 'D'

No.	Name of Holders	Address	Amount		Description of assets over which security extends
			Rs.	P.	

Signature

Dated 20

LIST 'E'—UNSECURED CREDITORS

The names to be arranged in alphabetical order and numbered consecutively

Statement of Affairs—List 'E'

Rs. P.

Total amount of claim

Less : Contra Account

No such set-off should be included in Schedule I attached to List 'A'

No.	Name	Address and occupation	Amount of debt			Date when contracted	Folio of ledger or other book where particulars to be found	Consideration
			Rs.	Month	Year			
	Unsecured balance of creditors partly secured — brought from List 'B'							
	Balance not preferential of Preferential Creditors — brought from List 'C'							

Signature

Dated 20

LIST 'F'—LIST OF PREFERENCE SHAREHOLDERS

The names to be arranged in alphabetical order and numbered consecutively

Statement of Affairs—List 'F'

Consecutive Number	Register Number	Name of shareholder	Address	Nominal Amount of share	Number of shares held	Amount per share called-up		Total amount called-up	
						Rs.	P.	Rs.	P.

Signature

Dated 20

LIST 'G'—LIST OF EQUITY SHAREHOLDERS

The names to be arranged in alphabetical order and numbered consecutively

Statement of Affairs—List 'G'

Consecutive Number	Register Number	Name of shareholder	Address	Nominal Amount of share	Number of shares held	Amount per share called-up		Total amount called-up	
						Rs.	P.	Rs.	P.

Signature

Dated 20

LIST H—DEFICIENCY OR SURPLUS ACCOUNT
Statement of Affairs—List H
Form of Deficiency or Surplus Account

Items contributing to Deficiency or Reducing Surplus :		
1.	Excess (if any) of capital and liabilities over (assets as ... 20 ...) (as shown by Balance Sheet, copy annexed)	
2.	Net dividends and bonuses declared during the period from ... 20 ... to the date of statement	
3.	Net trading losses (after charging items shown in note below) for the same period	
4.	Losses other than trading losses written-off or for which provision has been made in the books during the same period (give particulars or annex schedule)	
5.	Estimated losses now written-off or for which provision has been made for purposes of preparing the statement (give particulars or annex schedule)	
6.	Other items contributing to Deficiency or Reducing Surplus:	_____
		=====
Items reducing Deficiency (or Contributing to Surplus):		
7.	Excess (if any) of assets over capital and liabilities on the ... 20 ... as shown on the Balance Sheet (copy annexed)	Rs. _____
8.	Net trading profit (after charging items shown in note below) for the period from the ... 20 ... to the date of statement	
9.	Profit and income other than trading profit during the same period (give particulars or annex schedule)	
10.	Other items reducing Deficiency or Contributing to Surplus: Deficiency/Surplus as shown in Statement of Affairs	Rs. _____
		=====
Note: As to Net Trading Profits and Losses		
Particulars are to be inserted here (so far as applicable) of the items mentioned below. Which are to be taken into account in arriving at the amount of net trading Profits or Losses shown in this account :		
Provisions for Depreciation, Renewals, or Diminution in value of fixed assets		
Charges for Indian Income-tax and other Indian taxation of profits		
Interest on Debentures and other fixed loans		
Payment to Directors made by the company required by law to be disclosed in the accounts:		
Exceptional or non-receiving expenditure:		
		Rs. _____
Less: Exceptional or non-receiving receipts:		
		Rs. _____
Balance, being other trading Profits or Losses:		
		Rs. _____
Net trading Profits or Losses as shown in Deficiency or Surplus Account above		
		Rs. _____
Signature		Dated 20

Illustration 1:

Sri Gobinda Chandra Sadhu khan is appointed liquidator of Sun Co. Ltd in voluntary liquidation on 1st July 1993.

Following balances are extracted from the books on that date:

	Rs.		Rs.
<i>Capital:</i>		Machinery	45,000
24,000 shares of Rs. 5 each	1,20,000	Leasehold Properties	60,000
Reserve for Bad Debts	15,000	Stock-in-trade	1,500
Debentures	75,000	Book Debts	90,000
			<i>Contd..</i>

	Rs.		Rs.
Bank Overdraft	27,000	Investments	9,000
Liabilities for Purchases	30,000	Calls-in-Arrear	7,500
		Cash in hand	1,500
		Profit and Loss Account	52,500
	<u>2,67,000</u>		<u>2,67,000</u>

You are required to prepare a Statement of Affairs to the meeting of Creditors.

The following assets are valued as:

	Rs.
Machinery	90,000
Leasehold Properties	1,09,000
Investments	6,000
Stock-in-trade	3,000

Bad Debts are Rs. 3,000 and the doubtful debts are Rs. 6,000 which are estimated to realize Rs. 3,000. The Bank Overdraft secured by deposit of title deeds of Leasehold Properties. Preferential Creditors are Rs. 1,500. Telephone rent outstanding is Rs. 120.

Solution:

Statement of Affairs of Sun Co. Ltd.
as at July 1, 2009

Assets:	Estimated realisable value Rs.		
Assets not specially pledged (as per List 'A')			
Cash in hand	1,500		
Book Debts (Rs. 90,000 – Rs. 6,000)	84,000		
Calls-in-Arrear	7,500		
Investments	6,000		
Stock-in-trade	3,000		
Machinery	90,000		
	1,92,000		
Assets pledged (as per List 'B')			
Estimated Realisable Values Rs.	Due to Secured Creditors Rs.	Deficiency Ranking as Unsecured Rs.	Surplus 'Carried to Last Column Rs.
Leasehold Properties			
1,09,000	27,000	—	82,000
Estimated surplus from assets specially pledged			82,000
Estimated total assets available for Preferential Creditors, Debentureholders secured by a floating charge and Unsecured Creditors			2,74,000

Contd.

Summary of Gross Assets		Rs.
	Gross realisable value of assets especially pledged	Rs. 1,09,000
	Other Assets	Rs. 1,92,000
		<u>3,01,000</u>
Gross Liabilities	<i>Liabilities:</i>	
Rs.	Secured Creditors (as per List 'B') to the extent to which claims are estimated to be covered by assets specially pledged.	
27,000		
1,500	Preferential Creditors :	<u>1,500</u>
	Estimated balance of assets available for Debentureholders secured by a floating charge and Unsecured Creditors.	2,72,500
75,000	Debentureholders secured by a floating charge (as per List 'D')	75,000
		<u>1,97,500</u>
	Estimated surplus as regards Debentureholders Unsecured Creditors (as per List 'E').	
	Liability for expenses	Rs. 30,000
30,120	Outstanding telephone bill	Rs. 120
1,33,620	Estimated surplus as regards Creditors	<u>30,120</u>
		<u>1,67,380</u>

Illustration 2:

M. Co. Ltd. Went into voluntary liquidation on 1.3.2009.

The following are extracted from its books on that date:

	Rs.		Rs.	Rs.
<i>Capital:</i>		Building		1,50,000
50,000 Equity Shares of Rs. 10 each	5,00,000	Plant and Machinery		2,10,000
Debentures		Stock-in-Trade		95,000
(secured by a floating charge)	2,00,000	Book Debts		
Bank Overdraft	30,000		75,000	
Creditors	40,000	Less: Provision	<u>10,000</u>	65,000
		Calls-in-Arrear		1,00,000
		Cash in hand		10,000
		Profit and Loss Account		1,40,000
	<u>7,70,000</u>			<u>7,70,000</u>

Plant and Machinery and Building are valued at Rs. 1, 50,000, and Rs. 1, 20,000, respectively. On realization, losses of Rs. 15,000 are expected on Stock. Book-Debts will realise Rs. 70,000. Calls-in-arrear are expected to realise 90%. Bank Overdraft is secured against Buildings. Preferential Creditors for taxes and wages are Rs. 6,000 and Miscellaneous Expenses outstanding Rs. 2,000.

Prepare a Statement of Affairs to be submitted to the meeting of creditors.

Solution:

**In the Books of M. Co. Ltd.
Statement of Affairs
as at 1st March 2009**

	Assets not specially pledged (as per List 'A')	Estimated realisable value Rs.
	Rs.	
	Current Assets	
	Cash	10,000
	Book Debts	70,000
	Calls in Arrears	90,000
	Stock	80,000
		2,50,000
	Fixed Assets	
	Plant and Machinery	1,50,000
		4,00,000
	Assets not specially pledged (as per List 'A')	Estimated realisable value Rs.
	Rs.	
	Assets specially pledged (as per List 'B')	
	Estimated Realisable Values Rs.	Due to Secured Creditors Rs.
	Deficiency Ranking as Unsecured Rs.	Surplus Carried to Last Column Rs.
	Building	
	1,20,000	30,000
	—	90,000
	Estimated surplus from assets specially pledged	90,000
	Estimated Total Assets available for Preferential Creditors	
	Debentureholders and Unsecured Creditors	4,90,000
	Summary of Gross Assets	
	Gross realisable value of assets specially pledged	1,20,000
	Other Assets	4,00,000
		5,20,000
Gross Liabilities	Liabilities	
Rs.	Secured Creditors (as per List 'B') to the extent to which claims are estimated to be covered by assets specially pledged.	
30,000	Preferential Creditors (Taxes and Wages)	6,000
6,000	Estimated balance of assets available for Debentureholders and Unsecured Creditors	4,84,000
2,00,000	Debentureholders Secured by floating charges (as per List 'D')	2,00,000
	Estimated Surplus as regards unsecured creditors	2,84,000
34,000	Unsecured Creditors (as per List 'E')	34,000
2,70,000	Estimated Surplus as regards contributories	2,50,000
		<i>Contd.</i>
		Rs.
	Preference Shares (as per List 'F')	Nil
	50,000 Equity Share of Rs. 10 each fully paid (as per List 'G')	5,00,000
	Estimated Deficiency as regard contributories	2,50,000

Illustration 3:

The following information is extracted from the books of Unlucky Ltd. on 31st July 2009, on which date a winding-up order was made:

	Rs.
Unsecured Creditors	38,000
Salaries due for 5 months	2,000
Bills Payable	10,600
Debtors—Good	43,000
Doubtful (estimated to produce Rs. 6,200)	13,000
Bad	8,800
Bills Receivable (Good Rs. 1,000)	1,600
Bank Overdraft	4,000
Land (estimated to produce Rs. 50,000)	36,000
Stock (estimated to produce Rs. 58,000)	82,000
Furniture and Fixtures	8,000
Cash in hand	400
Estimated Liabilities for Bills Discounted	6,000
Secured Creditors holding first mortgage on Land	40,000
Partly Secured Creditors holding secured mortgage on Land	20,000
Weekly Wages unpaid	600
Liabilities under Workmen's Compensation Act, 1925	200
Income-tax due	800
5,000, 9% Mortgage Debentures of Rs. 10 each, interest payable to 30th June and 31st December, paid to 30th June 2009	50,000
Share Capital	
2,000, 10% Preference Shares of Rs. 10 each	20,000
5,000 Equity Shares of Rs. 10 each	50,000
General Reserve since 31st Dec. 2005	10,000

In 2005 the company earned a profit of Rs. 45,000 but thereafter it suffered trading losses totalling Rs. 58,400. The company also suffered a speculation loss of Rs. 5,000 during 2006. Excise authorities-imposed penalty of Rs. 35,000 in 2007 for evasion of tax which was paid in 2008. From the foregoing information, prepare the Statement of Affairs and the Deficiency Account.

Solution:

Unlucky Ltd. (in Liquidation)
Statement of Affairs
as at 31.7.2009

Assets:	Estimated realisable value Rs.
Assets not specially pledged (as per List 'A')	
Cash in hand	400
Bills Receivable	1,000
Trade Debtors	49,200
Stock	58,000
Furniture	8,000
	1,16,600
	<i>Contd..</i>

Assets specially pledged (as per List 'B')				Rs.
Estimated Realisable Values Rs.	Due to Secured Creditors Rs.	Deficiency Ranking as Unsecured Rs.	Surplus	
Land				
50,000	60,000	10,000	—	
	(Rs. 40,000 + Rs. 20,000)			Nil
Estimated total assets available for Preferential Creditors, Debentureholders secured by a floating charge and Unsecured Creditors				<u>1,66,600</u>
Summary of Gross Assets				
Gross realisable value of assets specially pledged			Rs. 50,000	
Other Assets			Rs. 1,16,600	
			<u>Rs. 1,66,600</u>	
Gross Liabilities	Liabilities			
Rs.	(To be deducted from surplus or added to deficiency as the case may be).			
50,000	Secured Creditors (as per List 'B') to the extent of which claims are estimated to be covered by assets specially pledged			
3,200	Preferential Creditors (as per List 'C') ¹			<u>53,200</u>
				<u>1,13,400</u>
	Estimated balance of assets available for Debentureholders secured by a floating charge and unsecured creditors.			
	Debentureholders secured by a floating charge (as per List 'D')			Rs. 50,000
50,375	Interest due for 1 month (July 2009) @ 9% p.a.			<u>Rs. 375</u>
	Estimated surplus as regards Debentureholders			<u>50,375</u>
69,000	Unsecured Creditors (as per List 'E') ² .			<u>63,025</u>
<u>1,72,575</u>	Estimated deficiency as regards Creditors			<u>69,000</u>
	Issued and Called-up Capital:			(-) <u>5,975</u>
	2,000, 10% Preference Shares of Rs. 10 each, fully paid (as per List 'F')			20,000
	5,000 Equity Shares of Rs. 10 each, fully paid (as per List 'G')			50,000
	Estimated deficiency as regards contributories			<u>(-) 75,975</u>

Notes:

1. Preferential Creditors (as per List 'C')

	Rs.
Weekly Wages	600
Liability for Workmen's Compensation Act, 1925	200
Income-tax due	800
Salaries (for 4 months)	<u>1,600</u>
	<u>3,200</u>

2. Unsecured Creditors (as per List 'E')

	Rs.
Unsecured Creditors	38,000
Bills Payable	10,600
Bank Overdraft	4,000
Liability on Bills Discounted	6,000
Salaries (for the month)	400
Partly Secured Creditors (Rs. 20,000 – Rs. 10,000)	10,000
	<u>69,000</u>

List H, Deficiency on Surplus Account

Items contributing to Deficiency	Rs.
1. Excess of capital and liabilities over assets on 31.12.2003 as shown by the Balance Sheet	Nil
2. Net dividend and bonuses declared during the period from 1.1.2004 to 31.7.2009	Nil
3. Net trading losses after charging depreciation, taxation, interest on Debentures etc. (loss after 2003, Rs. 58,400 plus Rs. 375 for Debenture interest of 1 month)	58,775
4. Losses other than trading losses written-off or for which provision has been made in books during the same period	
Speculation loss	Rs. 5,000
Penalty imposed by excise authorities	Rs. 35,000
	<u>40,000</u>
5. Estimated losses now written-off or for which provision has been made for the purpose of preparing the statement :	
Bills Receivable	Rs. 600
Debtors	15,600
Stock	24,000
Contingent Liabilities for Bills Discounted	6,000
	<u>46,200</u>
6. Other items contributing to deficiency	Nil
Items reducing deficiency	
7. Excess of assets over capital and liabilities on 31.12.2003 as shown in Balance Sheet	(-) 10,000
8. Net trading profit (after charging depreciation, taxation, interest on Debentures etc.)	(-) 45,000
9. Profit and income other than trading profits	(-) Nil
10. Other items reducing deficiency—	
Profit expected on realisation of Land	(-) 14,000
Total Deficiency as shown by Statement of Affairs	<u><u>75,975</u></u>

5.6 DEFICIENCY/SURPLUS ACCOUNT: LIQUIDATOR'S FINAL STATEMENT OF ACCOUNT

The liquidator's task is to realise the assets and disburse the amounts among those who have a rightful claim to it; in every case the liquidator has to prepare a statement showing how much he realised and how the amount was distributed.

The following is the order in which disbursements will be made by the liquidator: —

(a) Secured creditors up to their claim or up to the amount realised by sale of securities held by them, whichever is less. The creditors themselves may sell the securities; they will pay to the liquidator any surplus after meeting their claims. Only the surplus is shown as a receipt; the payment to secured creditors is not shown in the liquidator's final statement of account.

The balance left unsatisfied—that is when the claims of the creditors are more than the amount realised by sale of securities—will be added to unsecured creditors. Workmen's dues will rank *pari passu* with the secured creditors. These are called overriding preferential payments.

(b) Legal charges.

(c) Remuneration to the liquidator.

(d) Costs of winding up.

(e) Preferential creditors.

(f) Debenture holders or other creditors having a floating charge on the assets of the company. (While preparing the Liquidator's Statement of Account, payment to preferential creditors is shown, however, after the payment to debenture holders having a floating charge.)

(g) Unsecured creditors. (This may include liability in respect of dividend or amounts due to shareholders on account of profits. In this case, the amount in respect of dividends, etc., shall be paid only after the outsiders are satisfied.)

(h) Preference shareholders,

(i) Equity shareholders. Unless the articles contain provisions to the effect that preference shareholders are entitled to participate in the surplus left after meeting the claims of the equity shareholders in full, the whole of the amount left after payment to preference shareholders will go to the equity shareholders.

The various claims have priority in the order mentioned above. Hence, if the amount available is exhausted after paying, say, the preferential creditors, payment cannot be made to unsecured creditors or anybody else coming after the preferential creditors. The form prescribed by the Supreme Court is given later.

While preparing the Liquidator's Statement of Account, it should be remembered that there is no double entry involved. It is only a statement although presented in the form of an account. (It is really a summary of the Cash Book after the start of liquidation).

Some Special Points:

Liquidator's Remuneration. In case of compulsory winding up, the remuneration is fixed by the Court and the amount is payable to the Court since the official liquidator is a salaried employee of the Government. In case of voluntary winding up, the remuneration is fixed by the meeting which appoints the liquidator. The remuneration once fixed cannot be increased.

Usually, the remuneration consists of a commission on assets realised plus a commission on the amount paid to unsecured creditors. Unsecured creditors include preferential creditors unless otherwise stated. The commission on unsecured creditors is on the amount paid and hence care should be exercised in calculating the commission.

If the commission is 2% on amount paid to unsecured creditors, a payment of Rs 100 to the unsecured creditors will entail a commission of Rs 2 to the liquidator, thus absorbing Rs 102. Hence, if the amount available is insufficient to pay the unsecured creditors fully, the commission due to the liquidator will be 2/102 of the amount available; the balance will be paid to the unsecured creditors.

Suppose, the amount realised by sale of assets is Rs. 3,00,000, and the amount due is Rs. 3,40,000 including Rs. 10,000 as preferential creditors. Then, if the liquidator is entitled to a commission of 3% on amounts realised and 2% on amounts distributed among the unsecured creditors, his remuneration will be calculated as follows: —

	₹
3% on amount realised by sale of assets, viz., ₹ 3,00,000	9,000
2% on preferential creditors, viz., ₹ 10,000	200
2/102 of the amount remaining viz., 2,80,800	5,506
(₹ 3,00,000 — 9,000 — 200 — 10,000)	
Or 2% on the amount paid to unsecured creditors, viz.	
₹ 2,80,800 — 5,506 or ₹ 2,75,294.	14,706

If the amount available is sufficient to pay all the creditors, the calculation of the remuneration to the liquidator is simple. Suppose, the liquidator is to get 2% on amount distributed among the unsecured creditors whose claims are ₹ 60,000; the amount available, say, is ₹ 80,000. The creditors will be paid ₹ 60,000. The liquidator will get 2% of this figure, viz., ₹ 1,200. The remaining amount (₹ 80,000 — 60,000 — 1,200) will be paid to the shareholders.

Illustration 1:

The Ultra Optimist Ltd. went into liquidation. Its assets realised Rs 3,50,000 excluding amount realised by sale of securities held by the secured creditors.

The following was the position:

	₹
Share Capital : 50,000 shares of ₹ 10 each	
Secured Creditors (securities realised ₹ 40,000)	35,000
Preferential Creditors	6,000
Unsecured Creditors	1,40,000
Debentures having a floating charge on the assets of the company	2,50,000
Liquidation Expenses	5,000
Liquidator's Remuneration	7,500

Prepare the Liquidator's Final Statement of Account.

Solution :

THE ULTRA OPTIMIST LTD.
Liquidator's Final Statement of Account

	₹		₹
Assets Realised :		Liquidator's Remuneration	7,500
“Other” assets	3,50,000	Liquidation Expenses	5,000
Surplus from Securities	5,000	Debentures having a floating charge	2,50,000
		Preferential Creditors	6,000
		Unsecured Creditors—	
		61.79% of ₹ 1,40,000*	86,500
	3,55,000		3,55,000

Since the amount is not sufficient to pay the unsecured creditors fully, nothing can be paid to the shareholders.

Illustration 2:

A company went into liquidation on 31st March, 2012 when the following balance sheet was prepared:

<i>Particulars</i>	<i>Note No.</i>	<i>Amounts as at 31st March, 2012</i>
I. Equity and Liabilities		
<i>Shareholders' funds</i>		
Share capital	1	1,95,900
Reserve and surplus	2	(98,680)

<i>Current liabilities</i>		
Short-term borrowings	3	12,000
Creditors	4	1,79,300
Total		<u>2,87,600</u>
II. Assets		
<i>Non-current assets</i>		
Fixed assets		
Tangible assets	5	1,13,500
Intangible assets	6	50,000
Current assets		
Stock		56,800
Trade receivables	7	64,820
Cash and cash equivalents	8	2,500
		<u>2,87,620</u>

Notes

	₹
1. Share Capital	
Issued, Subscribed and Paid up:	
19,500 Equity Shares of ₹ 10 each, fully paid up	<u>1,95,000</u>
2. Reserves and Surplus	
Debit balance of Profit and Loss Account	<u>(98,680)</u>
3. Short-term Borrowings	
Bank Overdraft	<u>12,000</u>
4. Creditors	
Preferential Creditors	24,200
Partly Secured	55,310
Unsecured	99,790
	<u>1,79,300</u>
5. Tangible Assets	
Leasehold Property	48,000
Plant and Machinery	55,500
Furniture	10,000
	<u>1,13,500</u>
6. Intangible Assets	
Goodwill	<u>50,000</u>
7. Debtors	
Accounts of Credit Customers	<u>64,820</u>
8. Cash and Cash Equivalents	
Cash on Hand	<u>2,500</u>

The liquidator realised the assets as follows :—

	₹
Leasehold Property which was used in the first instance to pay the partly secured creditors <i>pro rata</i>	35,000
Plant and Machinery	45,000
Furniture	6,000
Stock	39,000
Trade Receivables.....	58,500
Cash on Hand	2,500

The expenses of liquidation amounted to ₹ 1,000 and the liquidator's remuneration was agreed at 2.5% on the amount realised, including cash, and 2% on the amount paid to the unsecured creditors.

You are required to prepare the Liquidator's Final Accounts showing the distribution.

(Adapted from C.A. Final)

Solution:

Liquidator's Final Statement of Account

Receipts	Estimated value* ₹	Value realised ₹	Payments	₹
Assets Realised :			Liquidator's Remuneration**:	₹
Cash	2,500	2,500	2.5% on ₹ 1,86,000	4,650
Debtors	64,820	58,500	2% on ₹ 24,200	484
Stock	56,800	39,000	2% on ₹ 1,18,300	2,366
Plant & Machinery	55,500	45,000	Liquidation Expenses	1,000
Furniture	10,000	6,000	Preferential Creditors	24,200
			Unsecured Creditors (89.55%)	1,18,300
		1,51,000		1,51,000

Note. (i) Goodwill valued at ₹ 50,000 in books is valueless.

(ii) The total amount due to the unsecured creditors is ₹ 1,32,100 calculated as follows:—

	₹
Unsatisfied balance of partly secured creditors	20,310
Unsecured creditors	99,790
Bank Overdraft	12,000
	1,32,100

Form No. 156
(See Rule 329)
Companies Act, 1956

* Strike out what does not apply

* Here state whether the winding up is a members' or creditors' voluntary winding-up.

Liquidator's Statement of Account of the Winding-up (Members'/Creditors' Voluntary winding-up)
(Pursuant to Section 497/509)*

- Name of the company
- Nature of proceeding :
- Date of commencement of the winding-up :
- Name and address of the Liquidator :

Statement showing how the winding-up has been conducted and the property of the company has been disposed of from 20 (commencement of winding-up) to 20 (close of winding-up.)

Receipts	Estimated Value	Value realised	Payments	Payment	
	₹ P	₹ P.		₹ P.	₹ P.
Assets:			Legal Charges		
Cash at Bank	..		Liquidator's remuneration:—		
Cash in hand	..		Where applicable —		
Marketable Securities	..		% on ₹ realised		
Bills Receivable	..		% on ₹ distributed		
Trade Debtors	..		Total		
Loans and Advances	..		(By whom fixed		
Stock in Trade	..		Auctioneers' and valuers' charges		
Work in Progress	..		Costs of possession and maintenance of estate		
Freehold Property	..		Costs of notices in Gazette and news-papers		
Leasehold Property	..		Incidental outlay (establishment charges and other expenses of liquidation)		
Plant and Machinery	..		total costs and charges		
Furniture, Fittings, Utensils, etc.	..				
Patents, Trade marks, etc.	..				
Investments other than marketable securities	..				

Surplus from Securities	..		(i) Debentureholders:	
Unpaid Calls at commencement of winding up	..		Payment of ₹	per ₹
Amounts received from calls on contributories made in the winding-up	..		debenture	
Receipts per Trading Account			Payment of ₹	per ₹
Other Property, viz,			debenture	
.....			Payment of ₹	per ₹
.....			debenture	
Total	..		(ii) Creditors:—	
			* Preferential	
Less			* Unsecured:—	
Payment to redeem securities	..		Dividend (s) P. in the rupee on ₹	
Costs of execution	..		(The estimate of the amount expected to rank	
Payments per Trading Account	..		for dividend was ₹	
			(iii) Returns of contributories:—	
		 P. per rupee	** share
		 P. per rupee	** share
		 P. per rupee	** share
				Add balance

* State the number; Preferential creditors need not be separately shown if all creditors have been paid in full.

** State nominal value and class of share.

(1) The following assets estimated to be of the value of ₹ have proved to be unrealisable:—
(Give details of the assets which have proved to be unrealisable).

(2) Amount paid into the Companies Liquidation Account in respect of:—

(a) Unclaimed dividends payable to creditors in the winding-up

₹

(b) Other unclaimed distributions in the winding-up

₹

(c) Moneys held by the company in trust in respect of dividends or other sum due before the commencement of the winding up to any person as a member of the company

₹

(3) Add here any remarks the Liquidator thinks desirable:—

Dated this day of 20

(Sd.)

Liquidator.

I declare that the above statement is true and contains a full and accurate account of the winding-up from the commencement to the close of the winding-up.

Dated this day of 20

(Sd.)

Liquidator.

Debenture Interest:

Debenture interest should be paid to the date of payment if the company is solvent. If the company is insolvent, interest should be paid only up to the date of winding up; the same applies to interest payable to other creditors. A company is solvent if it can pay all its creditors.

Preference Dividend:

The position regarding arrears of dividend on preference share capital may be summarised as follows:—

(i) The question of arrears does not arise in case of non-cumulative preference shares. But if the shares are not specifically stated as non-cumulative, they should be treated as cumulative.

(ii) No dividend is payable for any period falling after the commencement of winding up.

(iii) As regards arrears of dividend up to the date of winding-up, the provisions of the Articles of Association will apply. As a rule, a dividend becomes payable only when declared by the shareholders in general meeting. If dividend on preference shares was declared, it is to be paid as a debt and not as an arrear of dividend.

It is settled law that in the case of cumulative preference shares, the arrears of dividend are payable on winding up, subject, of course, to settlement of all claims of outsiders. Thus, if need be and possible, a call should be made on equity shareholders to pay arrears of dividend on cumulative preference shares.

Equity Shareholders are paid last of all, if funds are available. In case the equity shares are partly paid and the amount available is not sufficient to satisfy the claims of preference shareholders in full, the equity shareholders should be called upon to pay a suitable amount.

Example:

1. The amount available after paying all creditors is Rs 75,000. The company's share capital consists of 10,000 Preference Shares of Rs 10 each, and 10,000 Equity Shares of Rs 10 each, Rs 6 paid. In this case the equity shareholders will have to pay Rs 2.50 per share so that their contribution (Rs 2.50, x 10,000) together with the amount already available will enable the preference shareholders to be paid off.

2. But suppose, in the above example, the amount available after paying all creditors is Rs 20,000, other facts being the same as above. In that case, the equity shareholders will pay Rs 4 per share because that is the maximum, they can be called upon to pay. They will contribute Rs 40,000 thus making the total amount available to be Rs 60,000. This will be paid to the preference shareholders.

If the equity shareholders have paid different amounts on their shares, the loss suffered by each equity shareholder should be equal. While distributing cash among them or while calling upon them to pay, care should be taken to see that all equity shareholders suffer equally.

Examples:

1. The amount available after paying creditors and preference shareholders is Rs 80,000. The company's equity share capital consists of 10,000 shares of Rs 10 each, Rs 8 paid up and 5,000 shares of Rs 10 each, Rs 6 paid up. In this case, first Rs 2 must be returned on those shares on which Rs 8 has been paid up. This will make all shares Rs 6 paid. This will absorb Rs 20,000; the remaining Rs 60,000 will be distributed on 15,000 shares, i.e., Rs 4 per share. The loss suffered by equity shareholders will be Rs 2 per share.

2. The amount available after paying creditors is Rs 60,000.

The company's share capital consists of: —

(a) 10,000 14% Preference Shares of Rs 10 each.

(b) 40,000 Equity Shares of Rs 10 each, Rs 9.50 paid.

(c) 60,000 Equity Shares of Rs 10 each, Rs 9 paid.

In this case, the additional amount required for paying the preference shareholders is Rs 40,000, i.e., 1,00,000 — 60,000. This amount should be raised by first of all calling up 50 paise on 60,000 equity shares (which will raise Rs 30,000 and which will make all equity shares Rs 9.50 paid up). The remaining amount of Rs 10,000 should be raised by calling up a further 10 paise on all equity shares.

Thus, holders of 40,000 equity shares will pay 10 paise per share and those holding 60,000 equity shares will pay 60 paise per share.

Illustration 3:

The following information to you:

A Ltd.
Balance Sheet of as at 31st March, 2012

<i>Particulars</i>	<i>Note No.</i>	<i>Amounts as at 31st March, 2012</i>
₹		
I. Equity and Liabilities		
<i>Shareholders' funds</i>		
Share capital	1	4,55,000
Reserve and surplus	2	(83,500)
<i>Non-current liabilities</i>		
Long term borrowing	3	1,00,000
<i>Current liabilities</i>		
Trade payables	4	1,45,000
Other current liabilities	5	14,000
Total		6,30,500
II. Assets		
<i>Non-current assets</i>		
Fixed assets		
Tangible assets	6	3,90,000
<i>Current assets</i>		
Inventories, at cash		55,000
Trade receivables	7	1,10,000
Cash and cash equivalents	8	75,500
Total		6,30,500

Notes:

1. Share Capital		₹
Issued, Subscribed and Paid up:		
10,000 Equity Shares of ₹ 10 each,		
₹ 7.50 per share called and paid up		75,000
30,000 Equity Shares of ₹ 10 each,		
₹ 6 per share called and paid up		1,80,000
20,000 14% Preference Shares of ₹ 10 each, fully paid up		2,00,000
		<u>4,55,000</u>
2. Reserves and Surplus		
Debit balance of Profit and Loss Account		<u>(83,500)</u>
3. Long-term Borrowings		
14% Debentures, having a floating charge on all the assets		<u>1,00,000</u>
4. Trade Payables		
Sundry Creditors		<u>1,45,000</u>
5. Other Current Liabilities		
Interest Due on Debentures		<u>14,000</u>

6. Tangible Assets	
Land and Buildings	1,00,000
Machinery and Plant	2,50,000
Furniture	40,000
	<u>3,90,000</u>
7. Trade Receivables	
Sundry Debtors	1,10,000
8. Cash and Cash Equivalents	
Balance with Bank	<u>75,500</u>

The company went into liquidation on the above date.

The preference dividends were in arrear for two years. The arrears are payable automatically on liquidation. Creditors include a loan for ₹ 50,000 on the mortgage of Land and Buildings. The assets were realised as follows :—

	₹
Land and Buildings	1,20,000
Machinery and Plant	2,00,000
Furniture	30,000
Inventories	60,000
Trade Receivables	80,000

The expenses of liquidation amounted to ₹ 10,900. The liquidator is entitled to a commission of 3 per cent on all assets realised except cash and a commission of 2 per cent on amounts distributed among unsecured creditors. Preferential creditors amount to ₹ 15,000. Assume the payment was made on September 30, 2012.

Prepare the Liquidator's Statement of Account.

Solution :

Liquidator's Statement of Account

Receipts	Estimated value ₹	Value realised ₹	Payments	Amount paid ₹
Assets realised;			Liquidator's remuneration : ₹	
Balance with Bank	75,500	75,500	3% on ₹ 4,90,000	14,700
Trade Receivables	1,10,000	80,000	2% on ₹ 95,000	<u>1,900</u>
Inventories	55,000	60,000	Expenses of liquidation	10,900
Plant and Machinery	2,50,000	2,00,000	Debentures having a	
Furniture	40,000	30,000	floating charge	1,00,000
Surplus from securities		70,000	Interest up to 30th	
			September, 2012	<u>21,000</u>
			Creditors: Preferential	15,000
			Others	80,000
			Preference shareholders	2,00,000
			Arrears of preference dividend	56,000
			Equity shareholders :	
			₹ 1.50 on 10,000 shares	15,000
			2.5 paise on 40,000 shares	<u>1,000</u>
				16,000
		<u>5,15,500</u>		<u>5,15,500</u>

Illustration 4:

Miniature Ltd. went into voluntary liquidation on 31st March, 2012. The balances in its books on that day were:

	₹		₹
Issued Capital :-			
13,000 14% Preference shares of ₹ 10 each, fully paid up	1,30,000	Furniture at cost	9,360
6,500 Equity Shares of ₹ 10 each, ₹ 5 paid up	32,500	Investment at cost	2,21,000
14% Debentures	26,000	Life Insurance Policy received from a debtor	16,900
Loan from Bank (guaranteed by Directors)	39,000	Sundry Debtors	1,04,000
Sundry Trade Creditors	1,07,000	Cash at Bank	11,700
Income Tax Payable	17,550	Profit and Loss Account	4,680
Employees' Salaries for 1 month (including ₹ 4,950 for Managing Director)	15,590		
	<u>3,67,640</u>		<u>3,67,640</u>

The Bank called upon the Directors to implement their guarantee. The preference dividend had been paid up to 30th September, 2009. There were no arrears of debenture interest. The amount owing to the Government for income-tax was in respect of assessment years 2010-2011 and 2011-2012 of Rs 3,250, Rs 14,300 respectively. The company closes its accounts on 31st March each year.

The Liquidator admitted an amount of Rs 2,730 for salaries in lieu of notice. The rent was paid up to 31st March, 2012. The premises were held under a lease with annual tenancy. The landlord agreed to waive his right to notice on the Liquidator undertaking to pay him two months' rent, i.e., Rs 650 and to vacate the premises by 31st May, 2012 which he did.

One of the creditors for Rs 13,000 was under a contract to deliver certain goods to the Company in March, 2012 and the Company had contracted to supply the same goods to Basic Ltd., who were included in Sundry Debtors at Rs 6,500.

The creditor refused to make delivery but admitted a claim made by the Liquidator for damages at Rs 1,625. Basic Ltd. made a claim for loss against the Company for Rs 975 which was admitted by the Liquidator.

Furniture was sold for Rs 7,800. Investments were found to be valueless. Sums owing by Debtors were all collected and the Insurance Policy was surrendered for Rs 15,600 after the Liquidator had paid a premium of Rs 585. A shareholder holding 2,600 equity shares failed to pay the call made by the Liquidator. Legal costs came to Rs 780 and liquidator's remuneration to Rs 6,500.

Prepare Liquidator's Final Statement of Account. (Adapted C.A., Final)

Solution :

<i>Notes.</i>		₹
(i) Preferential creditors:		
Employees' salaries for one month excluding the remuneration payable to the managing director		10,640
Income tax for 2011-2012 (assuming the assessment for the year was made within 12 months prior to 31st March, 2012)		<u>14,300</u>
		<u>24,940</u>
(ii) Unsecured creditors :		
Loan from bank (Directors for their payment to Bank)		39,000
Sundry trade creditors		1,07,000
Income tax for 2010-2011		3,250
Salary of managing director		4,950
Amount to be paid to employees in lieu of notice		<u>2,730</u>
		<u>1,56,930</u>
Less: Amount recoverable from the creditor who did not supply the contracted goods		<u>1,625</u>
		<u><u>1,55,305</u></u>

Receiver for Debenture-holders:

A receiver is generally appointed by the Court to take possession of certain property for protective purposes or for receiving income and profits from the property and for applying it as directed. Sometimes, a mortgagee is also given the power to appoint a receiver in certain circumstances. The debenture-holders may have the power under the Debenture Deed.

The Receiver will have the duty of duly accounting for the sums received by him. In case the company is being wound up, the Receiver (if appointed) will have to observe the rule regarding preferential payments and after paying the mortgagee by whom he is appointed (or paying those persons for whose protection he is appointed by the Court) he will have to hand over the surplus to the Liquidator.

There will thus be two accounts: (1) the Receiver's Statement of Account and (2) Liquidator's Final Statement of Account. The Receiver is entitled to recover his expenses and remuneration from sums collected by him.

Illustration 5:

The following is the Balance Sheet of Overconfident Ltd. as on 31st March, 2012.

₹		
<i>Particulars</i>	<i>Note No.</i>	<i>Amounts as at 31st March, 2012</i>
I. Equity and Liabilities		
<i>Shareholders' funds</i>		
Share capital	1	2,42,500
Reserve and surplus	2	(43,500)
<i>Non-current liabilities</i>		
Long-term borrowings	3	2,80,000
<i>Current liabilities</i>		
Short-term borrowings	4	25,000
Trade payables	5	55,000
Other current liabilities	6	20,000
Total		<u><u>5,79,000</u></u>
II. Assets		
Buildings		50,000
Other assets		5,29,000
Total		<u><u>5,79,000</u></u>

Notes:

₹	
1. Share Capital	
Issued, Subscribed and Paid up:	
10,000 14% Preference Shares of ₹ 10 each, fully paid up	1,00,000
10,000 Equity Shares of ₹ 10 each, fully paid up	1,00,000
5,000 Equity Shares of ₹ 10 each, ₹ 8.50 paid up	42,500
	<u><u>2,42,500</u></u>
2. Reserves and Surplus	
Preliminary Expenses	(10,000)
Debit balance of Profit and Loss Account	(33,500)
	<u><u>(43,500)</u></u>
3. Long-term Borrowings	
14% Debentures	2,50,000
Loan on Mortgage	30,000
	<u><u>2,80,000</u></u>
4. Short-term Borrowings	
Bank Overdraft	25,000
	<u><u>25,000</u></u>
5. Trade Payables	
Accounts of Credit Suppliers	55,000
	<u><u>55,000</u></u>
6. Other Current Liabilities	
Income Tax Due	
2010-11	15,000
2011-12	5,000
	<u><u>20,000</u></u>

The mortgage was secured on the buildings and the debentures were secured by a floating charge on all the assets of the company. The debenture-holders appointed a Receiver. A Liquidator was also appointed, the company being voluntarily wound up.

The Receiver was entrusted with the task of realising the Buildings which fetched Rs 40,000. The Receiver took charge of "Sundry Assets" amounting to Rs 4,00,000 and sold them for Rs 3,70,000. The Bank was secured by a personal guarantee of the directors who discharged their obligations in full.

The balance of the assets realised Rs 1,20,000. The costs of the Receiver amounted to Rs 1,000 and his remuneration to Rs 1,250. The expenses of liquidation were Rs 2,000 and the remuneration of the liquidator was Rs 750. Preference dividend was in arrear for 3 years. According to the Articles, the arrears were payable if there was a surplus on winding up.

Prepare the accounts to be submitted by the Receiver and the Liquidator.

Solution :

Receiver's Receipts and Payments Account

<i>Receipts</i>		₹	₹	<i>Payments</i>		₹
Assets Realised				Costs of the Receiver		1,000
..				Remuneration of the Receiver		1,250
..				Preferential Payments		20,000
..			3,70,000	(the assessment is presumed to		
Surplus Received from Mortgagee				have been made within		
Proceeds of Buildings	40,000		10,000	12 months preceding the date		
Mortgage Paid	30,000			of liquidation)		
				Debentureholders		2,50,000
				Balance transferred to Liquidator		1,07,750
			3,80,000			3,80,000

Liquidator's Final Statement of Account

<i>Receipts</i>	₹	<i>Payments</i>	₹
Surplus received from Receiver	1,07,750	Liquidator's Remuneration	750
Sundry Assets realised	1,20,000	Costs of Liquidation	2,000
		Unsecured Creditors	80,000
		Preference Shareholders	1,00,000
		Equity Shareholders:	
		₹ 1.50 on 10,000 shares	15,000
		₹ 2.00 on 15,000 shares	30,000
	2,27,750		45,000
			2,27,750

The equity shareholders suffer a loss of ₹ 6.50 per share.

Since there is insufficient amount to return fully the capital contributed by the equity shareholders, preference shareholders have no claim for arrears of dividend.

Illustration 6:

X-ray Ltd. is a private company, the members' holding being:

	X	R	A	Y	Total
Equity shares ₹ 10 each,	—	7,200	5,400	5,400	18,000
14% Preferences Shares (₹ 10 each)	20,000	5,000	—	—	25,000

The company's balance sheet on 30th September, 2012 was as follows:

₹		
Particulars	Note No.	Amounts as at 30th March, 2012
I. Equity and Liabilities		
<i>Shareholders' funds</i>		
Share capital	1	4,30,000
Reserve and surplus	2	3,33,000
<i>Non-current liabilities</i>		
Long-term borrowings	3	2,00,000
<i>Current liabilities</i>		
Short-term borrowings	4	90,000
Trade payables	5	2,00,000
Other current liabilities	6	50,000
Total		13,03,000
II. Assets		
<i>Non-current assets</i>		
Fixed assets	7	5,70,000
Tangible assets	8	30,000
<i>Current assets</i>		
Current investments	9	41,000
Inventories		1,40,000
Trade receivables	10	1,50,000
Cash and cash equivalents	11	3,72,000
Total		13,03,000

Notes:

₹	
1. Share Capital	
Issued, Subscribed and Paid up	
18,000 Equity Shares of ₹ 10 each, fully paid up	1,80,000
25,000 14% Preference Shares of ₹ 10 each, fully paid up	2,50,000
	<u>4,30,000</u>
2. Reserves and Surplus	
General Reserve	<u>3,33,000</u>
3. Long-term Borrowings	
14% Debentures	<u>2,00,000</u>
4. Short-term Borrowings	
Loan from Director Y	50,000
Loan from Director R	40,000
	<u>90,000</u>

5. Trade Payables	
Creditors for Goods in Trade	<u>2,00,000</u>
6. Other Current Liabilities	
Liability for Income Tax	<u>50,000</u>
7. Tangible Assets	
Freehold Property	3,00,000
Plant	1,20,000
Furniture	1,20,000
Motors	30,000
	<u>5,70,000</u>
8. Non-currents Investments	
Trade Investments	<u>30,000</u>
9. Current Investments	
Quoted Investments	<u>41,000</u>
10. Trade Receivables	
Accounts of Trade Debtors	<u>1,50,000</u>
11. Cash and Cash Equivalents	
Balance with Bank	<u>3,72,000</u>

Dividends on Preference shares were paid up to 30th September, 2011. Under the Articles, arrears of preference dividend were automatically payable in the event of the company being wound up. Also, holders of preference shares are entitled to participate equally with equity shareholders in surplus assets up to Rs 2 per share.

On 1st October, 2012 it was decided to take the company into liquidation; R, A and Y decided to form a partnership to carry on the business previously carried on by the company. They agreed that the partnership capital should be Rs 4,50,000 to be provided in the same ratio as that of equity shares held by them.

They also agreed that they would bring into the firm, as loan, any cash received by them. X agreed to lend to the firm the amount which he would receive by way of capital on his preference shares.

The liquidator was given power to distribute assets in specie; R, A and Y agreed to take the assets so distributed, bringing them into the firm at the values placed on them by the liquidator.

The liquidation was completed on 31st January, 2013; the liquidator dealt with the assets as follows:

- (i) Freehold property sold for Rs 4,15,000.
- (ii) Plant distributed at Rs 92,500.
- (iii) Furniture distributed at a valuation of Rs 1,80,000
- (iv) One motor sold for Rs 7,500; the other distributed at Rs 25,000.
- (v) Quoted investments sold for Rs 81,000.

(vi) Trade Investments distributed at Rs 55,000.

(vii) Inventories distributed at book values; and

(viii) Trade Receivables realised in full subject to bad debts of Rs 3,500. The creditors were repaid subject to a discount of Rs 1,000; other liabilities were paid off on 31st January, 2013. The liquidator's remuneration was agreed at 1% on the assets converted into cash and, in addition, 2% on the total return of capital to contributories. Liquidation expenses totalled Rs 2,000. Prepare the Liquidator's Statement of Account and show the distribution among R, A and Y. (Adapted from C.A. Eng., PEL)

Solution :

Xray Ltd.
Liquidator's Statement of Account

Receipts	Estimated Value	Value Realised ₹	Payments	₹	Payment ₹
Cash at Bank		3,72,000	Liquidator's Remuneration		
Quoted Investments		81,000	1% on ₹ 6,50,000	6,500	
Sundry Debtors		1,46,500	2% on ₹ 9,00,000	18,000	24,500
Motor		7,500	Liquidation Expenses		2,000
Freehold property		4,15,000	Debentures :		
Assets distributed in specie:			Paid up value	2,00,000	
Plant		92,500	Interest for 6 months	14,000	2,14,000
Furniture		1,80,000	Creditors :		
Motor		25,000	Preferential	50,000	
Trade Investments		55,000	Others (in full)	2,89,000	3,39,000
Inventories		1,40,000	Preference Shareholders :		
			Arrears of Dividend (one year)		35,000
			₹ 12 per share on 25,000 shares		3,00,000
			Equity Shareholders:		
			₹ 33.33 per share on 18,000 shares		6,00,000
Total		15,14,500			15,14,500

Statement showing the amount distributed amongst members :

	Total ₹	X ₹	R ₹	A ₹	Y ₹
Preference Shares @ ₹ 12 per share	3,00,000	2,40,000	60,000	—	—
Equity Shares @ ₹ 12 per share	2,16,000	—	86,400	64,800	64,800
Surplus (in the ratio of 72:54:54 or 4:3:3)	3,84,000	—	1,53,600	1,15,200	1,15,200
Total	9,00,000	2,40,000	3,00,000	1,80,000	1,80,000

Capital in the new firm (₹ 4,50,000 in the ratio of 4:3:3)	4,50,000	—	1,80,000	1,35,000	1,35,000
Balance as Loan	4,50,000	2,40,000	1,20,000	45,000	45,000

Working Notes:

(i) Liquidator's Remuneration:					₹
1% on assets realised in cash ₹ 6,50,000 i.e. ₹ 10,22,000 less ₹ 3,72,000, balance at bank					6,500
2% on amount distributed as capital to contributories:					₹
Total available				15,14,500	
Less Payments : Liquidator's Remuneration	6,500				
Liquidation Expenses	2,000				
Debentures	2,14,000				
Creditors	3,39,000				
Preference Dividend	35,000				
				<u>5,96,500</u>	
				<u>9,18,000</u>	
Liquidator's Remuneration ₹ 9,18,000 × 2/102					18,000
					<u>24,500</u>
(ii) Amount available for contributories: (₹ 9,18,000 less Liquidator Remuneration)					9,00,000
Distribution: Preference Shareholders ₹ 12 per share					3,00,000
Equity Shareholders ₹ 12 per share					2,16,000
					<u>5,16,000</u>
Surplus for Equity Shareholders					3,84,000
					<u>9,00,000</u>
(iii) Cash brought into the new firm:					
Total cash available with liquidator					10,22,000
Cash Payments : Remuneration to Liquidator	24,500				
Expenses	2,000				
Debentures	2,14,000				
Creditors	3,39,000				
Preference Dividend	35,000				
				<u>6,14,500</u>	
Cash distributed among partners and brought into the firm as newly constituted.					4,07,500
Add: Assets distributed in specie					4,92,500
					<u>9,00,000</u>

Illustration 7:

The following is the Balance Sheet of Y Limited as at 31st March, 2012:

Particulars	Note No.	Amount as at 31st March, 2012
I. Equity and Liabilities		
Shareholders' funds		
Share capital	1	7,10,000
Reserve and surplus	2	(2,40,000)
Non-current liabilities		
Long-term borrowings	3	2,00,000

<i>Current liabilities</i>		
Short-term borrowings	4	90,000
Trade payables	5	4,00,000
Other current liabilities	6	10,000
Total		<u>11,70,000</u>
II. Assets		
<i>Non-current assets</i>		
Fixed assets		
Tangible assets	7	7,80,000
<i>Current assets</i>		
Inventories		1,10,000
Trade receivables	8	2,20,000
Cash and cash equivalents	9	60,000
Total		<u>11,70,000</u>

Notes:

1. Share Capital

Issued, Subscribed and Paid up:	
20,000 Equity Shares of ₹ 10 each, ₹ 7.50 per share paid up	1,50,000
60,000 Equity Shares of ₹ 10 each, ₹ 6 per share paid up	3,60,000
20,000 10% Preference Shares of ₹ 10 each, fully paid up	2,00,000
	<u>7,10,000</u>

2. Reserves and Surplus

Debit balance of Profit and Loss Account	(2,40,000)
--	------------

3. Long-term Borrowings

10% Debentures, having a floating charge on all the assets	<u>2,00,000</u>
--	-----------------

4. Short-term Borrowings

Loan	<u>90,000</u>
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5. Trade Payables

Creditors for Goods in Trade	<u>4,00,000</u>
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6. Other Current Liabilities

Interest Accrued on Debentures, having a floating charge on all the assets	<u>10,000</u>
---	---------------

7. Tangible Assets

Land and Buildings	4,00,000
Plant and Machinery	3,00,000
Furniture	80,000
	<u>7,80,000</u>

8. Trade Receivables

Debtors for Goods in Trade	<u>2,20,000</u>
----------------------------	-----------------

9. Cash and Cash Equivalents

Balance with Bank	<u>60,000</u>
-------------------	---------------

On that date, the company went into Voluntary Liquidation. The dividends on preference shares were in arrears for the last two years. Loan was on a mortgage of Land and Buildings. The assets realised were as under :

	₹
Land and Buildings	3,40,000
Plant and Machinery	2,90,000

Furniture	70,000
Inventories	1,20,000
Trade Receivables	1,60,000

Interest accrued on loan on mortgage of buildings upto the date of payment amounted to ₹ 10,000. The expense of Liquidation amounted to ₹ 4,600. The Liquidator is entitled to a remuneration of 3% on all the assets realised (except cash at bank) and 2% on the amounts distributed among equity shareholders. Preferential creditors included in sundry creditors amount to ₹ 30,000. All payments were made on 30th June, 2012. Prepare the liquidators' final statement of account.

[Adapted C.A. (Inter) Nov. 1994]

Solution :

Liquidator's Statement of Accounts

Receipts	Estimated Value (₹)	Value Realised (₹)	Payments (₹)	Payment (₹)
Assets realised :			Liquidation Expenses	4,600
Balance with Bank	60,000	60,000	Liquidator's Remuneration :	
Trade Receivables	2,20,000	1,60,000	3% on ₹ 9,80,000 realised	29,400
Inventories	1,10,000	1,20,000	2% on ₹ 50,000 distributed among equity shareholders	1,000
Plant and Machinery	3,00,000	2,90,000		30,400
Furniture	80,000	70,000		
Surplus from Secured Creditors :			Debentureholders :	
Land and Buildings, ₹ 3,40,000 -- ₹ 1,00,000		2,40,000	10% Debentures	2,00,000
			Interest accrued on debentures	15,000
			Creditors :	
			Preferential	30,000
			Unsecured	3,70,000
				4,00,000
			Return to Contributors	
			Preference Shareholders :	
			10% Preference Share Capital	2,00,000
			Arrears of Dividend	40,000
				2,40,000
			Equity Shareholders :	
			₹ 1.75 per share on 20,000 shares	35,000
			₹ 0.25 per share on 60,000 shares	15,000
				50,000
		9,40,000		9,40,000

Working Notes :

(i) Interest accrued on debentures :	₹
Interest accrued upto the date of balance sheet	10,000
Interest accrued for subsequent three months, ₹ 2,00,000 × 3/12 × 10/100	5,000
Total	15,000
(ii) Commission to liquidator on assets realised :	
Land and buildings	3,40,000
Plant and machinery	2,90,000
Furniture	70,000
Inventories	1,20,000
Trade Receivables	1,60,000
	9,80,000
Commission @ 3% = ₹ 9,80,000 × 3 / 100 = ₹ 29,400	

(iii) Commission to liquidator on amount distributed :	
Receipts	9,40,000
Less : Payments, ₹ (4,600 + 29,400 + 2,15,000 + 30,000 + 3,70,000 + 2,40,000)	<u>8,89,000</u>
Amount available before commission	<u>51,000</u>
Commission @ 2% = ₹ 51,000 x 2 / 102 = ₹ 1,000	
(iv) Total paid up equity share capital = ₹ 5,10,000	
Loss to be borne by them = ₹ 5,10,000 - ₹ 50,000 = ₹ 4,60,000	
Loss per share = ₹ 4,60,000 / 80,000 = ₹ 5.75	
Refund per equity share will paid up value of ₹ 7.50 = ₹ 7.50 - ₹ 5.75 = ₹ 1.75	
Refund per equity share will paid up value of ₹ 6.00 = ₹ 6 - ₹ 5.75 = ₹ 0.25	

“B” List of Contributories:

Those persons who ceased to be shareholders (other than by death) within a year of the date of winding up of the company are liable to pay up the amount unpaid on the shares held by them, if the amount due to various persons, while such former members were shareholders, remains unpaid at the time of winding up.

Such former members are not liable to contribute for debts incurred after they ceased to be members. They will not also be liable, if all the creditors can be paid out of the moneys realised from sale of assets or from the shareholders who are members at the time of winding up (“A” List). Also, there will be no liability to pay anything if the present shareholders pay or have paid the amount due on the shares.

Suppose, A held 1,000 shares of Rs 10 each, Rs 7.50 paid up. He transferred his shares on 31st October, 2011 to B. The company goes into liquidation on 31st March, 2012. A debt existing on, 31st October, 2011 remains unpaid. A can be called upon to pay the debt subject to the maximum limit of Rs 2,500 because his total liability, when he transferred his shares, was Rs 2.50 per share.

Had A transferred the shares on, say, the 15th March, 2011, there would have been no liability upon him. Also, if B has paid the amount due on the shares, A has no liability, if there are more than one member who ceased to be such within one year of the date of winding up, each would be liable to pay proportionately subject to the maximum due on the shares.

Suppose (1) a company goes into liquidation on 31st October, 2010 leaving a debt of Rs 2,400 unpaid; (2) it is found that A who held 1,000 shares and B who held 500 shares of Rs 10 each, Rs 7 paid up, had transferred the shares on 15th November, 2010; and (3) the debt had been incurred sometime before 15th November, 2010.

In this case, A and B will contribute proportionately, that is in the ratio of 2 to 1. A will pay Rs 1,600 and B will pay Rs 800.

Illustration 8:

In liquidation which commenced on 1st April, 2012 certain creditors could not receive payment out of the realisation of the assets and out of contribution from “A” list contributories. The following are the details of certain transfers which took place after 1st April, 2011: —

Shareholders	Numer of Shares transferred	Date of ceasing to be member	Creditors remaining unpaid and outstanding on the date of ceasing to be member
		₹	
A	1,000	1st May, 2011	6,000
B	1,500	1st July, 2011	7,500
C	300	1st Nov, 2011	8,000
D	200	1st Feb, 2012	9,500

Solution:

The amount of Rs 6,000 outstanding on 1st May, 2011 will have to be contributed by all the four persons in the ratio of number of shares held by them, i.e., in the ratio of 10:15:3:2.

Thus, A will have to contribute Rs 2,000. B, Rs 3,000; C, Rs 600 and D. 1400. Similarly, the further debts incurred between 1st May, 2011 and 1st July, 2011 viz., Rs 1,500 (for which A is not liable) will be contributed by B, C, and D in the ratio of 15:3:2. B will have to contribute Rs 1,125, C will have to contribute Rs 225 and D will have to contribute Rs 150.

The further increase from Rs 7,500 to Rs 8,000; viz., Rs 500 occurring between 1st July, 2011 and 1st November, 2011 will be shared by C and D who will be liable for Rs 300 and Rs 200 respectively. The increase between 1st November, 2011 and 1st February, 2012 is solely the responsibility of D.

The following statement makes the position clear.

Statement of Liability of B List Contributories

Creditors outstanding on date ceasing to be member	A 1,000 share	B 1,500 shares	C 300 shares	D 200 shares	Amount to be paid to creditors
	₹	₹	₹	₹	₹
(1) 6,000	2,000	3,000	600	400	6,000
(2) 1,500	—	1,125	225	150	1,500
(3) 500	—	—	300	200	500
(4) 1,500	—	—	—	1,500	50*
Total (a)	2,000	4,125	1,125	2,250	
(b) Maximum Liability on shares held 4,000	6,000	1,200	800		
(c) Amount paid (a) or (b) whichever is lower	2,000	4,125	1,125	800	

Illustration 9:

Pessimist Ltd. has gone into liquidation on 10th May, 2012. The details of members, who have ceased to be members within one year ('B' contributories) are given below. The debts that could not be paid out of realisation of assets and contribution from present members ('A' contributories) are also given with their date-wise break up. Shares are of Rs 10 each, Rs 6 per share paid up.

You are to determine the amount realisable from each person.

Shareholders	No. of shares transferred	Date of transfer	Proportionate unpaid debts
P	1,000	20.4.2011	3,000
Q	1,200	15.5.2011	5,000
R	1,500	18.9.2011	9,200
S	800	24.12.2011	10,500
T	500	12.3.2012	11,000

[Adapted C.A. (Inter), Nov. 2000]

Solution :

P has ceased to be a member more than a year ago from the date of winding up; hence he is not liable as a contributory. The amount of ₹ 5,000 outstanding on 15.5.2011 will have to be contributed by Q, R, S and T in the ratio of number of share held by them i.e. 1200, 1500, 800 and 500 respectively.

The additional debts incurred from 15.5.2011 to 18.9.2011 i.e. ₹ 4,200 will be contributed by R, S and T in the ratio of 1500, 800 and 500 respectively. The further increase of ₹ 1,300 will be borne by S and T in the ratio of 800 and 500 respectively. Finally, the last increase of ₹ 500 will be the sole responsibility of T, limited to his maximum liability.

The following statement makes the position clear.

Statement of Liability of B List Contributories

Creditors outstanding on date ceasing to be member	Q 1,200 shares ₹	R 1,500 shares ₹	S 800 shares ₹	T 500 shares ₹	Amount to be paid to creditors ₹
(1) 5,000	1,500	1,875	1,000	625	5,000
(2) 4,200	—	2,250	1,200	750	4,200
(3) 1,300	—	—	800	500	1,300
(4) 500	—	—	—	500	125
Total (a)	<u>1,500</u>	<u>4,125</u>	<u>3,000</u>	<u>2,375</u>	<u>10,625</u>
(b) Maximum liability on shares held @ ₹ 4 per share	<u>4,800</u>	<u>6,000</u>	<u>3,200</u>	<u>2,000</u>	
(c) Amount paid, (a) or (b) whichever is less	<u>1,500</u>	<u>4,125</u>	<u>3,000</u>	<u>2,000</u>	

Illustration 10:

In a winding up of a company certain creditor remained unpaid. The following persons had transferred their holding sometimes before winding up:

Name	Date of transfer	No. of shares transferred	Amount due to creditors on the date of transfer
	2011		₹
P	January 1	1,000	7,500
Q	February 15	400	2,500
S	March 15	700	18,000
T	March 31	900	21,000
U	April 5	1,000	30,000

Solution :

Statement of liability as contributories of former members

Creditors outstanding on the date of transfer (ceasing to be member)		Q	R/X	S	U	Amount to be paid to creditors
No. of Shares		400	200	700	1,000	
2011	₹	₹	₹	₹	₹	₹
Feb. 15	12,500	2,174	1,087	3,804	5,435	12,500
Feb. 28	15,000					
	— 12,500	—	263	921	1,316	2,500
March 15	18,000					
	— 15,000			316	1,105	1,579
April 5	30,000					
	— 18,000	12,000		2,000		10,000
Total (a)	30,000	2,174	3,666	5,830	18,330	30,000
Maximum Liability at ₹ 20 per share on shares held (b)			8,000	4,000	14,000	20,000
Lower of (a) and (b)			2,174	3,666	5,830	18,330

Working Notes :

- (i) The transferors are P, Q, S, T and U. When the transferees pay the amount due as 'present' member contributories, there will not be any liability on the transferors. It is only when the transferees do not pay as 'present' member contributories that the liability would arise in the case of 'past' members as contributories.
- (ii) X to whom share were transmitted on demise of his father R would be liable as an existing member contributory. He steps into the shoes of his deceased father under section 430. His maximum liability would be at ₹ 20 per share on 200 shares received on transmission i.e. for ₹ 4,000.
- (iii) P will not be liable to pay any amount as the winding up proceedings commenced after one year from the date of the transfer. T also will not be liable as the transferee Z has paid the balance ₹ 20 per share as call in advance.
- (iv) Q, R/X, S and U will be liable, as former members, to the maximum extent as indicated, provided the transferees do not pay the calls.

5.7 RECEIVER'S STATEMENT OF ACCOUNTS

According to Sec. 421 of the Companies Act, 1956, every receiver of the property of a company appointed under a power conferred by any instrument and who has taken possession, to fill with

Registrar of Companies an abstract of his receipts and payments in the prescribed form. He is an independent person.

He may be appointed by a court, or he may be appointed under any instrument of the company etc. In the former case, he becomes an officer of that court and, in the latter case; he becomes an agent who will look after the interest of the instrument holders. Depending upon the nature of his responsibility he may be a trustee, e.g., a receiver appointed under Debenture Trust Deed.

However, debenture-holders may appoint a receiver provided the terms of issuing debentures so permit. If the terms of issuing debentures provide, the debenture-holders may appoint the Receiver who will take over the property of the company in order to protect the interest of debenture-holders.

If the terms of issuing Debentures do not provide, in that case, the debenture-holders may apply to the court for appointment of the Receiver. The Receiver will realize the assets which are charged for the debenture- holders.

The Receiver will pay to the debenture-holders after deducting his expenses and remuneration. If any surplus is left the same should be given to the liquidator. The abstract of Receiver's receipts and payments will be as per under Form No. 36 that follows (Central Govt. Rules and Forms, 1956).

Form No. 36
 No. of Company..... no registration fee payable
 Receiver's Or, Manager's Abstract of Receipts and Payment
 (Pursuant to Sec. 424 read with Sec. 421)

Name of company Ltd./ Pvt.
 Name and Address of Receiver or Manager

Date and Description of security containing the powers under which Receiver or Manager is appointed.

Period covered by the Abstract
 From
 To

Presented by

Abstract			
<i>Receipts</i>	Rs.	<i>Payment</i>	Rs.
Brought forward		Brought forward	3,86,000
Carried forward		Carried forward	

Dated: The day of..... 20.....

Signature

Receiver

Manager

Illustration 1:

Hopeless Ltd. went into the hands of Receiver appointed by Debenture-holders as on 31st March 20Q9. The interest on Debentures is payable on 31st March each year.

Balance Sheet
as at 31st March 2009

Liabilities	Rs.	Assets	Rs.
6% Cumulative Pref. shares (Rs. 10)	25,000	Fixed Asset	90,000
Equity Share Capital Rs. 10		Stock	79,000
Rs. 7.5 called-up	75,000	Debtors	35,000
Capital Reserve	10,000	Profit & Loss A/c	45,000
5% Debentures	30,000	Calls-in-Arrear	1,000
(Secured for floating charge)			
Debenture Interest (Net)	1,200		
7% Bank Loan	20,000		
(Including Interest)			
Creditors	88,800		
	<u>2,50,000</u>		<u>2,50,000</u>

Creditors include Rs. 6,100 preferential creditors for rates and wages etc. and Rs. 300 tax on accrued Debenture Interest. The Receiver collected Rs. 20,000 from Debtors against Rs. 21,000 claims. Stock (book value Rs. 49,000) was sold out for Rs. 42,000.

Debentures were paid forthwith. Receiver's expenses and Remuneration amounted to Rs. 3,000. By June 2009, he paid the preferential creditors and secured loans and handed over the balance of 30.6.2009 to the liquidator, the date on which winding-up resolution was passed.

You are required to prepare Receipts and Payments Account of Receiver.

Solution:

Receiver's Receipts and Payments Account

	Rs.		Rs.
Realisation of Sundry Assets:		Receiver's Expenses and Remuneration	3,000
Debtors	20,000	Preferential Creditors	6,100
Stock	42,000	Debentures	30,000
Calls-in-Arrear		Add: Interest (gross)	
on 5,000 shares		(1,200 + 300)	1,500
			<u>31,500</u>
		7% Bank Loan	20,000
		Add: Interest (3 months)	350
			<u>20,350</u>
		Balance handed over to Liquidator	1,050
	<u>62,000</u>		<u>62,000</u>

Calls-in-Arrear and Calls-in-Advance:

If there is any Calls-in-Arrear the same should be collected first by the official liquidator before making actual payment to contributors. At the same time, if there is any Calls-in-Advance the same must be returned to the particular shareholder(s).

Illustration 2:

Break Ltd. went into voluntary liquidation on 31.3.2009. The balances in its books on that date were:

<i>Liabilities</i>	Rs.	<i>Assets</i>	Rs.
<i>Share Capital</i>		Land	50,000
<i>Authorised and Subscribed</i>		Building	2,00,000
5,000, 6% Pref. Shares of Rs. 100 each, fully paid	5,00,000	Plant and Machinery	6,25,000
2,500 Equity Shares of Rs. 100 each, Rs. 75 paid-up	1,87,500	Stock	1,37,500
7,500 Equity Share of Rs. 100 each, Rs. 60 paid-up	4,50,000	Sundry Debtors	2,75,000
5% Debentures (Secured by a floating charge on all assets)	2,50,000	Cash and Bank	75,000
Interest Due on Debentures	12,500	Profit and Loss A/c	4,10,000
Bank Overdraft	1,00,000		
Unsecured Creditors	2,00,000		
Taxes due on Govts. within 12 months	12,500		
Salaries and Wages due for 4 months for workers	60,000		
	17,72,500		17,72,500

The liquidator is entitled to a remuneration of 5% on all assets realized except cash and 1% on the amount distributed to unsecured creditors other than preferential creditors. Bank Overdraft is secured by deposit of title deed of land and building which realized Rs. 3, 00,000. Other assets realized the following sums:

	Rs.
Plant and Machinery	5,00,000
Stock	1,50,000
Sundry Debtors	2,00,000
Expenses of liquidation amounted to Rs. 27,250.	

Liquidator realized all assets on 1.4.2009 and discharged his obligation on the same date. Dividend on preference shares were in arrears for two years. Prepare Liquidator's Final Statement of Account.

Solution:

**In the Books of Break Ltd.
Liquidator's Final Statement of Account**

	Rs.	Rs.			Rs.
Cash at Bank		75,000	Liquidator's Remuneration		
<i>Assets realised:</i>			(5% on Rs. 10,50,000)	52,500	
Land and Building (3,00,000 – 1,00,000)	2,00,000		(1% on Rs. 2,00,000)	2,000	
Plant and Machinery	5,00,000				54,500
Stock	1,50,000		Liquidation Expenses		27,250
Sundry Debtors	2,00,000		Debentureholders—		
		10,50,000	Principal	2,50,000	
			Add: Interest	12,500	
					2,62,500
					<i>Contd.</i>

	Rs.	Rs.		Rs.
Calls on Shares @ Rs. 8.93 per share on 7,500 shares		66,975*	Preferential Creditors (Outstanding Taxes, Salaries & Wages)—	12,500 60,000
				72,500
			Unsecured Creditors— (3,00,000 – 1,00,000) Preference Shareholders Principal Add: Arrear Div.	2,00,000 5,00,000 60,000
				5,60,000
			Equity Shareholders A/c 2,500 Equity Shares @ Rs. 6.09 per share	15,225
		<u>11,91,975</u>		<u>11,91,975</u>

Workings:

* Deficit = Total Receipts – Total Payments
= Rs. 11,25,000 – Rs. 11,76,750
= Rs. 51,750

Less: From Notional calls
@ Rs. 15 on 7,500 shares = Rs. 1,12,500
Rs. 60,750

Refund per share = Rs. 60,750 ÷ 10,000 = Rs. 6.075 per share

∴ Net Call Amount Rs. 15 – Rs. 6.075 = Rs. 8.925 or, say, Rs. 8.93 per share.

Treatment of Calls-in-Advance and Calls-in-Arrear

Illustration 3:

The position of Valueless Ltd. on its liquidation is:

Issued and paid-up capital:

3,000 11% Pref. Shares of Rs. 100 each, fully paid. 3,000 Equity Shares of Rs. 100 each fully paid. 1,000 Equity shares of Rs. 50 each, Rs. 30 per share paid. Calls-in-Arrear are Rs. 10,000 and calls received in advance Rs. 5,000. Pref. dividends are in arrear for one year. Amount left with the liquidator after discharging all liabilities is Rs. 4,13,000. Articles of Association of the company provide for payment of Pref. dividend arrears in priority to return of equity capital. You are required to prepare the Liquidator's Final Statement of Account.

Solution:

**In the Books of Valueless Ltd.
Liquidator's Final Statement of Account**

	Rs.		Rs.
Cash A/c	4,13,000	Dividend	33,000
Calls-in-Arrear	10,000	Pref. Shareholders	3,00,000
Proceeds of Call—		Calls-in-Advance	5,000*
Final call of Rs. 5 per share of Rs. 50 each (1,000 × Rs. 5)	5,000 ¹	Equity Shareholders of Rs. 100 each (3,000 × Rs. 30)	90,000
	<u>4,28,000</u>		<u>4,28,000</u>

Workings

- Calls-in-Advance should be paid at First.

	Rs.
1. Amounts available	
Balance of Cash	4,13,000
Add: Calls-in-Arrear	10,000
	4,23,000
Less: Pref. Shareholders	3,00,000
Pref. Dividend	33,000
Calls-in-Advance	5,000
	3,38,000
	85,000
Add: Amount to be received from equity shareholders of Rs. 50 each (1,000 × Rs. 20)	20,000
	1,05,000

No. of Equivalent Shares

3,000 shares of Rs. 100 each is equal to 6,000 shares of Rs. 50 each

1,000 " Rs. 50 each " 1,000 shares of Rs. 50 each

7,000

∴ Final Payment = $\frac{\text{Rs. } 1,05,000}{\text{Rs. } 7,000} = \text{Rs. } 15$ per share of those who paid
Rs. 50 each.

Thus, equity shares of Rs. 100 each will be Rs. 30 (i.e. $\text{Rs. } 15 \times \frac{100}{50}$)

So, Equity Shareholders of Rs. 50 each are to pay Rs. 20 per share and receive Rs. 15, i.e. Net Amount Rs. 5 (Rs. 20 – Rs. 15) they would have to pay.

Illustration 4:

The Balance Sheet of Asco Ltd. as on 31st March 2009:

<i>Liabilities</i>	Rs.	<i>Assets</i>	Rs.
<i>Share Capital</i>		<i>Fixed Assets</i>	
1,000, 6% Pref. Shares of Rs. 100 each, fully paid	1,00,000	Machinery	1,90,000
2,000 Equity Shares of Rs. 100 each, fully paid	2,00,000	Furniture	10,000
2,000 Equity Shares of Rs. 100 each, Rs. 75 paid	1,50,000	<i>Current Assets</i>	
Loan—Bank (Secured on Stock)	1,00,000	Stock	1,20,000
<i>Current Liabilities & Provisions</i>		Debtors	2,40,000
Creditors	3,50,000	Cash at Bank	50,000
Income-tax Payable	10,000	<i>Misc. Expenditure</i>	
	9,10,000	P & L A/c	3,00,000
			9,10,000

The company went into liquidation on 1.4.2009.

The assets were realised as:

	Rs.
Machinery	1,66,000
Furniture	8,000
Stock	1,10,000
Debtors	2,30,000
Liquidation expenses amounted to	4,000

The liquidators are entitled to a commission at 2% on amount paid to unsecured creditors. Calls on partly paid shares were made but the amounts due on 200 shares were found to be irrecoverable. Prepare Liquidator's Statement of Account.

Solution:

**In the Books of Asco. Ltd.
Liquidator's Final Statement of Account**

	Rs.	Rs.		Rs.
Cash at Bank		50,000	Liquidator's Remuneration (@ 2% on Rs. 3,50,000)	7,000
<i>Assets Realised:</i>			Liquidator's Expenses	4,000
Machinery	1,66,000		Preferential Creditors	10,000
Furniture	8,000		(Income-tax)	
Stock (1,10,000 – 1,00,000)	10,000		Unsecured Creditors	3,50,000
Debtors	2,30,000		Preference Shareholders:	
		4,14,000	Principal	1,00,000
Calls-in-Arrear			Equity Shareholders	
1,800 Equity Shares @ Rs. 15 per share (i.e., Rs. 25 – Rs. 10)		27,000*	<i>(bal. fig.)</i>	
			2,000 Equity Shares of Rs. 100 each, fully paid @ Rs. 10 per share	20,000*
		4,91,000		4,91,000

* Deficit = Total Payments – Total Receipts = (-) Rs. 7,000
(Rs. 4,71,000 – Rs. 4,64,000)

Less: Amount received on notional calls (1,800 × Rs. 25) = 45,000

Notional Surplus 38,000

∴ Notional Surplus per share = Rs. 38,000 ÷ 3,800 = Rs. 10.

Illustration 5:

T. Ltd. was placed in voluntary liquidation on 31.12.2002, when its Balance Sheet was as:

<i>Liabilities</i>	Rs.	<i>Assets</i>	Rs.
<i>Issued Share Capital:</i>		Freehold Property	5,80,000
50,000 Equity Shares of Rs. 10 each, fully paid, less calls in arrear amounting to Rs. 25,000	4,75,000	Plant and Machinery	2,89,000
6,000, 5% Cumulative Pref. Shares of Rs. 100 each, fully paid	6,00,000	Motor Vehicles	57,500
Securities Premium Account	50,000	Stock	1,86,000
5% Debenture Account	1,00,000	Debtors	74,000
Interest on Debentures	2,500	Profit and Loss Account	2,14,000
Bank Overdrafts	58,000		
Creditors	1,15,000		
	14,00,500		14,00,500

The Preference dividends are in arrear from 1999 onwards.

The company's Articles provide that, on liquidation, out of the surplus assets remaining after payment of liquidation costs and outside liabilities, there shall be paid, firstly, all arrears of Preference dividend; secondly, the amount paid-up on the Preference shares together with a premium thereon of Rs. 10 per share; thirdly, any balance then remaining shall be paid to the Equity shareholders. The Bank Overdraft was guaranteed by the Directors who were called upon by the

Bank to discharge their liability under the guarantee. The Directors paid the amount to the Bank. The liquidator realized the assets as:

	Rs.
Freehold Property	7,00,000
Plant and Machinery	2,40,000
Motor Vehicles	59,000
Stock	1,50,000
Debtors	60,000
Calls-in-Arrears	25,000

Creditors were paid less discount of 5%. The Debentures and accrued interest were repaid on 31st March 2003. Liquidation costs were Rs. 3,820 and the liquidator's remuneration was 2% on the amounts realized. Prepare the Liquidator's Statement of Account.

Solution:

**Liquidator's Statement of Account
for the period ending 31st March 2003**

	Rs.	Rs.		Rs.	Rs.
<i>Assets Realised:</i>			Liquidator's Remuneration		
Freehold Property		7,00,000	@ 2% on Rs. 12,34,000		24,680
Plant and Machinery		2,40,000	Liquidation Expenses		3,820
Motor Vehicles		59,000	Debentureholders:		
Stock		1,50,000	Principal	1,00,000	
Debtors		60,000	Add: Interest	3,750 ¹	
Calls-in-Arrears		25,000			1,03,750
			Unsecured Creditors:		
			(Bank Overdraft)		
			Directors	58,000	
			Creditors	1,15,000	
			Less: 5% discount	5,750	
				1,09,250	
			" Pref. Shareholders:		1,67,250
			Share Capital	6,00,000	
			Add: Share Premium @ 10%	60,000	
				6,60,000	
			Add: Arrear Dividends		
			(for 4 years)	1,20,000	
					7,80,000
			Equity Shareholders:		
			(bal. fig. @ Rs. 3.09 per		
			share on 50,000 shares)		1,54,500
		<u>12,34,000</u>			<u>12,34,000</u>

1. As the company is solvent the debenture-holders are credited to interest up to the date of repayment (i.e., Rs. 2,500 as per Balance Sheet and Rs. 1,250 for 3 months). If the company is insolvent, interest should be paid only up to the date of winding-up. A company is considered as solvent only when it can pay all of its outside liabilities.

2. If the articles of the company provides that preference shareholders are to be given equal rank both as regards payments of dividends and capital in priority to equity shares, arrear pref. dividend is also payable even if not declared in priority to any return of capital to the equity shareholders (Re. Watter Symons Ltd.) and arrear is payable up to the date of winding-up only.

Illustration 6:

The following is the Balance Sheet of Poddar Ltd. which is in the hands of the liquidator:

Balance Sheet
as at 31.12.2009

<i>Liabilities</i>	Rs.	<i>Assets</i>	Rs.
<i>Share Capital:</i>		<i>Fixed Assets</i>	2,00,000
1,000, 6% Preference Shares of Rs. 100 each, fully paid	1,00,000	Stock	1,20,000
2,000 Equity Shares of Rs. 100 each, fully paid	2,00,000	Book Debts	2,40,000
2,000 Equity Shares of Rs. 100 each, called Rs. 75	1,50,000	Cash in hand	40,000
Loan from Bank (on security of stock)	1,00,000	Profit and Loss Account	3,00,000
Trade Creditors	3,50,000		
	<u>9,00,000</u>		<u>9,00,000</u>

The assets realised the following amounts (after all costs of realisation and liquidator's commission amounting to Rs. 5,000 paid out of cash in hand Rs. 40,000 as per Balance Sheet):

	Rs.
Fixed Assets	1,68,000
Stock	1,10,000
Book Debts	2,30,000

Calls on partly paid shares were made but the amounts due on 200 shares were found to be irrecoverable.

Prepare Liquidator's Final Statement of Receipts and Payments.

Solution:

In the Books of Poddar Ltd. (In Liquidation)
Liquidator's Final Statement of Receipts and Payments A/c

	Rs.	Rs.		Rs.
Cash in hand		40,000	Liquidator's Remuneration	5,000
<i>Assets Realised:</i>			Trade Creditors	3,50,000
Fixed Assets	1,68,000		Preference Shareholders	1,00,000
Stock	10,000		Equity Shareholders	20,000
(1,10,000 – 1,00,000)			@ Rs. 10 on 2,000 shares	
Book Debts	<u>2,30,000</u>	4,08,000		
Proceeds of call on 1,800 Equity Shares @ Rs. 15		27,000		
		<u>4,75,000</u>		<u>4,75,000</u>

Notes: Return per Equity share

	Rs.
Cash available before paying Preference shareholders (Rs. 5,48,000 – Rs. 4,55,000)	93,000
Add: Notional calls 1,800 shares (2,000 – 200) × Rs. 25	45,000
	1,38,000
Less: Preference Share Capital	1,00,000
Available for Equity shareholders	38,000

∴ Return per share = $\frac{\text{Rs. } 38,000}{3,800 (4,000 - 200)} = \text{Rs. } 10$
 and Loss per Equity share Rs. (100 – 10) = Rs. 90*

* This loss per equity share can also be calculated as:

	Rs.	Rs.
Equity Share Capital	3,50,000	
Less: Forfeited amount in respect of 200-shares	15,000	
		3,35,000
Add: Deficiency as regards Pref. shareholders (1,00,000 – 93,000)		7,000
Total Deficiency		3,42,000
∴ Deficiency per share	Rs. $\frac{3,42,000}{3,800} = 90$	

Notes: Calls to be made @ Rs. 15 per share (Rs. 90 – 75) on 1,800 shares.

Equity Shares of various denomination

Illustration 7:

The following is the Balance Sheet of Y Ltd. as at 31st March 2004:

Liabilities	Rs.	Assets	Rs.
Share Capital		Fixed Assets	
2,000 Equity Shares of Rs. 100 each, Rs. 75 per share paid-up	1,50,000	Land and Building	4,00,000
6,000 Equity Shares of Rs. 100 each, Rs. 60 per share paid-up	3,60,000	Plant and Machinery	3,80,000
2,000, 10% Pref. Shares of Rs. 100 each, fully paid-up	2,00,000	Current Assets	
10% Debentures (having floating charges on all assets)	2,00,000	Stock at Cost	1,10,000
Interest Accepted on Debentures (also secured as above)	10,000	Sundry Debtors	2,20,000
Sundry Creditors	4,90,000	Cash at Bank	60,000
	14,10,000	Profit and Loss A/c	2,40,000
			14,10,000

On that date, the company went into voluntary liquidation. The dividends for preference shares were in arrears for the last two years. Sundry Creditors include a loan of Rs. 90,000 on mortgage of Land and Buildings.

The assets realized were:

	Rs.
Land and Building	3,40,000
Plant and Machinery	3,60,000
Stock	1,20,000
Sundry Debtors	1,60,000

Interest accrued on loan on mortgage of building up to the date of payment amount to Rs. 10,000. The expenses of liquidation amounted to Rs. 4,600. The liquidator is entitled to a remuneration of 3% on all the assets realized (except Cash and Bank) and 2% on the accounts distributing among equity shareholders. Preferential creditors included in Sundry Creditors amounted to Rs. 30,000 All payments were made on 30th June 2004. Prepare the Liquidator's Final Statement of Account.

Solution:

**In the Books of Y Ltd.
Liquidator's Final Statement of Account**

	Rs.	Rs.		Rs.	Rs.
Cash at Bank		60,000	Liquidator's Remuneration		
<i>Assets Realised</i>			(3% on Rs. 9,80,000)	29,400	
Land and Building			(2% on Rs. 51,000 × $\frac{7}{102}$)	<u>1,000</u>	30,400
(3,40,000 – 1,00,000)	2,40,000		Liquidation Expenses		4,600
Sundry Debtors	1,60,000		Creditors		3,70,000
Stock	1,20,000		Debentureholders —		
Machinery	<u>3,60,000</u>		Principal	2,00,000	
		8,80,000	Add: Interest		
			(10,000 + 5,000)	<u>15,000¹</u>	2,15,000
			" Preferential Creditors		30,000
			" Pref. Shareholders—		
			Principal	2,00,000	
			Add: Arrear Division	<u>40,000</u>	2,40,000
			" Equity Shareholders		
			2,000 Shares @ Rs. 17.50	35,000	
			6,000 Shares @ Rs. 2.50	<u>15,000</u>	50,000 ²
		<u>9,40,000</u>			<u>9,40,000</u>

Illustration 8:

The following was the Balance Sheet of X Limited as on 31.3.2008:

Balance Sheet of X Limited as at 31.3.2008

<i>Liabilities</i>	Rs.	<i>Assets</i>	Rs.
Share Capital		Fixed Assets	
14%, 4,000 Preference Shares of Rs. 100 each, fully paid-up	4,00,000	Land	40,000
8,000 Equity Shares of Rs. 100 each, Rs. 60 per share paid-up	4,80,000	Buildings	1,60,000
Reserves and Surplus	Nil	Plant and Machinery	5,40,000
Secured Loans		Patents	40,000
1. 14% Debentures (Having a floating charge on all assets)	2,30,000	Investments	Nil
Interest accrued on above debentures (Also having a floating charge as above)	32,200	Current Assets, Loans and Advances	
2. Loan on Mortgage of Land and Building	1,50,000	A. Current Assets	
Unsecured Loan	Nil	Stock at Cost	1,00,000
Current Liabilities and Provisions		Sundry Debtors	2,30,000
A. Current Liabilities		Cash at Bank	60,000
Sundry Creditors	1,17,800	B. Loans and Advances	
	<u>14,10,000</u>	Miscellaneous Expenses	Nil
		Profit and Loss A/c	2,40,000
			<u>14,10,000</u>

On 31.3.2008 the company went into voluntary liquidation. The dividend on 14% preference shares was in arrears for one year. Sundry Creditors include preferential creditors amounting to Rs. 30,000.

The assets realized the following sums: Land Rs. 80,000; Building Rs. 2,00,000; Plant and Machinery Rs. 5,00,000; Patent Rs. 50,000; Stock Rs. 1,60,000; Sundry Debtors Rs. 2,00,000.

The expenses of liquidation amounted to Rs. 29,434. The liquidator is entitled to a commission of 2% on all assets realized (except cash at Bank) and 2% on amounts distributed among unsecured creditors other than preferential creditors. All payments were made on 30th June 2008. Interest on mortgage loan shall be ignored at the time of payment. Prepare the liquidator's final statement of account.

Solution:

**In the Books of X Ltd.
Liquidator's Final Statement of Account**

	Rs.		Rs.	Rs.
Assets Realised:		Liquidator's Remuneration		25,556
Cash at Bank	60,000	Liquidation Expenses		29,434
Sundry Debtors	2,00,000	Debentureholders:		
Stock	1,60,000	14% Debentures	2,30,000	
Plant and Machinery	5,00,000	Interest Account	40,250 ²	
Patents	50,000			2,70,250
Surplus from Land & Building (Rs. 80,000 + Rs. 2,00,000 - Rs. 1,50,000)	1,30,000	Creditors:		
		Preferential	30,000	
		Unsecured	87,800	
				1,17,800
				<i>Contd.</i>

	Rs.		Rs.	Rs.
		Preference Shareholders:		
		Preference Shares		
		Capital	4,00,000	
		Arrears of Dividend	56,000	
				4,56,000
		Equity Shareholders (<i>bal. fig.</i>)		
		(Rs. 2,00,960 + 8,000)		
		= 25.12 per share		2,00,960 ³
	<u>11,00,000</u>			<u>11,00,000</u>

Workings

	Rs.
1. Liquidator's Remuneration	
2% on assets realised (2% of Rs. 11,90,000)	23,800
2% on payments to unsecured creditors (2% pm Rs. 87,800)	1,756
	<u>25,556</u>
2. Interest Outstanding on 14% Debentures	
Interest accrued as on 31.3.2008	32,200
Interest accrued up to the date of payment, i.e., 30.6.2008	8,050
	<u>40,250</u>
3. Amount Payable to Equity Shareholders	
Paid-up equity share capital	4,80,000
Less: Amount available for equity shareholders—	2,00,960
Loss	<u>2,79,040</u>
∴ Loss per share $\frac{\text{Rs. } 2,79,040}{8,000}$ - Rs. 34.88.	

Illustration 9:

The following is the Balance Sheet of Confidence Builders Ltd., as at 30th Sept. 2007:

Liabilities	Rs.	Assets	Rs.
Share Capital:		Land and Buildings	1,20,000
Issued : 11% Pref. Shares of Rs. 10 each	1,00,000	Sundry Current Assets	3,95,000
10,000 Equity Shares of Rs. 10 each, fully paid-up	1,00,000	Profit and Loss Account	38,500
5,000 Equity Shares of Rs. 10 each, Rs. 7.50 per share paid-up	37,500	Debenture Issue Expenses to be written-off	2,000
13% Debentures	1,50,000		
Mortgage Loan	80,000		
Bank Overdraft	30,000		
Creditors for Trade	32,000		
Income-tax Arrears:			
(assessments concluded in July 2007)			
Assessment Year 05-06	21,000		
Assessment Year 06-07	5,000		
	<u>26,000</u>		
	<u>5,55,500</u>		<u>5,55,500</u>

Mortgage loan was secured against land and buildings. Debentures were secured by a floating charge on all the other assets. The company was unable to meet the payments and therefore the debenture-holders appointed a Receiver and this was followed by a resolution for members' voluntary winding-

up. The Receiver for the Debenture-holders brought the Land and Buildings to auction and realized Rs. 1, 50,000.

He also took charge of Sundry Assets of the value of Rs. 2, 40,000 and realized Rs. 2, 00,000. The Liquidator realized Rs. 1, 00,000 on the sale of the balance of sundry current assets. The Bank Overdraft was secured by a personal guarantee of two of the Directors of the company and, on the Bank raising a demand; the Directors paid-off the dues from their personal resources.

Costs incurred by the Receiver were Rs. 2,000 and by the Liquidator Rs. 2,800. The Receiver was not entitled to any remuneration but the liquidator was to receive 3% fee on the value of assets realized by him. Preference shareholders had not been paid dividend of period after 30th September 2006 and interest for the last half-year was due to the debenture-holders.

Prepare the accounts to be submitted by the Receiver and the Liquidator.

Solution:

Before preparing the Liquidator's Final Statement of Accounts, we are to prepare a Receiver's Receipts and Payments Account as:

**In the Books of Confidence Builders Ltd.
Receiver's Receipts and Payments Account**

		Rs.			Rs.
2007 Sept. 30	Balance b/d		2007 Sept. 30	Receiver's Cost	2,000
	Assets Realised	2,00,000		Preferential Creditors	26,000
	Surplus Received from Mortgage:			(Tax raised for 12 months)	
	Sale Proceed of L & B	1,50,000		Debenture- holders	1,50,000
	Less: Mortgage Loan	80,000		Add: Interest for 6 months	9,750
		70,000			1,59,750
		<u>2,70,000</u>		Surplus (bal.) transferred to the liquidators	82,250
					<u>2,70,000</u>

Liquidator's Final Statement of Account

	Rs.		Rs.
Surplus received from the Receiver	82,250	Liquidation Expenses	2,800
Assets realised	1,00,000	Liquidator's Remuneration	3,000
—Proceeds of Current Assets		<i>Secured Creditors:</i>	
Proceeds of Call on 5,000 shares @ Rs. 2.17 *	10,850	Trade Creditors	32,000
		Bank Overdraft	30,000
		Preferenceholders (with Div.) (1,00,000 + 22,000)	1,22,000
		Equity Shareholders (i.e.) 33 paise in the rupee on 10,000 shares	3,300
	<u>1,93,100</u>		<u>1,93,100</u>

* Proceeds of Call

		Rs.
Notional call @ 2.5 on 5,000 shares	=	12,500
Less: Deficit (1,89,800 – 1,82,250)	=	7,550
		<u>4,950</u>

Number of shares deemed to be fully paid 15,000

So, Refund on fully paid shares = Rs. $\frac{4,950}{15,000} = 0.33$ p

∴ Call money on partly paid shares will be Rs. 2.17 (2.50 – 0.33)

Illustration 10:

You are asked by a liquidator of a company to prepare a statement of account to be laid before a meeting of the shareholders from the following:

Balance Sheet of the company on the date of liquidation on 1.1.2010

Balance Sheet of the company on the date of liquidation on 1.1.2010

	Rs.		Rs.
<i>Share Capital:</i>		Fixed Assets	4,00,000
4,000 Equity Shares of Rs. 100 each, called Rs. 80	3,20,000	Book-Debts	3,00,000
1,000 Pref. Shares of Rs. 100 each, called Rs. 70	70,000	Loss as on Date	1,00,000
Loan from Bank (Secured on Building and Machinery)	1,50,000		
Trade Creditors	2,60,000		
	<u>8,00,000</u>		<u>8,00,000</u>

The assets realized as follows: 1.4.2010: Fixed Assets Rs. 1, 00,000; Book Debts Rs. 1, 00,000, Expenses paid Rs. 4,000. 1.6.2010: Fixed Assets (final) Rs. 2, 00,000, Book Debts Rs. 1, 00,000. 1.8.2010: Book Debts (final payment) Rs. 50,000. The liquidator is entitled to 5% on collections and 2% on the account paid to Equity shareholders.

Prepare the statement on the assumption that disbursements are made in accordance with law, as and when cash is available.

Solution:

**In the Books of the Company (in Liquidation)
Liquidator's Statement of Account**

		Rs.			Rs.
2010 April 1	<i>Assets Realised:</i> Book Debts	1,00,000	2010 April 1	Liquidator's Remuneration (5% on Rs. 1,00,000)	5,000
				Expenses	4,000
		<u>1,00,000</u>		Balance c/d	91,000
					<u>1,00,000</u>
2010 April 1	Balance b/d	91,000	2010 June 1	Liquidator's Remuneration:	
June 1	Book Debts	1,00,000		@ 5% on	
	Surplus from Securities (Rs. 3,00,000 – Rs. 1,50,000)	1,50,000		Rs. 1,00,000 = 5,000	
				@ 2% on	
				Rs. 5,882 = 118	5,118
				Trade Creditors	2,60,000
				Prof. Shareholders	70,000
				Eq. Shareholders (@ Rs. 1.47 per share)	5,882
		<u>3,41,000</u>			<u>3,41,000</u>

Contd.

		Rs.			Rs.
2010 Aug. 1	To Book Debts	50,000	2010 Aug. 1	By Liquidator's Remuneration:	
				@ 5% on	
				Rs. 50,000 = 2,500	
				@ 2% on	
				Rs. 46,569 = 931	3,431
				" Eq. Shareholders	
				(@ Rs. 11.64 per share)	46,569
		<u>50,000</u>			<u>50,000</u>

Illustration 11:

The following is the position as on 31.12.2009 of X. Ltd., which goes into voluntary liquidation as on that date:

	Rs.		Rs.
<i>Share Capital:</i>		Fixed Assets	9,00,000
10,000 Equity Shares of Rs. 50 each	5,00,000	Stock	24,00,000
1,000 Preference Shares of Rs. 100 each	1,00,000	Debtors	18,00,000
General Reserve	1,00,000	Cash at Bank	1,00,000
Loan from State Financial Corporation (secured)	2,00,000	Loans and Advances	4,00,000
Loan from Bank (secured)	38,00,000		
Creditors	9,00,000		
	<u>56,00,000</u>		<u>56,00,000</u>

The following information is given:

- (a) The loan from State Financial Corporation is secured by first charge on Fixed Assets.

(b) The Bank is secured by pledge of gold, hypothecation of all Current Assets and a second charge on Fixed Assets.

(c) Creditors include Preferential Creditors of Rs. 2, 00,000. On 15.1.2010, Stocks are sold. Stock in pledge/godown realized Rs. 14, 00,000 and other stocks were sold for Rs. 4, 00,000. On 31.1.2010, expenses of liquidation amounting to Rs. 3,000 are met and Fixed Assets are sold for Rs. 13, 00,000. On 15.2.2010, all other Current Assets realised for Rs. 19, 10,000 and liquidator's remuneration amounting to Rs. 7,000 are paid.

Prepare Liquidator's Cash Account and Liquidator's Final Statement of Account presuming that all payments are made in order of preference on earliest availability of Cash.

Solution:

**In the Books of X. Ltd. (in Liquidation)
Liquidator's Cash Account**

2010		Rs.	2010		Rs.
Jan. 1	Balance b/d	1,00,000	Jan. 1	Bank Loan	1,00,000
15	Stock	4,00,000	15	Bank Loan	4,00,000
31	Fixed Assets	13,00,000	31	Liquidation Exp.	3,000
				S.F./Corpn. (loan)	2,00,000
				Bank Loan	10,97,000
				(bal. fig.)	13,00,000
					<i>Contd.</i>

2010		Rs.	2010		Rs.
Feb. 15	Current Assets	19,10,000	Feb. 15	Liquidator's	
				Remuneration	7,000
				Bank Loan	8,03,000
				(bal. fig.	
				of Bank loan)	
				Preferential:	
				Creditors	2,00,000
				Other Creditors	7,00,000
				Pref. Shareholders	1,00,000
				Eq. Shareholders	1,00,000
		<u>37,10,000</u>			<u>19,10,000</u>
					<u>37,10,000</u>

Liquidator's Final Statement of Account

	Rs.		Rs.
<i>Assets Realised:</i>		Liquidator's Remuneration	7,000
Cash at Bank	1,00,000	Liquidator's Expenses	3,000
Surplus from Securities	10,10,000	Unsecured Creditors	9,00,000
(Fixed Assets + Pledged		Preference Shareholders	1,00,000
Current Assets – Secured Loan)		Equity Shareholders	1,00,000
(Rs. 13,00,000 + Rs. 37,10,000 –			
Rs. 40,00,000)			
	11,10,000		11,10,000

Illustration 12:

X Ltd. went into voluntary liquidation on 31st Oct. 2009.

The balances in its books on that day were:

Balance Sheet
as at 31st Oct. 2009

	Rs.		Rs.
<i>Issued Capital</i>		Furniture at cost	9,360
13,000, 6% Preference Shares		Investments at cost	2,21,000
of Rs. 10 each, fully paid-up	1,30,000	Life Insurance Policy	
6,500 Ordinary Shares of		received from a Debtor	16,900
Rs. 10 each, Rs. 5 paid-up	32,500	Sundry Debtors	1,04,000
5% Debentures	26,000	Cash at Bank	11,700
Loan from Bank		Profit and Loss A/c	4,680
(Guaranteed by Directors)	39,000		
Sundry Trade Creditors	1,17,000		
Income-Tax	17,550		
Employees' Salaries for			
1 month (including Rs. 1,950			
for Managing Director)	5,590		
	3,67,640		3,67,640

The bank called upon the Directors to implement their guarantee. The preference dividend had been paid up to 30th June 2009. There were no arrears of debenture interest. The amount owing to the Government for income-tax was in respect of assessment years 2007-2008, 2008-09 and 2009-2010 of Rs. 3,250, Rs. 13,650 and Rs. 650, respectively. The company closes its accounts on 31st December each year.

All the employees of the company had already been served with a notice to quit on 31st Oct. 2009. The liquidator admitted an amount of Rs. 2,730 for salaries in lieu of notice. The rent was paid up to 31st Oct. 2009. The premises were held under a lease with annual tenancy. The landlord agreed to waive his right to notice on the liquidator undertaking to pay him two months' rent, i.e., Rs. 650, and to vacate the premises by 31st Dec. 2009, which he did.

One of the creditors for Rs. 13,000 was under a contract to deliver certain goods to the company in Dec. 2009, and the company had contracted to supply the same goods to B. Ltd., who were included in Sundry Debtors at Rs. 6,500. The creditor refused to make delivery but admitted a claim made by the liquidator for damages at Rs. 1,625. B. Ltd. made a claim for loss against the company for Rs. 975 which was admitted by the liquidators.

Furniture was sold for Rs. 7,800. Investments were found to be valueless. Sums owing by Debtors were all collected and the Insurance Policy was surrendered for Rs. 15,600 after the liquidator had paid a premium of Rs. 585. A shareholder holding 2,600 ordinary shares failed to pay the call made by the liquidator. Legal costs came to Rs. 780 and liquidator's remuneration was Rs. 6,500.

Prepare Liquidator's Final Statement of Account in the order of payments.

Solution:

In the Books of M. Ltd.			
Liquidator's Final Statement of Account			
Dr.			Cr.
	Rs.		Rs.
Cash at Bank	11,700	Legal Costs	780
<i>Assets Realised</i>		Liquidator's Remuneration	6,500
Life Policy (15,600 – 585)	15,015	Liquidation Expenses	650
Sundry Debtors	1,03,025	Debentures—	
Furniture	7,800	(having a floating charge)	26,000
Proceeds of Call—		Preferential Creditors	17,940 ¹
@ Rs. 5 on 3,900		Unsecured Creditors	1,05,170
(6,500 – 2,600) Equity Shares	19,500	<i>(bal. fig.) @ of 64.8%</i>	
	<u>1,57,040</u>		<u>1,57,040</u>

Working Notes:

1. Preferential Creditors	Rs.
Salaries of employees (for one month but excluding the remuneration payable to Managing Director)	3,640
Income-tax for 2008-2009 and 2009-2010 (assuming that the assessment was made within 12 months prior to 31st Oct. 2009)	14,300
	<u>17,940</u>
2. Unsecured Creditors	
Bank Loan	39,000
Sundry Trade Creditors	1,17,000
Income-Tax for 1997-98	3,250
Managing Director's Remuneration	1,950
Amount paid to employees	2,730
	<u>1,63,930</u>
<i>Less: Amount recoverable from a creditor for non-supply of contracted goods</i>	1,625
	<u>1,62,305</u>
3. It has been assumed that Debentures have a floating charge on the assets of the company.	

5.8SUMMARY

- Corporate restructuring is a corporate action taken to significantly modify the structure or the operations of the company. This usually happens when a company is facing significant

problems and is in financial jeopardy. Often, the restructuring is referred to the ways to reduce the size of the company and make it small. Corporate restructuring is essential to eliminate all the financial troubles and improve the performance of the company. Corporate restructuring is an action taken by the corporate entity to modify its capital structure or its operations significantly. Generally, corporate restructuring happens when a corporate entity is experiencing significant problems and is in financial jeopardy. The process of corporate restructuring is considered very important to eliminate all the financial crisis and enhance the company's performance. The management of concerned corporate entity facing the financial crunches hires a financial and legal expert for advisory and assistance in the negotiation and the transaction deals. Usually, the concerned entity may look at debt financing, operations reduction, any portion of the company to interested investors.

- In addition to this, the need for a corporate restructuring arises due to the change in the ownership structure of a company. Such change in the ownership structure of the company might be due to the takeover, merger, adverse economic conditions, adverse changes in business such as buyouts, bankruptcy, lack of integration between the divisions, over employed personnel, etc.
- Mergers and acquisitions always involve the consolidation of two separate companies, which can be both private and public.
- M&A is intended to increase the value of a company by diversifying into new markets, improving market share, or expanding geographically.
- A merger is an agreement that combines two separate, existing companies into a new, larger entity. The aim of a merger is to create a stronger, single company.
- A merger is often referred to as a 'merger of equals' as the companies involved usually have a similar size and value.
- An acquisition - sometimes referred to as a business acquisition or a takeover - occurs when one company takes control of another, either through purchasing shares or acquiring assets.
- Within an acquisition, the acquired company is absorbed and no longer operates as an independent entity; however, the purchasing company may still have the rights to use the name and trademarks of the acquired company.

- Although the terms ‘merger’ and ‘acquisition’ are often used interchangeably, mergers and acquisitions are slightly different activities.
- The main difference between mergers and acquisitions is the balance of power in the new entity. Within a merger, the original companies – in theory – become equal partners in the new organisation; however, an acquisition always results in one business handing control to the other.
- Another key difference between mergers and acquisitions is their perception. The term ‘acquisition’ can have negative connotations for the company that is absorbed into the other, whereas a merger is usually seen in a better light.
- The combined concept of M&A is slowly replacing the individual terms ‘acquisition’ and ‘merger’ and has become a commonly used, general term that refers to any kind of activity whereby businesses join together. This is for two main reasons:
 - A true merger (a ‘merger of equals’) is extremely uncommon. In practice, one party is almost always larger, more powerful, or more valuable than the other;
 - M&A is a more neutral term that is usually well received by shareholders, employees, or directors.
- The word ‘Liquidation’ has not been used anywhere in the Companies Act, 1956. It is the word ‘winding up’ which has been used in this Act. By winding up of a Company, we mean, “Winding up of a Company is the process whereby its life is ended and its property is administered for the benefit of its creditors and members. And an administrator, called a Liquidator, is appointed and he takes control of the Company, collects its assets, pays its debts and finally distributes any surplus among the members in accordance with their rights.”
- A Company is an artificial person. It is created by law. Therefore, the law alone can dissolve it. On dissolution, Company’s name is struck off from the Register of Companies (maintained by Registrar of Companies). This fact may also be published in the official gazette.
- Liquidation of a Company, which is also called winding up of a Company, may be defined as the process through which the affairs of the Company are stopped for the purpose of liquidation, for which an officer, called liquidator, is appointed to take charge of the assets and liabilities of the Company. His duties are to realize the assets, discharge the liabilities and distribute the surplus, if any, to the members of the Company. Liquidation is the process a debt-laden company initiates to wind up its operations and sell its assets in order to repay said liabilities and other obligations. A company is liquidated when it is ascertained that the business is not in any state to continue. This may be due to various reasons such as insolvency (usually the main reason), unwillingness to carry on with the operations, etc.
- If the enterprise is bankrupt, the liquidator sells the company’s assets to repay all liabilities. The positive balance after repaying the creditors is then distributed among the company’s shareholders.

5.9 KEY WORDS

- **ABS:** Asset-backed security—security supported by assets such as loans, leases and credit card receivables.
- **Acceleration:** Acceleration refers to the taking of a formal step by lenders following an Event of default such as demand for early repayment of the loan. Actions that can be taken by the lenders following an event of default are normally set out in a list at the end of the Event of default clause.
- **Ad-hoc committee:** A creditors' committee used on a temporary basis (often contrasted to a formal committee) with no rights to formal recognition.
- **Administration:** Administration is a procedure under the IA 1986, under which a company in financial difficulties is run by an Administrator as a going concern prior to the implementation of longer-term options such as break-up and sale.
- **Administrator:** An Insolvency Practitioner appointed by the court or by a Floating charge holder or the directors or the company to control the company and achieve one of the purposes set out in IA 1986, Sch B1.
- **Administrative receivership:** When a company breaches the terms of its borrowing from a creditor with a Floating charge, or in other circumstances set out in the charge, that creditor may appoint

5.10 LEARNING ACTIVITY

1. Briefly discuss different forms of acquisition

2. Why do corporates go for restructuring exercises? Discuss the various forms of restructuring exercises that are being practiced by corporates across the globe.

3. Explain meaning, characteristics and rationale of restructuring

5.11 UNIT-END QUESTIONS

A. Descriptive Questions

1. What is internal restructuring? Explain internal restructuring process for a FMCG company.
2. Explain the concept of merger with relevant example.
3. What are the types of merger when Company A wants to Merge with other company?
4. John & Co. keeps their books by the single entry system. The position of the firm on 1st January 2019 was as follow: Stock in Trade: \$18,000, Debtors: \$15,000, Furniture and Fixtures: \$17,500, Cash at Bank: \$12,500, Sundry Creditors: \$13,500, Outstanding Salaries: \$2,200. The position of the firm on 31st December 2019 was as follows: Stock in Trade: \$24,000; Debtors: \$19,500, Furniture and Fixtures: \$15,000, Plant: \$10,000, Sundry Creditors: \$12,000, Bank Overdraft: \$8,000. During the year, John withdrew \$3,500 for his personal expenses. Charge interest on capital @ 5% p.a. Required: Prepare Statement showing profit or loss made by the firm for the year ended December 31, 2019.
5. **The Balance Sheet of Bubble Ltd. as on 31st Dec. 2004 was as follows:**

Share	Rs.	Land & Building	Rs.
8,000 Preference shares of Rs 10 each	80,000	Other Fixed Assets	25,000
12,000 Equity shares of Rs 10 each	1,20,000	Stock	2,00,000
Bank Loan	4,00,000	Debtors	5,25,000
8% Debentures	1,00,000	Profit and Loss A/c	1,00,000
Interest outstanding on Debentures	8,000		58,000
Creditors	2,00,000		
	9,08,000		9,08,000

The company went into liquidation on the date. Prepare Liquidator's Statement of Account after taking into account the following:

1. Liquidator expenses and liquidator's remuneration amounted to Rs 3,000 and Rs 10,000 respectively.
2. Bank loan was secured by pledge of stock.
3. -Debentures and Interest thereon are secured by a floating charge on all assets.
4. Fixed assets were realised at book values and current assets at 80% of book values.
7. The Ultra Optimist Ltd. went into liquidation. Its assets realised Rs 3, 50,000 excluding amount realised by sale of securities held by the secured creditors.

The following was the position:

Share Capital:

1,000 shares of Rs 100 each Rs 1,00,000 Secured Creditors (Securities realised (Rs 40,000) Rs 35,000 Preferential creditors Rs 6,000 Unsecured creditors Rs 1,40,000

Debentures having a floating charge on the assets of the company Rs 2, 50,000 Liquidation Expenses Rs 5,000 Liquidator's Remuneration Rs 7,500

Prepare the liquidator's final statement of account.

B. Multiple Choice Questions

1. The restructuring of a corporation should be undertaken if
 - a. The restructuring can prevent an unwanted takeover.
 - b. The restructuring is expected to create value for shareholders.
 - c. The restructuring is expected to increase the firm's revenue.
 - d. The interests of bondholders are not negatively affected.

2. The "information effect" refers to the notion that
 - a. A corporation's actions may convey information about its future prospects.
 - b. Management is reluctant to provide financial information that is not required by law.
 - c. Agents incur costs in trying to obtain information.
 - d. The financial manager should attempt to manage sensitive information about the firm.

3. In the long run, a successful acquisition is one that:
 - a. Enables the acquirer to make an all-equity purchase, thereby avoiding additional financial leverage.
 - b. Enables the acquirer to diversify its asset base.
 - c. Increases the market price of the acquirer's stock over what it would have been without the acquisition.
 - d. Increases financial leverage.

4. Changes in the company byelaws to make the acquisition of a company more difficult or more expensive are referred to as
 - a. Takeover
 - b. Anti-takeover Amendments
 - c. Corporate Control
 - d. Proxy Contests

5. When did the Insolvency and Bankruptcy Board of India (Voluntary Liquidation Process) Regulations, 2017 come into force:
 - a. 01 January, 2017
 - b. 01 February, 2017
 - c. 01 March, 2017
 - d. 01 April, 2017

Answer:

1. b 2. a 3. c 4. b5. d

5.12 SUGGESTED READINGS

- Hanif, M. & Mukherjee, A. (2015). *Corporate Accounting*. South West: Thomson.
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UNIT VI- LIQUIDATION OF COMPANIES

Structure

- 6.0. Learning Objective
- 6.1. Introduction
- 6.2. Banking Companies
- 6.3. Investment Accounts
- 6.4. Summary
- 6.5. Key words
- 6.6. Learning Activity
- 6.7. Unit -End Questions
- 6.8. Suggested Readings

6.0 LEARNING OBJECTIVE

After studying this unit, you will be able to:

- Explain banking companies
- Discuss Investment accounts

6.1 INTRODUCTION

Liquidation in finance and economics is the process of bringing a business to an end and distributing its assets to claimants. It is an event that usually occurs when a company is insolvent, meaning it cannot pay its obligations when they are due. Liquidation is a process through which a company which is running is shut down and its existence comes to an end. This often happens when the companies are unable to pay its creditors and hence need to sell off its assets to pay of them. Though in another version this could be a voluntary act as well where law ensures that all the debts of a company into existence is paid before it is closed or shut down. Liquidation or winding up is a legal term and refers to the procedure through which the affairs of a company are wound up by law.

A company is the creation of law, it cannot die itself as a natural death. So it comes to its end by law through the process of liquidation.

6.2 BANKING COMPANIES

According to Sec. 5 of the Banking Regulation Act, 1949, a banking company means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawn by Cheque, Draft, Order, or otherwise.

In short, a banking company means and includes any company which carries on the business or which transacts the business of banking in India. Therefore, any company which is engaged in trade or manufacture, which accepts deposits of money from the public for the purpose of financing its business only, shall not be deemed to carry on the business of banking.

No company can use as part of its name any of the words bank, banker or banking other than a banking company and, at the same time, no company can carry on business of banking in India unless and until it uses at least one of such words as part of its name.

Licensing of Banking Companies:

According to Sec. 22, no company shall carry on banking business in India unless it holds a license issued by the Reserve Bank of India.

If the following conditions are satisfied, the Reserve Bank of India may grant a license:

- (i) “That the company is or will be in a position to pay its present and future depositors in full as their claims accrue;
- (ii) That the affairs of the company are not being or are not likely to be conducted in a manner detrimental to the interests of its present or future depositor;
- (iii) That, in the case of a foreign banking company, the carrying on of a banking business by such company in India will be in the public interest, that the Government or law of the country of its origin does not discriminate against Indian banking companies carrying on business in that country, and that it complies with all the requirements of law applicable to it”.

Cancellation of License:

The Reserve Bank of India may cancel a license if:

- (i) The company ceases to carry on banking business in India;
- (ii) The company at any time fails to comply with any of the conditions on which the license was granted; or
- (iii) At any time, any of the conditions, on the satisfaction of which the Reserve Bank of India granted the license, has not been fulfilled.

Area of Business of Banking Companies:

Sec. 6 of the Banking Regulation Act, 1949, lays down that the following business may also be carried on by a banking company, in addition to the usual banking business:

- (a) 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 an attorney on behalf of customers, but excluding the business of a managing agent of a company;

(b) Contracting for public and private loans and negotiating and issuing the same;

(c) Selecting, 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 lending of money for the purpose of any such issue;

(d) Carrying on and transacting every kind of guarantee and indemnity business;

(e) 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;

(f) Acquiring or holding and generally dealing with any property, or title or interest in any such property which may form the security or part of the security for any loans or advances or which may be connected with any such security;

(g) Undertaking and executing trusts;

(h) Undertaking the administration of estates as executor, trustee or otherwise;

(i) Establishing and supporting associations, institutions, funds, trusts, and convenience for the benefit of employees, ex-employees, their dependents and the general public;

(j) Acquiring, constructing, maintaining and altering any building or works necessary for the purpose of the banking company;

(k) Selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing-off or turning into account or otherwise dealing with all or any part of the property and rights of the company;

(l) 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 Sec. 6.

(m) Doing such other things as are necessary for the efficient conduct of the above-named business, such as acquisition, construction, alteration etc. of any building or works necessary or convenient for the purpose of the company; and

(n) Any other form' of business which the Central Government may notify in the Official Gazette.

As such, other types of business are prohibited by a banking company.

6.3 INVESTMENT ACCOUNTS

Liquidation basis of accounting is generally applicable to both private and public companies when liquidation is “imminent.” Investment companies regulated under the Investment Company Act of 1940 are specifically exempt, as they cannot legally change the way they measure their net asset value. However, all other “nonregulated” investment companies, such as private equity and hedge funds, are allowed to use this accounting method should they need it.

When Should a Nonregulated Investment Company Use Liquidation Basis of Accounting?

When liquidation is “imminent” of course! According to FASB, liquidation is imminent when the likelihood of an entity returning from liquidation is remote and either:

1. A plan of liquidation is approved by the authoritative party of the entity, and it is remote that other parties can block the plan; or
2. A plan of liquidation is imposed by outside forces, such as a key investor redeeming out of a fund or an involuntary bankruptcy.

Note that certain investment companies are limited-life entities, such as private equity funds, and their governing documents have specified terms for liquidation. These types of funds should only apply the liquidation basis of accounting if the approved liquidation plan differs from those established in the governing documents at inception.

What is Required Under the Liquidation Basis of Accounting?

Once an investment company has determined the liquidation basis of accounting is appropriate, the measurement and recognition of assets, liabilities, costs or expenses, and income would change as well as the presentation and disclosures in the financial statements:

- Measure assets to reflect the estimated amount of cash or similar consideration the entity expects to collect in settlement or disposal of the assets. This may be different than fair value.
- Generally measure liabilities under normal GAAP, except that costs should be evaluated and estimates accrued through the estimated liquidation period. For example, evaluate and estimate professional fees for legal and compliance matters as well as operational and administrative costs through the estimated liquidation period, even if the period is in excess of a year.
- Plan to accrue other income and expenses expected to be incurred or earned through the end of liquidation, if and when a reasonable basis for such estimation exists.

- Re-measure and adjust all of the above at each reporting period.
- There are additional disclosure requirements as well as financial statement presentation options once liquidation basis is adopted, so be sure to check FASB ASC 946-205 and ASC 205-30 for implementation guidance.

If your nonregulated investment company is nearing a liquidation event, talk with your financial advisory team to discuss using the liquidation basis of accounting.

6.4 SUMMARY

- The business assets are then sold (liquidated) and any realisation of revenue is redistributed in order of priority. The company is struck-off the registrar of companies and this is known as dissolution, which is the final stage of the liquidation process in the UK. This article will aim to give you all the information you need to understand what this situation means, and the processes involved. The Liquidation or winding up a company is a process through which life of company and it's all affairs are wound up and its property administered for benefits of its creditors and members. An administrator, who is called liquidator, is appointed to take control of company, collect its assets, pay its debts and finally if any surplus assets are left, they are divided among the members of the company in proportion to their rights under the articles. This being done the company is dissolved on compliance within the requisite formalities prescribed by the companies' ordinance.
- A Bank is an establishment, office, and a company, which deals in money. A bank receives money in deposit accounts of its customers on certain conditions in different type of deposit accounts. The conditions of these accounts differ from the nature of accounts.
- In deposit accounts banks also pay interest to its customers as per the nature and conditions of the account. A bank also lends money to its customers as per decided guideline. Although no statutory definition of a bank is given anywhere but as per section 5(c) of Banking Regulation Act 1949 a "Banking Company" means any company which transacts the business of a Banking Company in India.
- The term has been further elaborated under section 5(B) of the said Act which says. The Banking means the accepting for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable able by cheque, draft, pay order or otherwise.

- One thing is very important to understand that any Bank functioning in India is bound to obey the rules of the Reserve Bank of India. A better care of the customers is taken by all banks is ensured by the Reserve Bank of India. As such the Reserve Bank of India keeps an attentive eye on the functioning of banks in India and also takes corrective steps whenever required to protect the interest of each banking customer.
- Investment means to spend money outside the business in order to earn some income which are non-trading in nature.
- Usually, money is invested in Government Bonds, Securities, Shares and Debentures of companies etc.

6.5 KEY WORDS

- **Balance Transfer:**The process of moving an outstanding balance from one credit card to another. This is usually done to obtain a lower interest rate on the outstanding balance. Transfers are sometimes subjected to a Balance Transfer Fee. See related question Balance Transfers.
- **Bank Custodian:**A bank custodian is responsible for maintaining the safety of clients' assets held at one of the custodian's premises, a sub-custodian facility or an outside depository. See related question Asset Management - Bank Custodians.
- **Bank Examination:**Examination of a bank's assets, income, and expenses-as well as operations by representatives of Federal and State bank supervisory authority-to ensure that the bank is solvent and is operating in conformity with banking laws and sound banking principles.
- **Bank Statement:**Periodically the bank provides a statement of a customer's deposit account. It shows all deposits made, all checks paid, and other debits posted during the period (usually one month), as well as the current balance.
- **Insurance (Hazard):**Insurance to protect the homeowner and the lender against physical damage to a property from sources such as but not limited to fire, wind, or vandalism. See related question Property Insurance.
- **Insured Deposits:**Deposits held in financial institutions that are guaranteed by the Federal Deposit Insurance Corporation (FDIC) against loss due to bank failure. See related question FDIC Insured Deposits.
- **Interest:**The term interest is used to describe the cost of using money, a right, share, or title in property.
- **Interest Rate:**The amount paid by a borrower to a lender in exchange for the use of the lender's money for a certain period of time. Interest is paid on loans or on debt instruments, such as notes or bonds, either at regular intervals or as part of a lump sum payment when the issue matures. See related questions Credit Cards and Consumer Loans - Interest Rates.

- Interest Rate Index:IA table of yields or interest rates being paid on debt that is used to determine interest-rate changes for adjustable-rate mortgages and other variable-rate loans. See related question Index-Linked CD.

6.6 LEARNING ACTIVITY

1. Write a note on Statutory Reserves requirement under Banking companies.

-
2. Write a note on Contingent liabilities in respect of Banking Company Final Accounts.
-
-

6.7 UNIT-END QUESTIONS

A. Descriptive Questions

1. What is banking company?
2. What is insurance company?
3. How does licensing of banking companies to be obtained to run operations of Punjab National Bank?
4. What is concept of reinsurance for Bharti Axa Life Insurance?
5. What are the types of insurance offered by Life Insurance company in India?

B. Multiple Choice Questions

1. As per the Banking Regulation Act, 1949, a bank can engage in the following banking business.
 - a. Borrowing and raising of money
 - b. Dealing in bills of exchange, hundis, promissory notes, etc.
 - c. Carrying on and transacting every kind of guarantee and indemnity business
 - d. All of the above
2. A banking company can pay dividend on its shares _____.
 - a. After writing off all its capitalised expenses including preliminary expenses
 - b. After charging depreciation on its investments
 - c. After charging bad debts where adequate provisions have been made to the satisfaction of the auditor
 - d. before charging depreciation on its investments and writing off all its capitalised expenses
3. The General Ledger of a bank contains _____.
 - a. all personal, real and nominal accounts

- b. all personal accounts
 - c. all real and nominal accounts
 - d. the control accounts of all personal, real and nominal ledgers
4. The items under 'Liabilities' in the balance sheet of a Bank are shown in the following order.
- a. Capital, Reserves and Surplus, Borrowings, Deposits
 - b. Deposits, Capital, Reserves and Surplus, Borrowings
 - c. Capital, Reserves and Surplus, Deposits, Borrowings
 - d. Borrowings, Deposits, Capital, Reserves and Surplus
5. Bills for collection are shown
- a. in the balance sheet of a Bank under assets
 - b. in the balance sheet of a Bank under liabilities
 - c. in the balance sheet of a Bank under both assets and liabilities
 - d. in the notes forming part of balance sheet of a Bank under contingent liabilities

Answer:

1. d2. a3. c4. a5. d

6.8 SUGGESTED READINGS

- Hanif, M. & Mukherjee, A. (2015). *Corporate Accounting*. South West: Thomson.
- Tulsian, P.C. (2014). *Corporate Accounting*. New Delhi: Tata McGraw-Hill Education.
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UNIT VII – VOYAGE ACCOUNTS

Structure

- 7.0. Learning Objective
- 7.1. Introduction
- 7.2. Meaning of important terms
- 7.3. Voyage in Progress
- 7.4. Summary
- 7.5. Key words
- 7.6. Learning Activity
- 7.7. Unit -End Questions
- 7.8. Suggested Readings

7.0 LEARNING OBJECTIVE

After studying this unit, you will be able to:

- Explain the treatment of special items of income & expenses used in voyage
- Describe Voyage accounts
- List different terms used in Voyage Accounts

7.1 INTRODUCTION

Voyage Account is an account which is prepared by the shipping companies. This account is prepared to get a complete record of the profits earned and loss incurred on the particular voyage undertaken by the shipping company. It records both inward and outward journey. It is prepared separately for each voyage.

The method of accounting followed by shipping companies is known as voyage accounting. Shipping companies prepare their accounts periodically and also prepare the results of each voyage separately. Shipping companies carry goods from one place to another. Some companies carry passengers also in addition to goods from one place to another place.

In order to ascertain the result of operating a ship's voyage, Voyage Account is prepared. The Voyage Account is a revenue account. It is important to note that there is no difference in the manner of preparing accounts period-wise and voyage-wise.

All expenses connected with the voyage, such as port charges, wages and salaries of the crew, captain and other staff, transshipment, agency fees, provisions, loading and unloading charges, bunker and

harbour wages, freight and insurance, insurance of the ship on a time policy according to duration of voyage, depreciation arising as a result of the journey, address commission paid to brokers for freight for the ship, commission to captain on net profit etc. are debited to concerned Voyage Account.

All incomes such as freight on cargo carried, passage money, primate etc. are credited.

7.2 MEANING OF IMPORTANT TERMS

Income

Following are the main sources of income of a Voyage –

- Freight – Freight charges are the main income collected against the transportation of the goods.
- Passage Money – Passage money is collected from the passengers; in case it is passengers' vessel.
- Primage – Primage is an additional freight in the form of surcharge on the freight.

Expenses

Following are the various ways of expenses of a vessel –

- Brokerage & Commission – Brokerage and commission is calculated on the freight charges including primage and it is paid to the charter's agent. Address commission is payable to the brokers on procurements of freight from the different parties.
- Insurance – The insurance charges on proportionate basis might be debited from the voyage account. For example, if insurance is for one year and journey of voyage is for three-month, insurance charges will be debited from the voyage account on 14th/14th ratio.
- Stores – Stores, which are purchased for voyage are debited from the voyage account on consumption basis i.e. opening stock + purchases – closing stock.
- Depreciation – Depreciation on ship is charged from the voyage account in the proportion of the period of a journey.
- Bunker Cost – Cost of water, coal, diesel, fuel, etc. used for the purpose of voyage is called bunker cost and may debited from the voyage account.
- Port Charges – Port authorities charge fees for allowing ships to use port for the loading/unloading the cargo. This fee amount is debited from the voyage account.
- Stevedoring Charges – Loading and unloading of cargo called stevedoring charges and should be debited from the voyage account.

Pro-forma

In the books of M/s Titanic Shipping Company

Voyage Account

For the period ending 31-12-2014

Particulars	Amount	Particulars	Amount
To Coal		By Freight	Xx
Opening Stock XX		By Primage	Xx
Add: Purchases XX			

XXXX			
Less: Closing Stock XX			

To Port Charges			
To Captain Expenses	xx		
To Harbour Wages	xx		
To Address Commission	xx		
To Brokerage	xx		
To Insurance Premium	xx		
To Salary & Wages	xx		
To Stores	xx		
To Depreciation	xx		
To Provision for Incomplete	xx		
Voyage	xx		
To Net Profit	xx		
(trf. To Profit & Loss A/c)			
	xx		

	-----		XXXX
	XXXX		

Illustration 1:

S. S. Jaihind commenced a voyage on 1. 10. 2010 from Mumbai to London and back. The voyage was completed on 30. 11. 2010. It carried a consignment of Jute on its outward journey and of Plant on its return journey. The ship was insured and the annual premium was Rs. 15,000.

Prepare a Voyage Account from the following particulars:

	Rs.		Rs.
Freight earned (Outward)	1,00,000	Wages and salaries	20,000
Freight earned (Inward)	50,000	Stores	6,000
Port Dues	5,000	Sundry Expenses	2,000
Bunker	20,000	Passage money received	4,000
Lighterage charges	3,000	Annual Depreciation	36,000

Address commission 5% on outward and 4% on Inward freight Primage is 5% on freight.

The manager is entitled to 5% commission on the profit earned after charging such commission.

Stores and Coal on hand were valued at Rs. 2,000 on 30. 11. 2010.

Solution

S. S. Jaihind			
Voyage No.— Account from Mumbai to London and back			
Started on 1 Oct. 2000 and completed on 30th Nov., 2000			
Dr.			Cr.
Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Port Dues	5,000	By Freight Outward	1,00,000
" Bunker	20,000	" Freight Return	50,000
" Lighterage Charges	3,000	" Passage money	4,000
To Wages and Salaries	20,000	By Primage 5% on freight	7,500
" Storages	6,000	(i.e., Rs. 1,50,000)	
" Sundry Expenses	2,000	" Closing Stores and Coal	2,000
" Depreciation for 2 months	6,000		
" Insurance for 2 months	2,500		
" Address Commission ¹	7,875		
" Manager's Commission ²	4,339		
" Profit on Voyage			
Transferred to P & L A/c	86,786		
	<u>1,63,500</u>		<u>1,63,500</u>

1. Address Commission to be calculated as under :

	Outward Rs.	Inward Rs.
Freight	1,00,000	50,000
Primage @ 5% on freight	5,000	2,500
	<u>1,05,000</u>	<u>52,500</u>

Amount of Commission

@ 5% on Rs. 1,05,000 = Rs. 5,250

@ 5% on Rs. 52,500 = Rs. 2,625

7,875

2. Manager's Commission to be calculated as under :

Profit before charging Commission = Rs. 91,125

∴ Commission will be Rs. 91,125 × $\frac{5}{105}$ = Rs. 4,339

Illustration 2:

S. S. Himalaya set on voyage from Calcutta to Mumbai.

On 31st December, on which date the accounts are to be closed, the return voyage had not been completed. The details for the entire voyage to Mumbai and back to Calcutta completed after 31st December were:

	Rs.		Rs.
Freight	4,00,000	Depreciation	40,000
Coal consumption	70,000	Insurance :	
Stores consumed	30,000	Ship	20,000
Port charges	15,000	Freight	8,000
Salaries of crew	40,000	Primage	10%
		Address commission	5%

Only Rs. 1,50,000 Freight was available on return journey.

Prepare a Voyage Account up to 31st December.

Solution

S. S. HIMALAYA

Dr.	Voyage No. — Account from December 31		Cr.
Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Coal consumed	70,000	By Freight	4,00,000
" Stores	30,000	" Primage @ 10%	40,000
" Port charges	15,000	" Voyage in-progress ¹	1,18,750
" Salaries of crew	40,000		
" Insurance :			
Ship	20,000		
Freight	8,000		
" Depreciation	40,000		
" Address Commission ²	22,000		
" Voyage in-progress (Freight in advance)	1,65,000		
" Net Profit	1,48,750		
Transferred to P & L A/c			
	<u>5,58,750</u>		<u>5,58,750</u>

Notes :

1. Voyage in-progress :

	Rs.	
$\frac{1}{2}$ of total expenses (excluding Address Commission and Insurance for freight)	<u>2,15,000</u>	
(i.e.) Rs. 70,000 + Rs. 30,000 + Rs. 15,000 + Rs. 40,000 + Rs. 20,000 + Rs. 40,000	=	<u>1,07,500</u>

Add : Address Commission and freight ($\frac{3}{8} \times$ Rs. 30,000) i.e. (Rs. 22,000 + Rs. 8,000)	=	11,250
		<u>1,18,750</u>

2. Address Commission : @ 5% on Rs. 4,00,000 = Rs. 40,000 $\times \frac{1}{2}$	=	20,000
Primage @ 10%	=	2,000
		<u>22,000</u>

Illustration 3:

S Jahid Jalaksha voyaged from Visakhapatnam for Calcutta of 1st February, 1998. On 31st March, 1998 when the accounts of the company are closed. S. S. Jalaksha was on her way back to Visakhapatnam from Calcutta on Voyage No. 707, having covered half of the return voyage.

The following details of expenses and incomes for the entire voyage to and from Calcutta are furnished:

	Rs.		Rs.
Freight charges	8,00,000	Store	60,000
port charges	30,000	Insurance of : Ship for the voyage	1,00,000
Salary of crew	80,000	Freight	40,000
Consumption of : Coal	1,40,000	Depreciation of the ship for the two months of the voyage	80,000

Primage is at 10% on freight charges. Address commission is at 5% on freight charges and primage. Only Rs 3 00,000 freight was available on return journey to Visakhapatnam. Three-fourths of the total voyage including return journey is complete on 31st 1998.

Of the total expenses, expenses unconnected with freight shall be carried forward as “in process” for the balance of the journey. As freight is actually earned only on completion of a voyage, you have to carry forward the freight in respect of the return journey as well as all incidental incomes.

Prepare voyage account for the period 1st February, 1998 to 31st March 1998.

Solution

S.S. Jalaksha

Dr. Voyage No. 707 Account from 1st February 1998 to 31st March, 1998 Cr.

Particulars	Amount	Amount	Particulars	Amount
	Rs.	Rs.		Rs.
To Port charges		30,000	By Freight charges	8,00,000
" Salaries of crew		80,000	" Primage	
" Coal consumption		1,40,000	(10% of Rs. 8,00,000)	80,000
" Coal consumption		60,000	" Voyage in progress	2,63,167 ²
" Stores consumption				
" Insurance charges :				
Ship	1,00,000			
Freight	40,000	1,40,000		
" Depreciation of ship		80,000 ³		
" Address commission (@5%)				
Freight	40,000			
Primage	4,000	44,000		
Freight and primage of unfinished voyage		3,30,000 ¹		
— Volu-in-progress (unfinished Voyage)				
" Profit and Loss A/c				
— Profit on voyage transferred		2,39,167		
		<u>11,43,167</u>		<u>11,43,167</u>

Workings :

1. Freight and Primage of Unfinished Voyage	Rs.	2. Voyage-in-Progress	Rs.
Freight on return Journey	3,00,000	Expenses (excluding Dept.) $4,10,000 \times \frac{1}{2}$	2,05,000
Add : Primage @ 10%	30,000	Add : Fright & Insurance & Address Com.	
		(Rs. 84,000 $\times \frac{3}{8}$)	31,500
		Add : Depreciation (Rs. 80,000 $\times \frac{1}{3}$)	26,667
	<u>3,30,000</u>		<u>2,63,167</u>

3. Depreciation

As per question it beomes 2 months i.e. one couple voyage $\times \frac{1}{2}$ for return. So $\frac{1}{3}$ rd should be carried forward.

Illustration 4:

Great India Shipping Company Ltd- of Mumbai acquired a new ship M. V. Samudra at a cost of Ks. 37, 50,000. The ship was ready for service on 1st April 2012. An Insurance policy was taken out at 2 /o p.a. on the ship, freight was insured at Rs. 10,000 p.a. During 3 months ended 30th June 2012 the ship completed one round trip to Calcutta and was half through the second trip (single way) to Calcutta.

The ship carried the following cargo:

To Calcutta 9,000 tons @ Rs. 300 per ton (2 trips)

From Calcutta 10,000 tons @ Rs. 270 per ton (2 trips)

To Calcutta 12,000 tons @ Rs. 250 per ton (1 trip)

5% Commission Was Paid to agents in addition to 1% address commission.

The expenses were as follows:

	Rs.		Rs.
Salaries and Wages of the crew	8,00,000	Port dues (Mumbai Rs. 70,000; Calcutta Rs. 50,000)	1,20,000
Fuel	4,00,000	Stevedoring at Rs. 20 per ton	6,20,000
Sundry Stores	80,000	Share of overhead for the ship for the period	2,50,000
		Provide depreciation for the period at 5% p.a.	

Prepare the consolidated Voyage Account for the period of three months ending 30th June 2012.

Solution

In the books of Great India Shipping Co. Ltd.
M. V. SAMUDRA

Dr.	Voyage No.— Account from 1st April 1992 to 30th June 2012		Cr.
Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Fuel	4,00,000	By Freight	
" Sundry Stores	80,000	9,000 × Rs. 300 = Rs.	27,00,000
" Port Dues	1,20,000	10,000 × Rs. 270 = Rs.	27,00,000
" Salaries and Wages	8,00,000	12,000 × Rs. 250 = Rs.	30,00,000
" Stevedoring charges	6,20,000		84,00,000
" Overhead	2,50,000	" Voyage-in-Progress	7,62,958 ¹
" Address Commission @ 1% on Rs. 84,00,000	84,000		
" Agents' Commission @ 5% on Rs. 84,00,000	4,20,000		
" Depreciation (@ 5% on Rs. 37,50,000 for 3 months)	46,875		
" Ship's Insurance (@ 2% on Rs. 37,50,000 for 3 months)	18,750		
" Insurance on freight (Rs. 10,000 × $\frac{3}{12}$)	2,500		
" Voyage-in-progress (Freight in Advance)	30,00,000		
" Net Profit — Transferred to P & L A/c	33,20,833		
	91,62,958		91,62,958

Workings :

I. Voyage-in-Progress

(i) $\frac{1}{5}$ th of (Salaries and Wages + Fuel + Insurance and Freight + Insurance on Ship + Sundry Stores + Overheads + Depreciation) i.e., Rs. 8,00,000 + Rs. 4,00,000 + Rs. 2,500 + Rs. 18,750 + Rs. 80,000 + Rs. 2,50,000 + Rs. 46,875) = Rs. 15,98,125 × $\frac{1}{5}$	= Rs. 3,19,625
(ii) Port Dues Rs. 70,000 × $\frac{1}{3}$	= Rs. 23,333
(iii) Stevedoring charges (Rs. 20 × 12,000)	= Rs. 2,40,000
(iv) Commission (Rs. 30,00,000 × 5%)	= Rs. 1,50,000
(v) Address Com. (Rs. 30,00,000 × 1%)	= Rs. 30,000
	Rs. 7,62,958

Illustration 5:

S. S. Kanishka sailed from Calcutta port on 1. 2. 2010 and arrived at Chennai port on 31. 3. 2010 via Visakhapatnam port on Voyage No. 403.

The following goods were loaded:

1,000 M. T. and 200 M. T. at Calcutta port for Chennai port and Visakhapatnam port, respectively.

Another 500 M.T. were loaded at Visakhapatnam for Chennai.

The freight charges were:

Calcutta port to Chennai port Rs. 600 per M. T. Calcutta port to Visakhapatnam port Rs. 500 per M. T. Visakhapatnam to Chennai port Rs. 400 per M. T.

The freight is subject to 10% primage, 5% Address Commission and 2½% brokerage. The freight was insured at ½%. The hull was insured for the voyage at 1%. Depreciation was provided at 3% p.a. The cost of the ship is Rs. 1 crore.

The following were the expenses incurred at different ports:

	Calcutta	Visakhapatnam/ vizag	Chennai
	Rs.	Rs.	Rs.
Port Charges	36,000	20,000	20,000
Coal	1,00,000	30,000	—
Captain's Contingencies	7,000	2,000	10,000
Harbour Wages	10,000	20,000	15,000

Stores purchased for the voyage amounted to Rs. 50,000. Opening stock of stores was Rs. 40,000 and Closing Stock was estimated at Rs. 30,000. Stock of Coal at close was estimated at Rs. 30,000 as against stock of Rs. 10,000 at the beginning. The ship will not come back to Calcutta port in the near future as part of the Voyage programme. Salaries and Wages amounted to Rs. 80,000 p.m.

Prepare Voyage No 403 Account.

Solution

S. S. KANISHKA

Voyage No. 403 Account from 1st Jan 2010 to 31st March 2010

Dr.	Particulars	Amount	Particulars	Amount	Cr.
		Rs.		Rs.	
To	Port Charges (Rs. 36,000 + Rs. 20,000 + Rs. 20,000)	76,000	By	Freight	
"	Captain's Cont. (Rs. 7,000 + Rs. 2,000 + Rs. 10,000)	19,000		—Calcutta to Channai 1,000 × Rs. 600	6,00,000
"	Harbour Wages (Rs. 10,000 + Rs. 20,000 + Rs. 15,000)	45,000		—Calcutta to Vizag 200 × Rs. 500	1,00,000
"	Stores (Rs. 40,000 + Rs. 50,000 - Rs. 30,000)	60,000 ¹	"	Vizag to Channai 500 × Rs. 400	2,00,000
"	Coal (Rs. 10,000 + Rs. 1,30,000 - Rs. 30,000)	1,10,000 ²			9,00,000
"	Salaries & Wages (80,000 × 2)	1,60,000	"	Primage (Rs. 9,00,000 × 10%)	90,000
"	Insurance on freight (Rs. 9,90,000 × ½%)	4,950			
"	Insurance on Hull (Rs. 1,00,00,000 × 1%)	1,00,000			
"	Dep. on Hull	50,000 ⁴			
"	Address Commission	49,500 ³			
"	Brokerage	24,750 ⁵			
"	Net Profit — Transferred to P & L A/c	2,90,800			
		<u>9,90,000</u>			<u>9,90,000</u>

Workings :

<p>1. Consumption of Stores = Opening Stock + Purchase – Closing Stock = Rs. 40,000 + Rs. 50,000 – Rs. 30,000 = Rs. 60,000</p> <p>2. Computation of Loan = Rs. 10,000 + Rs. 1,30,000 – Rs. 30,000 = Rs. 1,10,000</p> <p>3. Address Commission @ 5% on both freight & Primage i.e. on Rs. 9,90,000 × 5% = Rs. 49,500</p>	<p>4. Depreciation on Hull For 2 months (Rs. 1,00,00,000 × $\frac{3}{100} \times \frac{2}{12}$) = Rs. 50,000</p> <p>5. Brokerage @ 2.5% @ Rs. 9,90,000 × 2.5% = Rs. 24,750</p>
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Illustration 6:

M. V. Indian Express is regularly employed on cargo trade between India and East Africa. She sets on her voyage on 1st July 2000 and arrived at her destination on 14th August 2000.

You are requested to prepare a Voyage Account bearing in mind the following particulars:

(i) The vessel was purchased in 2005 for Rs. 100 lakh and at the time of purchase had 16 years of working life left (Depreciation on ship is charged on straight line basis).

(ii) Standing cost per day excluding recovery of depreciation is Rs. 22,000.

(iii) The vessel consumes daily 14 tonnes of fuel oil, 2 tonnes of diesel and 15 tonnes of fresh water. The cost of these are Rs. 1,000, Rs. 1,350 and Rs. 20 per tonne, respectively.

(iv) The vessel carried the under-mentioned cargo:

4,000 tonnes on which freight of Rs. 375 per tonne was charged and 3,500 tonnes on which the rate of freight was Rs. 190 per tonne.

Both the rates are to be enhanced by a surcharge of 20% over the basic rates.

(v) Freight brokers were due a brokerage of 2½%

(vi) Port Charges at the loading and discharging ports were Rs. 40,000 and Rs. 85,000, respectively.

Solution

M. V. INDIAN EXPRESS			
Voyage No. — Account from 18th July 2012 to 14th Aug. 2012			
Dr.			Cr.
Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Standing Charges ¹	9,90,000	By Freight	
" Bunker Costs ²	7,65,000	4,000 × Rs. 375 = Rs. 15,00,000	
" Port Charges	1,25,000	3,500 × Rs. 190 = Rs. 6,65,000	
" Depreciation ³	77,055	Rs. 21,65,000	
" Brokerage ⁴	64,950	Add : Surcharge	
" Profit on Voyage	5,75,995	@ 20%	Rs. 4,33,000
(Transferred to Profit and Loss Account)			25,98,000
	25,98,000		25,98,000

1. Standing Charges		3. Depreciation	
@ Rs. 22,000 per day for 45 days =		For 45 days—Rs. 1,00,00,000 × $\frac{1}{16} \times \frac{45}{365}$ =	Rs. 77,055
Rs. 22,000 × 45 =	Rs. 9,90,000		
2. Bunker Costs :		4. Brokerage	
Fuel — 14 × 45 × Rs. 1,000	= 6,30,000	@ 2 $\frac{1}{2}$ % on Rs. 25,98,000 =	Rs. 64,950
Diesel — 2 × 45 × Rs. 1,350	= 1,21,500		
Fresh Water — 15 × 45 × Rs. 20	= 13,500		
	<u>7,65,000</u>		

Illustration 7:

M. V. Indian Glory owned by the Hindustan Shipping Co. Ltd., is on the Mumbai-London lines trade. Her daily Standing Charges (fixed costs) are Rs. 45,000. In the period between 1st July and 31st December 2012, the ship had finished one round voyage to London and on the date when the books of accounts of the company were closed at the end of the year, the vessel was on her way to London, having sailed out of Bombay after midnight of 21st December. Loading for London commenced on 1.12. 2012.

Freight earned:

From the following details, prepare a Voyage Account:

(a) Completed Voyage Bombay to London:

(i) 20,000 tonnes textiles at Rs. 280 per tonne.

(ii) 10,000 tonnes copra at Rs. 340 per tonne.

On textile, a surcharge of 10% was also recovered.

London to Bombay:

30,000 tonnes of urea at Rs. 300 per tonne.

(b) Unfinished Voyage:

30,000 tonnes of general cargo at Rs. 240 per tonne plus surcharge of 5%.

Expenses:

(a) Stevedoring expenses:

(i) At Rs. 20 per tonne at Mumbai for general cargo and Rs. 25 per tonne for textile and copra.

(ii) At London on a uniform rate of £ 1 per tonne.

(b) Fuel consumption:

(i) On sailing days — 30 tonnes of fuel oil per day, 5 tonnes of diesel per day.

(ii) On days in port — 10 tonnes of fuel oil per day, 5 tonnes of diesel per day.

(iii) Cost per tonne — Fuel oil Rs. 1,400 per tonne, Diesel Rs. 2,500 per tonne.

(ii) Basra to Dubai with fertilisers at Rs. 240 per tonne. Address commission of 2% on freight payable to charterers and a brokerage of 1% is payable to agents on signing the charter. The steamer is issued with Lloyds on an annual premium of Rs. 6, 60,000. The master of the steamer is entitled to 1% of the net profits of each voyage after charging such commission.

Further details are:

Repairs and Renewals: at Bombay Rs. 38,000 and at Basra Rs. 20,000.

Stores, Supplies and Provisions: at Bombay Rs. 1,60,000, at Basra Rs. 1,40,000 and at Dubai Rs. 90,000, out of which Rs. 40,000 was in stock at conclusion of voyage.

Consumption of Bunker: Fuel oil 6 tonnes a day, diesel 2 tonnes a day and fresh water 25 tonnes a day while the steamer is in port and fuel oil 15 tonnes a day, diesel 2 tonnes a day and fresh water 25 tonnes a day while sailing. Fuel oil, diesel and fresh water cost Rs. 1,200, Rs. 2,500 and Rs. 50 per tonne, respectively. Stevedoring charges: at Bombay Rs. 20 per tonne, at Basra Rs. 15 per tonne for loading and Rs. 20 per tonne for discharging, and at Dubai Rs. 12 per tonne, load discharge.

Captain's Expenses: at Basra Rs. 16,000 and at Dubai Rs. 20,000.

Port Charges: at Bombay Rs. 70,000, at Basra Rs. 60,000 and at Dubai Rs. 54,000.

The steamer loaded the following cargo:

At Bombay general cargo-8,000 tonnes, out of which 6,000 tonnes were to be discharged at Basra, and the rest at Dubai. The freight from Mumbai to Dubai was fixed at Rs. 600 per tonne.

At Basra—Fertilisers for discharge at Dubai—6,000 tonnes. The ship completed the voyage on 30th April, 2012. Number of sailing days as per ship's log came to 16.

Prepare a Voyage Account bearing in mind that the company has to provide towards special survey repairs of the ship Rs. 24 lakh every year.

Solution

**In the books of Hind Shipping Ltd.
M. V. JALABHARATI**

Dr. Voyage No.—Account from 1st March 2012 to 30th April 2012 Cr.

Particulars	Amount	Amount	Particulars	Amount	Amount
	Rs.	Rs.		Rs.	Rs.
To Repairs and Renewals :			By Freight—		
Bombay	38,000		Bombay to Basra		
Basra	26,000		(6,000 × Rs. 500)	30,00,000	
Prov. for special survey repairs			Bombay to Dubai		
(Rs. 24,00,000 × $\frac{2}{12}$)	4,00,000		(2,000 × Rs. 600)	12,00,000	
		4,58,000	Basra to Dubai		
" Stores, Supplies & Provisions :			(6,000 × Rs. 240)	14,40,000	
Bombay	1,60,000				56,40,000
Basra	1,40,000				
Dubai	50,000				
		3,50,000			
" Consumption of Bunker :		9,93,250 ¹			
" Stevedoring Charges :					
Bombay (8,000 × Rs. 20)	1,60,000				
Basra					
—(Loading 6,000 × Rs. 15)	90,000				
	Rs.	Rs.		Rs.	Rs.
—(Unloading 6,000 × Rs. 20)	1,20,000				
Dubai					
—(Unloading 8,000 × Rs. 12)	96,000	4,66,000			
To Insurance		1,10,000			
(6,60,000 × $\frac{2}{12}$)					
" Captain's Expenses		36,000			
(16,000 + Rs. 20,000)					
" Port Charges—					
Bombay	70,000				
Basra	66,000				
Dubai	54,000	1,84,000			
Brokerage					
(5% on 30,00,000)	1,50,000				
(1% on 14,40,000)	14,400				
	1,64,400				
Less : Refund					
(1,50,000 × $\frac{1}{3}$)	50,000	1,14,400			
" Address Commission :					
(2% on Rs. 30,00,000)	60,000				
(2% on Rs. 14,40,000)	28,800	88,800			
" Master's Com. (@ $\frac{1}{4}$ %)		28,114			
" Net Profit—					
Transferred to P & L A/c		28,11,436			
		56,40,000			56,40,000

Workings :

1. Consumption of bunker :

(i) on sailing periods :

Fuel 15 tonnes × Rs. 1,200	=	Rs. 18,000		Rs.
Diesel 2 tonnes × Rs. 2,500	=	Rs. 5,000		
Fresh water 25 tonnes × Rs. 50	=	Rs. 1,250		
		24,250	× 16 days =	3,88,000

(ii) on Port periods :

Fuel 6 tonnes × Rs. 1,200	=	Rs. 7,200		
Diesel 2 tonnes × Rs. 2,500	=	Rs. 5,000		
Fresh water 25 tonnes × Rs. 50	=	Rs. 1,250		
		13,450	× 45 days =	6,05,250

(From 1st March to 30th April)

= 61 days = 9,93,250

7.3 VOYAGE IN PROGRESS

At the end of the accounting year where voyage is not completed and is still in progress, following accounting treatments are required –

Freight Received

Total freight received credited to the voyage account and the provision for incomplete voyage is debited from the voyage account. Provision is created for the voyage-in-progress in proportion of the incomplete journey.

Expenses

To complete matching concept, an income as well as expenses related to the incomplete voyage might be carried forward to the next accounting year on the respective account. Provision for the income earned should be debited from the voyage account and provision for the expenses should also be credited to the voyage account.

Basis of the expenses to be carried forward is as hereunder –

- Expenses which are related to the freight, need to be carried forward in a proportion to return freight. For example, if total freight is Rs. 2,500,000 out of which return freight is Rs. 1,200,000 and total expenses are Rs. 500,000, then expenses to be carried forward to the next accounting year — will be Rs. 240,000.

$$= \frac{1,200,000}{2,500,000} \times 500,000 = 240,000$$

- In case of the standing expenses, if return journey is incomplete, $\frac{1}{2}$ of the standing charges to be carried forward.
- In case where return journey is halfway back and the total expenses of voyage given 1212 of the total expenses to be carried forward.
- When the return journey is halfway back and the expenses till date are given 13rd13rd of the expense are to be carried forward.
- When one round of the trip is completed and on his half way back for single way and total expenses of voyage are given, then 13rd13rd expenses are to be carried forward.
- When one round trip is completed and on his half way back for single way and expenses till date are given, then 15th15th expenses are to be carried forward.

7.4 SUMMARY

- To know the financial results of a marine business, voyage accounting is prepared. Voyage account is similar to a Profit and Loss account; all expenses are debited to Voyage account and all incomes are credited to Voyage account.

- Voyage account is prepared to ascertain the profit or Loss of voyage. It covers both inward and outward travelling. It is very important that separate Voyage account should be prepared for each vessel.
- Voyage Account is specially designed for shipping companies. The voyage account is just like profit and loss account which fulfills the purpose of delivering the incomes or expenses and profit or loss of the shipping company for the particular year.
- Voyage Accounting is done in case of Shipping Companies. To know the results of the marine business voyage accounts are prepared. It is prepared to know the profit or losses on each voyage or shipment undertaken by the shipping company. Sometimes the accounting year of shipping company has come to an end, but the voyage is still in progress. That voyage is termed as Incomplete Voyage.
- Accounting for Incomplete Voyage is done on the basis of matching concept. It means expenses of current year are compared with the incomes of current year. So the amount related to incomplete voyage must be carried forward to the next year. In order to ascertain the result of operating a ship's voyage, a Voyage Account is prepared which is nothing but a revenue account or Profit and Loss Account relating to the expenditure incurred and income earned by a vessel for a particular voyage.
- A voyage includes both outward and return journey. Each voyage is numbered and separate record is to be maintained for all expenses and charges relating to each voyage together with the freight earned per voyage.
- The method of accounting followed by shipping companies is known as voyage accounting. Shipping companies prepare their accounts periodically and also prepare the results of each voyage separately.
- Shipping companies carry goods from one place to another. Some companies carry passengers also in addition to goods from one place to another place. In order to ascertain the result of operating a ship's voyage, Voyage Account is prepared.
- The Voyage Account is a revenue account. It is important to note that there is no difference in the manner of preparing accounts period-wise and voyage-wise.

7.5 KEY WORDS

- Brokerage and Address Commission: Brokerage and Commission payable to broker for procuring freight for the ship which is calculated on a certain percentage of freight inclusive of primage, and address commission is paid to the charterer which is debited to Voyage Account.
- Primage: Percentage on freight collected for the ship-owner previously and which is retained with the ship-owner for ensuring safe carriage of cargo. It is an income of the shipping company since it is a part of freight.

- **Passage Money:** Fare collected from the passengers travelled in addition to the fare' collected for merchandise.
- **Port Charges:** Charges paid to port authorities for allowing the ship using the port for loading or unloading purposes.
- **Bunkers Cost:** Amount spent on account of fuel, coal, diesel and fresh water and refers to actually coal bin of the ship. Generally, voyage profit represents the excess of voyage incomes earned over the expenses incurred for this purpose. But if, however, the voyage is in progress, the incomes and expenses relating to the unfinished voyage are carried forward to the next year.

7.6 LEARNING ACTIVITY

1. India Shipping Company of Bombay had a ship by name Bharat, whose written down value as on 1st July 2005 was Rs 24 lakhs. The ship was insured for Rs. 30 lakhs at 1% for voyage policy of hull. The ship made a trip to Sydney and returned to Madras during the period 1st July 2005 to 30th Sept. 2005.

The particulars relating to the voyage are given below:

1. Expenses incurred:

	Rs
Salaries of the crew	25,000
Fuel	55,000
Port dues	30,000
Stores expenses	32,000
Shares of overhead for the ship	16,000

2. Stevedoring at the rate of Rs. 3 per tonne.
3. Depreciation was charged on the written down value of the ship at the rate of 10% p.a.
4. The freight was insured at 1%.
5. The particulars of the freight consisted of the following:
 - (a) Leather goods 1,100 tonnes at the rate of Rs. 120 per tonne.
 - (b) Cotton 500 tonnes at the rate of Rs. 150 per tonne.
 - (c) Sugar 1,700 tonnes at the rate of Rs. 100 per tonne.
6. In addition to primage @ 10%, the brokerage payable was @ 5%.

Prepare Voyage Account for the three months.

-
-
2. Discuss the nature, necessity and method of preparing Voyage accounts. Your answer should illustrate and explain special items in voyage accounts.
-
-

7.7 UNIT-END QUESTIONS

A. Descriptive Questions

1. What are the Main Expenses and Incomes of Voyage?
2. SS Himalaya set out on a voyage from Calcutta to Bombay, On December 31 the accounts are to be closed, the return voyage had not been completed. The details for the entire Voyage to Bombay and back to Calcutta completed after December 31 were: Freight Rs. 400000 Coal consumed Rs. 70000 Salaries Consumed Rs. 30000 Port charges Rs.15000 Salaries of crew Rs. 40000 Depreciation Rs.40000 Insurance of ship Rs. 20000 Insurance of freight Rs. 8000 Address commission 5% Only Rs.150000 freight was available on the return journey. Prepare Voyage Accounts
3. A ship was chartered from Lagos to Accra on 31st December. The accounts were closed after the arrival of the ship. The details for the voyage to Accra and back were:

	\$		\$
Store consumed	7000	Freight	90000
Coal consumed	15000		
Depreciation	6000		
Port charges	3000		
Salaries of crew	8000		
Insurance of ship	10000		
Insurance of freight	5000		
Address commission	5%		

Fuel	1050		
------	------	--	--

\$40000 freight was received on return with 10% primage.

4. S.S. Jalaksha voyaged from Visakhapatnam for Calcutta of 1st February. 1998. On 31st March, 1998 when the accounts of the company are closed. S. S. Jalaksha was on her way back to Visakhapatnam from Calcutta on Voyage No. 707, having covered half of the return voyage.

The following details of expenses and incomes for the entire voyage to and from Calcutta are furnished: Primage is at 10% on freight charges. Address commission is at 5% on freight charges and primage. Only Rs 3 00,000 freight was available on return journey to Visakhapatnam. Three-fourths of the total voyage including return journey is complete on 31st 1998. Of the total expenses, expenses unconnected with freight shall be carried forward as "in process" for the balance of the journey. As freight is actually earned only on completion of a voyage, you have to carry forward the freight in respect of the return journey as well as all incidental incomes.

Prepare voyage account for the period 1st February, 1998 to 31st March 1998.

5. M. V. Indian Express is regularly employed on cargo trade between India and East Africa. She sets on her voyage on 1st July 2000 and arrived at her destination on 14th August 2000.

You are requested to prepare a Voyage Account bearing in mind the following particulars:

(i) The vessel was purchased in 2005 for Rs. 100 lakh and at the time of purchase had 16 years of working life left (Depreciation on ship is charged on straight line basis).

(ii) Standing cost per day excluding recovery of depreciation is Rs. 22,000.

(iii) The vessel consumes daily 14 tonnes of fuel oil, 2 tonnes of diesel and 15 tonnes of fresh water. The cost of these are Rs. 1,000, Rs. 1,350 and Rs. 20 per tonne, respectively.

(iv) The vessel carried the under-mentioned cargo:

4,000 tonnes on which freight of Rs. 375 per tonne was charged and 3,500 tonnes on which the rate of freight was Rs. 190 per tonne.

Both the rates are to be enhanced by a surcharge of 20% over the basic rates.

(v) Freight brokers were due a brokerage of 2½%

(vi) Port Charges at the loading and discharging ports were Rs. 40,000 and Rs. 85,000, respectively.

B. Multiple Choice Questions

1. Profit or loss on voyage account is transferred to
 - a. Profit and loss account of shipping company
 - b. Balance sheet
 - c. Trail balance
 - d. None of these
2. The balance of suspense account will show in
 - a. Profit and loss account debit side
 - b. Balance sheet
 - c. Trial balance
 - d. Income and expenditure account
3. Which of the following errors will not affect the trial balance?
 - a. Wrong balancing of an account
 - b. Wrong totalling of an account
 - c. Writing an amount in wrong account but on the correct side
 - d. None of the above
4. Bad debts written off previously, if recovered subsequently
 - a. Credited to profit and loss account
 - b. Debited to profit and loss account
 - c. Credited to bad debts recovered account
 - d. Credited to debtor's account

Answer

1. a2. b3. c4. a5. c

7.8 SUGGESTED READINGS

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UNIT VIII- FARM ACCOUNTS

Structure

- 8.0. Learning Objective
- 8.1. Introduction
- 8.2. Characteristics
- 8.3. Advantages and Disadvantages
- 8.4. Final Accounts of Farms.
- 8.5. Summary
- 8.6. Key words
- 8.7. Learning Activity
- 8.8. Unit -End Questions
- 8.9. Suggested Readings

8.0 LEARNING OBJECTIVE

After studying this unit, you will be able to:

- List advantages and disadvantages of farm accounts
- Describe Farm accounts
- Assess final accounts of farms

8.1 INTRODUCTION

Farm Accounts are statements of money paid out or received for goods and services used in farming business. Money is received due to sales of farm produce or loans from other sources while money is paid out for purchases of farm produce or settlement of debts. Farm accounting or accounting for agricultural farms is the application of accounting practices to agricultural operations. In recent years, commercial fanning has been engaging the attention of many and as a result a number of farmers are coming up. Corporate entities are entering into the farming business in a big way. Farm income refers to profits and losses that are incurred through the operation of a farm or agricultural business.

A farm income statement (sometimes called a farm profit and loss statement) is a summary of income and expenses that occurred during a specified accounting period. This period is usually the calendar year for farmers (January 1 - December 31). Some farms are eligible for special farm tax credits and other tax breaks.

Transactions, relating to farming activities may be categorized into four-Cash, credit, and exchange and notional. The cash and credit transactions are recorded in normal manner as any other business transaction.

The exchange transactions, in the nature of barter, for example, exchange of animal labour for human labour, exchange of seeds for output, etc. are normally recorded at opportunity cost – the price in the open market.

8.2 CHARACTERISTICS

For preparation of proper farm accounts, one should be familiar with the peculiar Characteristics of farm accounting. Some of these characteristics are:

- (i) Some crops and products of the farm may be consumed by the owner. These are treated as income to the farm as well as drawings by the owner. They are recorded as: Debit Drawings Credit Trading A/C
- (ii) It is possible that a single bank account is opened for both business and private purposes because the farming business is family type. Being so, private transactions should be segregated from business transactions so that the profit or loss on farming activities may be ascertained – without distortion due to private transactions.
- (iii) The family usually provides labour on the farm. Valuation of such labour should be made and added to cost of production if correct cost of production is to be ascertained.
- (iv) Farming activities are subject to natural calamities such as droughts, floods, diseases, etc. To counter these losses, insurance policies for various farming activities should be taken. A group policy (pilot crop insurance scheme) may also be taken.
- (v) Valuation of farm inventory is a difficult task. For example, it is a very difficult process to value standing crops, cattle, poultry etc., which are subject to natural calamities.
- (vi) The output of one farming activity may become the input of another farming activity, for example, part of crops produced may be used in cattle feed, pig feed or poultry feed.

8.3 ADVANTAGES AND DISADVANTAGES

Advantages

- (a) It evaluates the old plan and guides the farmers to adopt a new farm plan with advantage.
- (b) It makes the farmer conscious of the waste (leakage) in the farm business.
- (c) It gives comparative study of receipts, expenses and net earnings on different farms in the same locality and in different localities for formulating national agricultural policies.
- (d) It guides and encourages the most efficient and economical use of resources.
- (e) It serves as a valuable basis for improvements in farm management practices.

Disadvantages

Agricultural diversification includes the introduction of a wider range of output options within a traditional farming enterprise. For example, prime lamb production added to wool production, or the introduction of non-traditional crops and livestock such as agroforestry, deer farming and aquaculture.

Non-agricultural diversification includes enterprises such as farm-based accommodation and recreation, on-farm processing and or direct marketing of food and fibre, and passive diversification where land and/or buildings are leased for non-agricultural purposes.

Value adding is a form of non-agricultural diversification, where the farmer takes control of processing and or marketing of their primary product in order to capture the value that is added as the product moves along the production chain towards the final marketed product.

8.4 FINAL ACCOUNTS OF FARMS

In recent years, commercial farming has been assuming great importance. Agricultural activity is a predominant activity in India. Farming activities now comprises not only of growing crops but also include animal husbandry, poultry farming, sericulture (silk worm breeding), pisciculture (rearing fish, floriculture (growing flowers) etc. Thus, farming, these days, is basically mixed farming.

In advanced countries like the UK and the USA, commercial farming is being done on a large scale and hence farm accounting has also become popular and developed. However, in our country, farm accounting is of recent origin. A standard form of accounts for recording, farming transactions has yet to develop.

Farm Accounting:

Farm accounting or accounting for agricultural farms is the application of accounting practices to agricultural operations. In recent years, commercial farming has been engaging the attention of many and as a result a number of farmers are coming up. Corporate entities are entering into the farming business in a big way.

Therefore, the Institute of Cost and Works Accountant of India issued a booklet, explaining how the farm books should be kept and how the profit or loss arising from the farming operations should be ascertained. The farm accounting is a technique of using accounting data for cost and profit ascertainment of each farming activity and decision making with regard to the most profitable line of activity.

Accounting for Farms:

Transactions, relating to farming activities may be categorized into four-Cash, credit, and exchange and notional. The cash and credit transactions are recorded in normal manner as any other business transaction.

The exchange transactions, in the nature of barter, for example, exchange of animal labour for human labour, exchange of seeds for output, etc. are normally recorded at opportunity cost – the price in the open market.

Notional transactions are those that take place between the members of the owner's family and the farm, viewing the farm as an independent entity notionally. Some examples of such transactions are: use of household capital, use of land owned by the farm household, labour provided by members of the family, consumption of output by the family etc.

Profitability of Crops:

The performance of each crop shall be found out separately. The direct cost clearly identifiable with a crop shall be charged accordingly. The common cost should be suitably allocated on some accepted basis, for instance, depreciation or repairs can be divided on the basis of estimation of usage by different crops. Interest on fixed loan can be divided on the basis of length of crop season etc.

Books of Accounts:

The basic document needed is farm diary, where transactions are recorded in chronological order:

(1) Cash book:

As the business is carried on by families, it may not have time and resources for an elaborate system. The business is mostly carried on cash basis and therefore, by providing analytical columns in the cash book, both on receipts and payments side, the accounting can be made very simple.

Analytical column cash book will help the farmer to do away with other subsidiary books and also the ledger and yet, he will obtain all the information, he needs to prepare the final accounts.

(2) Debtors and Creditors Register, to keep credit transactions.

(3) Stock Register, which shows input and output of goods, sale, wastage and balance of stock.

(4) Fixed Assets Register contains details of cost of assets, depreciation and balance of assets.

(5) Loan Register, contains record of loans, details of interest etc.

(6) Register for Notional Transactions for making a record of transactions between farm and farm household.

(7) Cost Analysis register, for keeping records of each farming activity, in order to know the profit of each activity.

Cost and Revenue:

Expenses and incomes associated with farming activities, other than agricultural activities are given below:

(A) Poultry Farm:

Expenses or Costs:

1. Costs of chicken, feed;
2. Stocks like hay, packing boxes, fuel;
3. Maintenance cost of sheds;
4. Medicines;
5. Salaries and wages.

Revenue:

1. Sale of eggs, chickens, broiler, hens;
2. Sale of poultry excretions as manures.

(B) Dairy Farms:

Expenses or costs:

1. Cattle feed and hay;
2. Cost of cultivation of feed crop, if any;
3. Insecticides;
4. Salaries and wages;
5. Cost of maintaining milk processing facilities.

Revenue:

1. Sale of milk;
2. Sale of milk products;
3. Sale of calves;
4. Sale of dairy cattle;
5. Sale of slaughtered cattle.

(C) Fisheries:

1. Cost of seed;

2. Cost of water;
3. Cost of fish feed;
4. Maintenance costs of tanks;
5. Catching expenses;
6. Depreciation of nets and other assets;
7. Salaries and wages.

Revenue:

1. Sale of fish.

Treatment of Specific Items:

1. Land Development Expenses:

A business may purchase land for cultivation. A lot of money may have to be spent by the business on cleaning, levelling the land, providing drainage, irrigation facilities etc. before the land can be used for cultivation. All these expenses are termed as “Land Development Expenses”, and should preferably be added to the cost of land.

2. Drawings:

A farmer or his family may consume a part of farm production.

It is recorded as:

Drawings Account Dr.

To Crop or Milk or Poultry or Fish Account.

3. Similarly, when Farm Products are Consumed by Farm Workers it is Recorded as:

Wages Account Dr.

To Crop or Milk or Poultry or Fish Account

Apportionment Basis for Common Costs:

Seed, fertilizer, manure, pesticides, direct wages (Notional and Actual), land rent (Notional and actual) etc. can be identified crop-wise. But other costs like irrigation, services of agricultural machinery, implements or animal power depreciation, interest on capital etc. cannot be classified simply by nomenclature. Common costs of the agricultural farms are to be suitably apportioned among the crops for which such costs were incurred.

Many a time, common costs have been incurred for crop enterprises as well as livestock enterprises. Common costs should be apportioned among the crop enterprises on the basis of usage, wherever use of assets can be quantified. In other cases, length of crop season can be used.

The following list, not exhaustive, are given below:

Cost Element	Apportionment Base
Maintenance of farm shed and depreciation	Length of crop season
Maintenance of draught animal and depreciation	Animal base
Maintenance of agricultural machinery implements and depreciation	Machine hours
Interest on working capital	(Ratio) working capital investment for various crops
Interest on fixed capital	Length of crop season

Preparation of Final Accounts:

Farm final accounts can be prepared according to any of the following two methods:

1. Single Entry Method.
2. Double Entry Method.

1. Single Entry Method:

This method does not require maintenance of an elaborate system of accounting to ascertain the profit or loss and financial position of the business. The method requires the preparation of two statements of affairs one at the beginning of the accounting period and the other at the end of the accounting period.

The excess of assets over liabilities is the net-worth of the business. The profit or loss made by the business during a period can be ascertained by comparing the net-worth of the business on two dates, after making suitable adjustments for drawings, introduction of additional capital etc. (For more details, refer Single Entry System of Accounting).

2. Double Entry Method:

Accounting information contained in the accounting records may be presented in the form of an account for each type of product, for example, Wheat Account, Rice Account etc. Each Account is to be debited with opening stock, and the relevant expenses incurred, and the relevant expenses incurred, and credited with the sale proceeds and the closing stock.

The difference between the two sides of each account shows profit or loss. The profit or loss of each such account is transferred to General Profit and Loss Account, to which common expenses of all the activities of the farm are charged so as to arrive at net profit or loss, to be transferred to Capital Account. Finally, Balance Sheet is prepared.

NB: Land is usually not depreciated because its monetary value tends to increase with the passage of time.

Illustration 1:

From the data given below, prepare a 'Cattle Account':

	Rs
Opening stock of livestock	1,50,000
Closing stock of livestock	2,50,000
Opening stock of Cattle feed	8,000
Closing stock of cattle feed	6,000
Purchase of cattle during the year	4,00,000
Sale of cattle during the year	6,00,000
Sale of carcasses	2,000
Purchase of cattle feed	25,000
Wages for rearing cattle	8,000
Crop worth Rs. 10,000 grown in the farm was used for feeding cattle. Out of calves born, four died and their carcasses realised Rs. 100	
	<i>(B.Com., Mysore)</i>

SOLUTION

Cattle Account

	Amount		Amount
To Opening Stock:		By Sale of cattle	6,00,000
Livestock	1,50,000	" Sale of carcasses :	
Cattle feed	8,000	of cattle	2,000
" Purchase of cattle	4,00,000	of calves	100
" Purchase of cattle feed	25,000	" Closing stock:	
" Crop Account – Crop grown used for feeding cattle	10,000	Livestock	2,50,000
" Wages – Cattle rearing	8,000	Cattle feed	6,000
" Profit transferred to General P & L A/c	2,57,100		
	8,58,100		8,58,100

Illustration 2:

From the following information, prepare 'Crop Account':

	Rs
Opening stock:	
Fertilizer	15,000
Seeds	10,000
Wheat	50,000
Purchases:	
Seeds	6,000
Fertilizer	9,000
Wages:	
Paid in cash	68,000
Paid in kind by giving wheat	46,000
Sale of wheat	3,54,000
Wheat consumed by the proprietor	16,000
Depreciation on machinery	20,000

Closing stock:		
Wheat		40,000
Seeds		7,000
Fertilizer		8,000

(B.Com., Mysore, Delhi)

SOLUTION

Crop Account

	Rs.		Rs.
To Opening stock:		By Sale of wheat	3,54,000
Wheat	50,000	" Wages in kind (Contra)	46,000
Seeds	10,000	" Drawings – Consumption by proprietor	16,000
Fertilizer	15,000	" Closing stock:	
" Purchases:		Wheat	40,000
Seeds	6,000	Seeds	7,000
Fertilizer	9,000	Fertilizer	8,000
" Depreciation	20,000		
To wages:			
In cash	68,000		
In kind	46,000		
To Profit, transferred to General P & L A/c	2,47,000		
	4,71,000		4,71,000

Illustration 3:

From the following information prepare crop account to find out the profit made by the crop section.

	Rs	Rs
Opening stock	2,600	
Grain	600	
Fertilizers	400	3,600
Purchases		
Seeds	400	
Fertilizers	600	1,000
Wages paid in cash		3,500
Wages paid in kind by giving grain		2,500
Sale of grain		25,400
Grain consumed by the proprietor		600
Grain consumed on the livestock section		2,400
Depreciation on farm machinery		1,000
Repairs and maintenance of farm machinery		2,000
Closing stocks		
Grain	2,000	
Seeds	400	
Fertilizers	600	3,000

SOLUTION:

Crop Account

		Rs			Rs
To Opening stock			By sale of grain		25,400
Grain	2,600		By Grain consumed by the proprietor (Drawings)		600
Seeds	600		By Grain consumed by Live stock section		2,400
Fertilizers	400	3,600	By Wages in kind (contra)		2,500
To Purchases			By Closing stock		
Seeds	400		Grain	2,000	
Fertilizers	600	1,000	Seeds	400	
To Wages			Fertilizers	600	3,000
in cash	3,500				
in kind	2,500	6,000			
To Depreciation		1,000			
To Repairs and maintenance		2,000			
To Profit and Loss Account		20,300			
		33,900			33,900

Illustration 4:

From the following information given by Kiran, prepare Farm Accounts for the year ended 31st March 2005:

	<i>Workers</i>	<i>Proprietor</i>
	Rs	Rs
Milk	1,750	1,500
Poultry	1,200	600
Crops	2,400	1,250
	<i>Stock as on 1-4-2004</i>	<i>Stock as on 31-3-2005</i>
	Rs	Rs
Crops	3,900	4,100
Seeds	1,800	2,250
Cattle	71,000	1,02,000
Growing crops	3,000	3,900
Cattle feed	10,000	7,500
Poultry	9,000	12,000
Fertilizers	3,800	3,900
Poultry feed	1,100	2,300
Purchases during the year	Rs	
Seeds	1,250	
Cattle	40,000	
Poultry	15,000	
Fertilizers	4,000	
Cattle feed	14,000	
Poultry feed	3,000	
Sales during the year:		
Cattle	37,500	
Eggs	15,000	
Crops	22,500	
Poultry	13,000	
Milk	11,000	

SOLUTION

Farm Accounts
(Crop, dairy and Poultry Divisions)

	<i>Crops</i>	<i>Dairy</i>	<i>Poultry</i>		<i>Crop</i>	<i>Dairy</i>	<i>Poultry</i>
To Opening Stock:	Rs.	Rs.	Rs.	By Sales:	Rs.	Rs.	Rs.
Crops	3,900	—	—	Crops	22,500	—	—
Seeds	1,800	—	—	Cattle	—	37,500	—
Growing crops	—	—	—	Milk	—	11,000	—
Fertilizers	3,000	—	—	Poultry	—	—	13,000
Cattle	—	71,000	—	Eggs	—	—	15,000
Cattle feed	—	10,000	—	Wages	2,400	1,750	1,200
Poultry	—	—	9,000	Drawings	1,250	1,500	600
Poultry feed	—	—	1,100	Closing stock:	—	—	—
Purchases:	—	—	—	Crops	4,100	—	—
Seeds	1,250	—	—	Seeds	2,250	—	—
Fertilizers	4,000	—	—	Growing crops	3,900	—	—
Cattle	—	40,000	—	Fertilizers	3,900	—	—
Cattle feed	—	14,000	—	Cattle	—	1,02,000	—
Poultry	—	—	15,000	Cattle feed	—	7,500	—
Poultry feed	—	—	3,000	Poultry	—	—	12,000
Gross profit	22,550	26,250	16,000	Poultry feed	—	—	2,300
	40,300	1,61,250	44,100		40,300	1,61,250	44,100

Illustration 5:

From the following trial balance of Ram Singh prepare trading and profit and loss Account for the year ending 31st December 2006 and a balance sheet as on that date.

	Rs			Rs
Opening stock			Sales	
Paddy	500		Paddy	3,000
Potatoes	800		Potatoes	2,000
Cattle	1,000		Sugarcane	3,000
Sheep	700	3,000	Cattle	10,000
Purchases			Milk etc.	2,000
Cattle	8,000		Sheep	3,000
Sheep	1,000		Loan from Land Development bank	8,700
Seeds	500		Capital balance	20,000
Manures	1,000		Creditors for supplies	2,000
Cattle feed	1,000	11,500		
Crop expenses				
Labour	400			
Other expenses	300	700		
Livestock expenses				
Veterinary and medicines	500			
Labour	200			
Dairy expenses	300	1,000		
Expenses of machinery				
Repairs	300			
Diesel and oil	500			

Electricity	200	1,000	
General overheads			
Rent and Rates	1,000		
Insurance	200		
Wages for permanent labour	800		
Bank interest	500	2,500	
Farm machinery		10,000	
Cash in hand		1,000	
Cash at bank		3,000	
Land		20,000	
		53,700	53,700

Additional information

- (1) Closing stock
- | | |
|----------|-------|
| | Rs |
| Paddy | 1,000 |
| Potatoes | 600 |
| Cattle | 1,500 |
| Sheep | 1,000 |
- (2) 50 % of rent and rates may be taken as the share of Mr. Ram Singh for his residence.
- (3) Mr. Ram Singh has consumed the following out of farm output
- | | |
|-----------|-----|
| | Rs |
| Milk etc. | 200 |
| Potatoes | 100 |
| Paddy | 700 |
- (4) Provide 10% depreciation on machinery

(M Com. Kolkata)

SOLUTION:

TRADING ACCOUNT
For the year ending 31-12-2006

		Rs			Rs
To Opening stock			By Sale of crops		
Paddy	500		Paddy	3,000	
Potatoes	800		Potatoes	2,000	
Cattle	1,000		Sugarcane	3,000	8,000
Sheep	700	3,000	By Produce consumed by		
To Purchases			Ram Singh		1,000
Cattle	8,000		By Sale of livestock		
Sheep	1,000	9,000	Cattle	10,000	
To Crop expenses			Milk	2,000	
Seed	500		Sheep	3,000	15,000
Manure	1,000		By Closing stock		
Labour	400		Paddy	1,000	
Other expenses	300	2,200	Potatoes	600	
To Livestock expenses			Cattle	1,500	
Feed	1,000		Sheep	1,000	4,100
Veterinary	500				
Labour	200				
Diary expenses	300	2,000			
To Gross Profit		11,900			
		28,100			28,100

Profit and Loss Account
for the year ending 31.12.2006

	Rs		Rs
To General overheads		By Gross Profit	11,900
Rent and rates	1,000		
Less Ram Singh's share for his residence	500		
Insurance			500
Wages for permanent labour			200
Bank interest			800
To Expenses of machinery			500
Repairs	300		
Diesel and oil	500		
Electricity	200		
Depreciation	1,000		2,000
To Net Profit			7,900
			11,900

BALANCE SHEET
as on 31.12.2006

	Rs		Rs
Creditors for Supplies	2,000	Cash in hand	1,000
Loan from Land development Bank	8,700	Cash at bank	3,000
Capital	20,000	Inventory	
Add Net Profit	7,900	Paddy	1,000
	27,900	Potatoes	600
Less: Drawings	1,500	Cattle	1,500
	26,400	Sheep	1,000
		Farm machinery	10,000
		Less Depreciation	1,000
		Land	20,000
	37,100		4,100

Illustration 6:

The following particulars relate to Birjala Farm:

(a) Trial Balance as at 31st March, 2006:

	Rs	Rs
Capital		8,00,000
Stocks, 1st April, 2005		
Cattle	2,00,000	
Poultry	70,000	
Fertilizers	20,000	
Cattle food	30,000	
Poultry food	2,000	
Seeds	5,000	
Crops	10,000	
Growing crops	8,000	

Purchases:		
Cattle	80,000	—
Poultry	38,000	—
Cattle food	30,000	—
Poultry food	7,000	—
Fertilizers	10,000	—
Sales:		
Cattle	—	70,000
Poultry	—	1,60,000
Crops	—	2,19,000
Milk	—	1,18,000
Butter	—	3,000
Eggs	—	28,000
Land and Buildings	6,00,000	—
Agricultural Equipments	2,00,000	—
Debtors and Creditors	30,000	20,000
Cash and Bank	5,000	—
Wages and Salaries	1,10,000	—
Crop insurance	10,000	—
Bank Loan	—	1,00,000
Interest on loan	12,000	—
Miscellaneous expenses	15,000	—
Drawings	26,000	—
	15,18,000	15,18,000

(b) Consumption of certain items by workers and proprietor:

	Workers	Proprietor
	Rs	Rs
Poultry	10,500	4,000
Eggs	1,000	500
Butter	—	2,000
Milk	2,500	3,500

(c) Depreciation on agricultural equipment is to be provided at 12%.

(d) Salaries, miscellaneous expenses and interest expenses are to be apportioned as:

Cattle division	20%
Poultry division	30%
Crop division	50%

(e) Closing stocks, 31st March, 2006:

	Rs.
Cattle	2,80,000
Poultry	1,20,000
Fertilisers	10,000
Cattle food	6,000
Poultry food	4,000
Seeds	7,000
Crops	20,000
Growing crops	12,000

You are required to prepare the final accounts of Birjala Farm.

(I.C.W.A. Final)

SOLUTION:

**Profit And Loss Account of Birjala Farm
for the year ended 31st March, 2006**

Particulars	Cattle	Poultry	Crop	Particulars	Cattle	Poultry	Crop
	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
To Stocks 1-4-2005	2,00,000	70,000	18,000	By Sales	70,000	1,60,000	2,19,000
" Stocks				" Consumption by workers	2,500	11,500	
Fertilizers			20,000	" Consumption by proprietor	5,500	4,500	
Cattle food	30,000			" Sale of milk	1,18,000		
Poultry food		2,000		" Sale of butter	3,000		
Seeds			5,000	" Sale of eggs		28,000	
" Purchases	80,000	38,000		" Stocks, 31-3-2006	2,80,000	1,20,000	32,000
Cattle food	30,000			Stocks			
Poultry food		7,000		Fertilizers			10,000
Fertilizers			10,000	Cattle food	6,000		
" Wages & Salaries	24,800	37,200	62,000	Poultry food		4,000	
" Misc. expenses	3,000	4,500	7,500	Seeds			7,000
" Interest	2,400	3,600	6,000		10,000		
" Depreciation			24,000				
" Crop insurance			10,000				
" Net profit	1,14,800	1,65,700	1,05,500				
	4,85,000	32,800	2,68,000		4,85,000	3,28,000	2,68,000
" Net profit							

Balance Sheet as on 31st March, 2006

		Rs.			Rs.
Capital	8,00,000		Land and Buildings		6,00,000
Add: Net profit			Agricultural Equipment	2,00,000	
Cattle	1,14,800		Less: Depreciation	24,000	
Poultry	1,65,700				1,76,000
Crops	1,05,500		Stocks:		
	11,86,000		Cattle		2,80,000
Less Drawings	26,000		Poultry		1,20,000
	11,60,000		Crops		20,000
Drawings in kind	10,000		Growing crops		12,000
		11,50,000	Fertilizers		10,000
Bank Loan		1,00,000	Cattle food		6,000
Creditors		20,000	Poultry food		4,000
			Seeds		7,000
			Debtors		30,000
			Cash at Bank		5,000
		12,70,000			12,70,000

8.5 SUMMARY

- Therefore, the Institute of Cost and Works Accountant of India issued a booklet, explaining how the farm books should be kept and how the profit or loss arising from the farming operations should be ascertained. The farm accounting is a technique of using accounting data for cost and profit ascertainment of each farming activity and decision making with regard to the most profitable line of activity. In recent years, commercial farming has been assuming

great importance. Agricultural activity is a predominant activity in India. Farming activities now comprises not only of growing crops but also include animal husbandry, poultry farming, sericulture (silk worm breeding), pisciculture (rearing fish, floriculture (growing flowers) etc. Thus, farming, these days, is basically mixed farming.

- In advanced countries like the UK and the USA, commercial farming is being done on a large scale and hence farm accounting has also become popular and developed. However, in our country, farm accounting is of recent origin. A standard form of accounts for recording, fanning transactions has yet to develop.
- Farm accounting or accounting for agricultural farms is the application of accounting practices to agricultural operations. In recent years, commercial fanning has been engaging the attention of many and as a result a number of farmers are coming up. Corporate entities are entering into the farming business in a big way.
- Therefore, the Institute of Cost and Works Accountant of India issued a booklet, explaining how the farm books should be kept and how the profit or loss arising from the farming operations should be ascertained. The farm accounting is a technique of using accounting data for cost and profit ascertainment of each farming activity and decision making with regard to the most profitable line of activity.
- The farm accounting practice in India is said to be in its infant stage. This paper seeks to examine the rationale for a full-fledged farm accounting practice in the country. Literature reveals a strong relationship between the degrees of commercialization with that of the adoption of accounting practices. Therefore, the study attempts to examine the commercial traits in Indian farms, which genuinely envisage such practices in the sector. Thereafter, the existing practices of accounting in India are discussed by underscoring the measurement and valuation techniques of different farm account heads. Lastly, the study tries to draw attention to certain lacunas in the existing system. These are drawn using the authors' own observations, supported by past research. As outcomes of the study, a considerable commercial appeal is seen in the Indian farm sector. Certain farm accounts heads and their respective treatments are provided to explore the existing system of farm accounting in the country. The drawbacks of present practice are found in terms of recognition, measurement and presentation of financial data.

8.6 KEY WORDS

- **Extensive Farming:**When more land is brought under cultivation in order to increase output, it is termed as extensive cultivation or extensive farming. In extensive farming it is the only land, which is increased to get more yield, other factors remain unchanged.
- **Intensive Farming:**Under such farming, in contrast to extensive farming, more labour and capital is used in the same plot of land to get more yields.

- Mixed Farming [Crop Production + livestock raising (10% income)]: Mixed farming is one where crop production is combined with the rearing of the livestock. If a farm produces at least 10 % (at most 49%) of produce from livestock. the said farm would be called as mixed farm. Here, in case of mixed farming, the meaning of livestock is cow and buffalo only.
- Diversified fanning ($\geq 50\%$ income by single enterprise): A diversified is one that has several production enterprises or sources of income. But no source of income should produce more than 49% of income.
- Capitalistic Farming: In capitalistic farming the investment of land and capital is done by big business person or capitalist. Wages are paid to the laborers employed. Intensive farming and improved methods of cultivation are adopted. Farms are generally mechanized. Workers are better paid. The profit or loss of the business is borne by the capitalist or businessperson.

8.7 LEARNING ACTIVITY

1. What is the importance of farm accounting?

2. Explain farm budgeting

8.8 UNIT-END QUESTIONS

Descriptive Questions

1. What is farm accounting in India?
2. What are the characteristics of farm accounting for the Jain Irrigation?
3. From the data given below, prepare a 'Cattle Account':

	Rs
Opening stock of livestock	1,50,000
Closing stock of livestock	2,50,000
Opening stock of Cattle feed	8,000
Closing stock of cattle feed	6,000
Purchase of cattle during the year	4,00,000
Sale of cattle during the year	6,00,000
Sale of carcasses	2,000
Purchase of cattle feed	25,000
Wages for rearing cattle	8,000
Crop worth Rs. 10,000 grown in the farm was used for feeding cattle. Out of calves born, four died and their carcasses realised Rs. 100	(B.Com., Mysore)

4.

From the following information, prepare 'Crop Account':

	Rs
Opening stock:	
Fertilizer	15,000
Seeds	10,000
Wheat	50,000
Purchases:	
Seeds	6,000
Fertilizer	9,000
Wages:	
Paid in cash	68,000
Paid in kind by giving wheat	46,000
Sale of wheat	3,54,000
Wheat consumed by the proprietor	16,000
Depreciation on machinery	20,000
Closing stock:	
Wheat	40,000
Seeds	7,000
Fertilizer	8,000

B. Multiple Choice Questions

1. _____ an application of the accounting principles to the business of farming:
 - a. Farm planning
 - b. Farm budgeting
 - c. Farm accounting
 - d. Marketing

2. Beef and 'hides' are examples of:
 - a. Independent enterprise
 - b. Joint enterprise
 - c. Supplementary enterprise
 - d. Competitive enterprise

3. A crop loan over Rs. 1,00,000 will require:
 - a. Equitable mortgage
 - b. Registered mortgage of land
 - c. Personal security
 - d. None of these

4. A farmer having less than one hectare of irrigated the land, is known as:
 - a. Small farmers

- b. Marginal farmers
- c. Big farmers
- d. None of the above

5. Which of the following is not correctly matched?

- a. App rises continuously till APP and MPP is both equal.
- b. MPP rises continuously - Till MPP is more than APP
- c. TPP rises continuously - Till MPP is not equal to Zero
- d. APP & MPP both fall but TPP rises. When MPP is less than APP but more than zero

Answer

1. c 2. b 3. b 4. b 5. b

8.9 SUGGESTED READINGS

- Hanif, M. & Mukherjee, A. (2015). *Corporate Accounting*. South West: Thomson.
- Tulsian, P.C. (2014). *Corporate Accounting*. New Delhi: Tata McGraw-Hill Education.
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UNIT IX- INTRODUCTION TO HUMAN RESOURCE ACCOUNTING

Structure

- 9.0. Learning Objective
- 9.1. Introduction
- 9.2. Meaning
- 9.3. Importance
- 9.4. Objectives
- 9.5. Methods of valuation
- 9.6. Advantages and disadvantages
- 9.7. Summary
- 9.8. Key words
- 9.9. Learning Activity
- 9.10. Unit -End Questions
- 9.11. Suggested Readings

9.0 LEARNING OBJECTIVE

After studying this unit, you will be able to:

- Explain methods of valuation under human resource accounting
- State advantages and disadvantages of human resource accounting

9.1 INTRODUCTION

Human Resource Accounting is the process of identifying and measuring data about Human Resources and communicating this information to the interested parties. It is an attempt to identify and report the Investments made in Human Resources of an organisation that are currently not accounted for in the Conventional Accounting Practices.

Thus, Human Resource Accounting is a term applied by the Accountancy Profession to quantify the cost and value of employees of their employing organisation.

Human resource accounting (HRA) is the process of identifying and reporting investments made in the human resources of an organization that are presently unaccounted for in the conventional accounting practice. It is an extension of standard accounting principles. Measuring the value of

the human resources can assist organizations in accurately documenting their assets. In other words, human resource accounting is a process of measuring the cost incurred by the organisation to recruit, select, train, and develop human assets.

9.2 MEANING

Human Resource Accounting is the process of assigning, budgeting, and reporting the cost of human resources incurred in an organization, including wages and salaries and training expenses.

Human Resource Accounting is the activity of knowing the cost invested for employees towards their recruitment, training them, payment of salaries & other benefits paid and in return knowing their contribution to organisation towards its profitability.

The American Accounting Association's Committee on Human Resource Accounting (1973) has defined Human Resource Accounting as "the process of identifying and measuring data about human resources and communicating this information to interested parties". HRA, thus, not only involves measurement of all the costs/ investments associated with the recruitment, placement, training and development of employees, but also the quantification of the economic value of the people in an organisation.

Flamholtz (1971) too has offered a similar definition for HRA. They define HRA as "the measurement and reporting of the cost and value of people in organizational resources".

Human Resource Accounting (HRA) is a new branch of accounting. It is based on the traditional concept that all expenditure of human capital formation is treated as a charge against the revenue of the period as it does not create any physical asset. But now a day this concept has changed and the cost incurred on any asset (as human resources) should be capitalised as it yields benefits measurable in monetary terms.

Human Resource Accounting means accounting for people as the organisational resources. It is the measurement of the cost and value of people to organisations. It involves measuring costs incurred by private firms and public sectors to recruit, select, hire, train and develop employees and judge their economic value to the organisation.

9.3 IMPORTANCE

The need for human resources accounting arose primarily as a result of the growing concern for human relations management — in industry. Behavioural scientists concerned with the management of organisation pointed out that the failure of accountants to value human resources was a serious handicap for effective management.

1. A business manager has to use resources carefully to achieve immediate and long-term goals for the organisation. This necessitates valuable information about resources. The human beings constitute an important asset for an organisation. Without people in the organisation, other resources physical and financial cannot be effectively used. In conventional accounting, not much information is available about human resources.

2. The levels of income shown in the conventional statements in profit and loss accounts do not accurately reflect the level of business performance.

3. Expenses on human resources are charged to current revenue instead of being treated as investments to be amortised over the economic service of the employees with the result that the figures of net income shown are significantly distorted.

The result in the conventional balance sheets fail to reflect the value of human assets, hence there is distortion in value of organisation and the rate of return of investment. Distorted measures render assessment of organisation and inter-organisation comparison difficult.

4. Conventional treatment of investments on human resources may lead to the erosion of investors' interest through management decisions which is harmful for the long-run success of an organisation and to the investor' equity.

5. Traditional accounting involves treatment of human capital and non-human capital differently; the recorded value of other assets is indicated as non-human capital. There is no such record of human assets corresponding to the human capital of the organisation although the productivity and profitability depend largely on contribution by human assets.

To make it more explicit, two firms engaged in the same business line, use identical physical assets under similar market conditions, may have different end results in terms of their profitability and growth due to differences in their human assets. It is, therefore, not possible to assess the total value of the firm, since the value of human capital (i.e., human assets) is not taken into consideration while assessing the total valuation of the firm's assets.

6. Expenses incurred by a firm on recruitment, training and development of human resources, employees are at present as per practice, treated as current costs and written off against current revenue in the conventional accounts. Similarly, other employee related expenses such as welfare expenses, incentives, benefits are treated under the present system of accounting.

But all such expenses are in reality, expenses in the nature of investment in human resources and, the benefits of such investment on human resources are often derived or accrued over a longer period than the 'one year' in which these expenses are debited to the current revenue in the year a balance sheet is prepared.

The managements generally are interested to keep these costs on 'welfare' of human resources as low as possible, i.e., controlling or cutting down the 'costs.' These results in immediate savings in costs and resulting profits are achieved, neglecting the long-term impact of such a policy on the motivation or the morale of the employees.

7. The impact of management decision on human assets of the firm cannot be clearly perceived if the value of human resources is not reported in the profit and loss account and balance sheet.

9.4 Objectives

Rensis Likert described the following objectives of HRA:

- Providing cost value information about acquiring, developing, allocating and maintaining human resources.
- Enabling management to monitor the use of human resources.
- Finding depreciation or appreciation among human resources.
- Assisting in developing effective management practices.
- Increasing managerial awareness of the value of human resources.
- For better human resource planning.
- For better decisions about people, based on improved information system.
- Assisting in effective utilization of manpower.

9.5 METHODS OF VALUATION

(1) Historical Cost Method:

This method is based on costs incurred or recruitment, training, familiarization etc. It is developed by Rensis Likert. This is a very simple method based on traditional principles of accounting. Under this method an attempt is made to have a proper match between cost and revenue.

The plus point of this method is that the organization can show the value of human capital in its balance sheet and profit and loss account, the weak point of this method is that it fails to fulfil the need of developing a system of HRA based on systematic valuation of human resources.

(2) Replacement Cost Method:

Under this method the replacement cost of existing personnel is estimated. Replacement cost includes the cost of recruitment, training and opportunity cost for the intervening period. This serves the purpose of making valuation of human resources periodically. It helps in planning for human resources in future. The difficulty in this method is that the value differs from person to person making it difficult to find identical replacement of the present human assets.

(3) Economic Value Method:

The payment made to the human resources till their retirement are calculated and appropriately discounted to get their present economic value.

(4) Standard Cost Method:

This method is in improvement over replacement cost method. Under this method the standard costs of recruitment, training and development are developed and established every year to overcome complications in calculations. These costs represent the value of human resources for accounting. It is easy for implementation and control.

(5) Present Value Method:

Under this method the net contributions of employees to the earning of the organisation are discounted to have present value of human resources.

(6) Current Purchase Power Method:

In this method the historical costs are converted into current purchasing power of money with the help of index numbers.

(7) Opportunity Cost Method:

Under this method the value of human asset is determined in their alternative use or the next best alternative use. This value forms the basis for valuation of human asset of organisation. For calculation of opportunity cost bidding method is used. But it is difficult to decide bid or offer.

9.6 ADVANTAGES AND DISADVANTAGES

Benefits of Human Resource Accounting

The main benefits of Human Resource Accounting are: -

1. HR Accounting helps the company ascertain how much Investment it has made on its Employees and how much return it can expect from this Investment
2. The Ratio of Human Capital to Non-Human Capital computed as per the HR Accounting Concept indicates the degree of Labour Intensity of an Organisation.
3. HR Accounting provides a basis for planning of physical assets vis-a-vis Human Resources
4. HR Accounting provides valuable information to Investors interested in making Long Term Investments in Service Sector Companies

Limitations of HRA:

HRA is yet to gain momentum in India due to certain difficulties:

1. The valuation methods have certain disadvantages as well as advantages; therefore, there is always a bone of contention among the firms that which method is an ideal one.
2. There are no standardized procedures developed so far. So, firms are providing only as additional information.
3. Under conventional accounting, certain standards are accepted commonly, which is not possible under this method.
4. All the methods of accounting for human assets are based on certain assumptions, which can go wrong at any time. For example, it is assumed that all workers continue to work with the same organization till retirement, which is far from possible.

5. It is believed that human resources do not suffer depreciation, and in fact they always appreciate, which can also prove otherwise in certain firms.

6. The lifespan of human resources cannot be estimated. So, the valuation seems to be unrealistic.

9.7 SUMMARY

- Human resource accounting is the process of identifying and reporting investments made in the human resources of an organization that are presently unaccounted for in the conventional accounting practice. It is an extension of standard accounting principles. Human Resources Accounting involved in identifying, measuring, capturing, tracking and analyzing the potential of the human resources of a company and communicating the resultant information to the stakeholders of the company. Human Resource (HR) is though one of the valuable assets of the organization, there is no statutory regulation to report it in the organization's annual report.
- But sometimes the HR value of an organization can exceed its' tangible asset value, but traditional accounting systems provide little chance to record and recognize these values of HR.
- For instance, a few years back when Bill Gates declared to retire from the Microsoft Corporation, the share price of the company fall in a large amount.
- But traditional accounting suggests no impact on the financial condition of the company, but the actual scenario is totally different.
- It was a method by which a cost was assigned to every employee when recruited and the value that the employee would generate in the future. Human Resource accounting reflected the potential of the human resources of an organization in monetary terms, in its financial statements.
- Human Resources Accounting involved in identifying, measuring, capturing, tracking and analyzing the potential of the human resources of a company and communicating the resultant information to the stakeholders of the company.

9.8 KEY WORDS

- Selection procedure: Any measure, combination of measures, or procedure used as a basis for any employment decision. Selection procedures include the full range of assessment techniques--from traditional paper and pencil tests, performance tests, physical, education, and work experience requirements through structured or unstructured interviews and unscored application forms.

- Selection rate: The proportion of applicants or candidates who are hired, promoted, or otherwise selected for a particular position.
- Separation: Severance of an employment relationship. The action to separate from employment may be taken by the employee, the employer, or both.
- Targeted recruiting: Any recruitment activity directed toward any person or group of persons based on race, colour, religion, gender, national origin, or age that is not also equally and coincidentally directed toward all other persons.
- Uniformly applied: Applying employment criteria and processes in the same manner to members of a particular race, colour, religion, sex, or national origin group and others.
- Human Resource Accounting: Is the art of valuing, recording and presenting the work of all human resources in the accounts of an organization. It can help management in taking vital decisions relating to selection, layoff, transfer, training, and promotion.
- HRA: Human Resource Accounting

9.9 LEARNING ACTIVITY

1. Explain the difference between HRA for managers and HR Professionals?

2. How to determine rate of return on investment in Human Resource?

9.10 UNIT-END QUESTIONS

A. Descriptive Questions

1. What is Human resource accounting?
2. Discuss the importance of human resource accounting.
3. What are the advantages of human resource accounting for a Bank?
4. Outline the disadvantages of human resource accounting.
5. Explain the methods of Human Resource accounting can be implemented by an large organization?

B. Multiple Choice Questions

1. -----Accounting deals with employees and management in an organization.
 - a. Human Resource
 - b. Inflation

- c. Environment
2. ----- introduced the Opportunity cost approach in Human Resource Accounting.
 - a. Lev & Schwartz
 - b. Hekimian & Jones
 - c. Rensis Likert & Eric G. Flamholtz
 3. Present Value of Lev and Schwartz Model introduced by Lev and Schwartz was introduced in the year-----
 - a. 1972
 - b. 1971
 - c. 1981
 4. Following are the drawbacks and objections raised against ----- Accounting It cannot be valued and measured There are many methods and none are recognized by any law It calls for extensive research.
 - a. Creative Accounting
 - b. Forensic Accounting
 - c. Human Resource Accounting
 5. The difference between the revenue generated by the efforts of the employees and the cost incurred on the employees in the estimated life of all employees was introduced by ----- as Human Resource Model
 - a. Morse – Net Benefit Model
 - b. Jaggi & Lau – Group based valuation Model
 - c. Hermanson – Adjusted Future Wage Model.
 6. ----- includes the sum total of skills, talent, creativity, and values of the entire workforce in the organization.
 - a. Human Resource Accounting
 - b. Human Resource
 - c. None of the above
 7. The then CEO of Infosys, Narayana Murthy adopted, ----- model of Value based human resource accounting approach in his organization to compute the value of human capital asset
 - a. Flamholtz Model
 - b. Lev and Schwartz Model
 - c. Roger H Hermanson’s Unpurchased Goodwill Model

8. Following are the step to be adopted to calculate the value of Human Resource as per --- -----
---- Model. Estimated span of employment of each employee Identifying the position of service to be rendered by each employee Estimate the earnings for each such position of service Calculation of total expected earnings Calculation of the present value of the future expected earnings at the predetermined rates

- a. Lev and Schwartz
- b. Flamholtz
- c. Hermanson

Answer

1. a 2. b 3. b 4. c 5. a 6. b 7. b8. b

9.11 SUGGESTED READINGS

- Hanif, M. & Mukherjee, A. (2015). *Corporate Accounting*. South West: Thomson.
- Tulsian, P.C. (2014). *Corporate Accounting*. New Delhi: Tata McGraw-Hill Education.
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UNIT X- HUMAN RESOUCE ACCOUNTING – II

Structure

- 10.0. Learning Objective
- 10.1. Introduction
- 10.2. Models of Human Resource Accounting
- 10.3. Approaches to Human Resource Accounting
- 10.4. Summary
- 10.5. Key words
- 10.6. Learning Activity
- 10.7. Unit -End Questions
- 10.8. Suggested Readings

10.0 LEARNING OBJECTIVE

After studying this unit, you will be able to:

- List different models of human resource accounting
- Describe approaches to Human Resource Accounting

10.1 INTRODUCTION

The concept of human resource accounting has been defined by the committee on Human Resource Accounting of the American Accounting Association as “the process of identifying and measuring data about human resources and communication this information to interested parties.” Human resources accounting is basically an information system that tells management what changes are occurring over time to the human resources of the business. Approaches to human resource accounting were first developed in 1691. The next approach was developed from 1691–1960, and the third phase was post-1960.

There are two approaches to HRA. Under the cost approach, also called the "human resource cost accounting method" or model, there is an acquisition cost model and a replacement cost model. Under the value approach, there is a present value of future earnings method, a discounted future wage model, and a competitive bidding model.

Considering the pros and cons of various models, Chennai-based CA Laxminarayan Ramanujam has worked out a simple to use and easy to adopt, unique model titled GiveGET, for the Human Resource Valuation and Accounting, while accounting for PEACE.

10.2 MODELS OF HUMAN RESOURCE ACCOUNTING

1. The Lev and Schwartz Model.
2. The Eric Flamholtz Model
3. Morse Model.
4. Likert Model
5. Ogun's Model

The Lev and Schwartz Model

Lev & Schwartz advocated the estimation of future earnings during the remaining service life of the employee and then arriving at the present value by discounting the estimated earnings at the cost of capital. The assumptions in this method are realistic and scientific.

The method has practical applicability when the availability of quantifiable and analysable data is concerned.

Ad by Value impression

Still, this model is unable to give any method to record the value of human resources in the Books of Accounts. According to this model, the value of human resources is ascertained in the following ways:

1. All employees are classified into specific groups according to their age, experience, and skill.
2. Average annual earnings are determined for various ranges of age.
3. The total earnings which each group will get up to retirement age are calculated.
4. The total earnings calculated as above are discounted at the rate of the cost of capital.
5. The value thus arrived at will be the value of human resources/assets.

This method has some limitations, which are as follows:

1. This method does not indicate the accounting treatment of human resources.

2. This method only considers wages and salaries, but wages and salaries are not only the costs associated with the employees. Other costs are associated with the employees.
3. The model ignores the possibility and probability that an individual may leave an organization for a reason other than death or retirement. The model's expected value of human capital is a measure of the expected 'conditional value' of a person's human capital. The implicit condition is that the person will remain in an organization until death or retirement. This assumption is not practical.

The Eric Flamholtz Model

Flamholtz (1996) developed this model.

This is an improvement on the present value of future earnings model' since it takes into consideration the possibility or probability of an employee's movement from one role to another in his career and also of his leaving the firm earlier, that is, death or retirement.

The model suggests a five-step approach for assessing the value of an individual to the organization:

1. Forecasting the period will remain in the organization, i.e., his expected service life;
2. Identifying the services states, i.e., the roles that they might occupy including, of course, the time at which he will leave the organization;
3. Estimating the value derived by the organization when a person occupies a particular position for a specified period;
4. Estimating of the probability of occupying each possible mutually exclusive state at specified future times; and
5. Discounting the value at a predetermined rate to get the present value of human resources.

Morse Model

Under this model, the value of human resources is equivalent to the present value of the net benefits derived by the enterprise from the service of its employees. The following steps are involved in this approach:

1. The gross value of the services to be rendered in the future by the employees in their individual and collective capacity.
2. The value of direct and indirect future payments to the employees is determined.

3. The excess of the value of future human resources over the value of future payments is ascertained. This represents the net benefit to the enterprise because of human resources.

Likert Model

Rensis Likert in the 1960s was the first to research in HRA (Human Resource Accounting) and emphasized the importance of strong pressures on HR's qualitative variables and on its benefits in the long-run.

The Likert Model is a non-monetary value-based model. According to Likert's model, the human variable can be divided into three categories:

- Causal variables;
- Intervening variables; and
- End-result variables.

The interaction between the causal and intervening variables affect the end-result variables by way of job satisfaction, costs, productivity, and earnings.

Ogun's Model

Pekin Ogun (1976) was the pioneer of the Net benefit model. This, as a matter of fact, is an extension of the "net benefit approach," as suggested by Morse.

According to this approach, the certainty with which the net benefits in the future will accrue should also be taken into account while determining the value of human resources. The approach requires the determination of the following:

1. Net benefit from each employee.
2. Certainty factors at which the benefits will be available.
3. The net benefits from all employees multiplied by their certainty factor will give certainty-equivalent net benefits.

Quite a few Models have been suggested in the past for the Human Resource Accounting and these can be classified into 2 parts each having various Models.

Some of the important ones are:

A. Cost Based Models:

1. Capitalisation of Historical Costs:

As per this method of HR Accounting, the sum of all costs related to Human Resources (i.e. Recruitment, Acquisition, Formal Training, Informal Training, Informal familiarisation, experience and development) is taken together to represent the value of the human resources.

The value is amortised annually over the expected length of the service of individual employees and the unamortised cost is shown as Investments in the Human Assets. If an employee leaves the firm (i.e. Human Assets expire) before the expected service life period, then the net value to that extent is charged to the Current Revenue.

Limitations:

- i. This Model of HR Accounting is simple and easy to understand and satisfies the basic principles of matching the costs and revenues.
- ii. As the historical costs are sunk costs and are irrelevant for decision making, this model was severely criticised as it failed to provide a reasonable value to the human resources.
- iii. This method of HR Accounting capitalises only the Training and Development Costs incurred on the employees and ignores the future expected costs to be incurred for their maintenance.
- iv. This Model of HR Accounting distorts the value of the highly skilled human resources as such employees require less training and therefore, according to this model, they will be valued at a lesser cost.

2. Replacement Costs:

The Historical Cost Method was highly criticised as it only takes into account the Sunk Costs which are irrelevant for Decision Making. Thus, a new model for Human Resource Accounting was conceptualised which took into the account, the costs that would be incurred to replace its existing human resources by an identical one.

- a. Individual Replacement Costs – Which refers to the cost that would have to be incurred to replace an individual by a substitute who can provide the same set of services as that of the individual being replaced.
- b. Positional Replacement Costs – Which refers to the cost of replacing the set of services referred by an incumbent in a defined position

Thus, the Positional Replacement Cost takes into account the position in the organisation currently held by the employee and also the future positions expected to be held by him.

Limitations:

- i. As per this method of HR Accounting, the determination of replacement cost of an employee is highly subjective and often impossible.
- ii. Particularly at the management cadre, finding out an exact replacement is very difficult. The exit of a top management person may substantially change the human assets value.

3. Opportunity Cost Model:

This model was advocated by Hekimian and Jones in the year 1967 and is also known as the Market Value Method. This method of measuring Human Resources under this Model is based on the concept of opportunity cost i.e. the value of an employee in its alternative best use, as a basis of estimating the value of human resources.

The opportunity cost value may be established by competitive bidding within the firm, so that in effect, managers bid for any scarce employee. A human asset therefore, will have a value only if it is a scarce resource, that is, when its employment in one division denies it to another division.

Limitations:

- i. One of the serious limitations of this method for Human Resource Accounting is that it excludes employees of the type which can be hired readily from outside the firm.
- ii. Thus, this approach seems to be concerned with only one section of a firm's human resources, having special skills within the firm or in the labour market.

B. Economic Value Models:

1. Present Value of Future Earnings Model:

This Model of human resource accounting was developed by Lev and Schwartz in the year 1971 and involves determining the value of human resources as per the present value of estimated future earnings discounted by the rate of return on Investment (Cost of Capital). As per this valuation model of Human Resource Accounting, the following expression is used for calculating the expected value of a person's human capital

Limitations:

- i. This Model of HR Accounting ignores the possibility and probability that an Individual may leave an organisation for reasons other than Death or Retirement.
- ii. This Model of HR accounting also ignores the probability that people may make role changes during their careers. For example, an Assistant Engineer will not remain in the same position throughout the expected service life in the Organisation.
- iii. Despite the above limitations, this model is the most commonly used model across the Globe for the purpose of Human Resource Accounting.

2. Reward Valuation Model/ Flamholtz Model:

Flamholtz advocated that an Individual's Value to an organisation is determined by the services he is expected to render. This model of Human Resource Accounting is an improvement to the "Present Value of Future Earnings Model" as it takes into account the probability that an individual is expected to move through a set of mutually exclusive organisational roles or service states during a time interval. Such movement can be estimated probabilistically by using the following model

Limitations:

- i. The major drawback of this model of Human Resource Accounting is that it is difficult to estimate the probabilities of likely service states of each employee.
- ii. Determining the monetary equivalent of service states is also very difficult and costly affair.
- iii. Since the analysis is restricted to Individuals, it ignores the value-added element of Individuals working as groups.

3. Valuation on Group Basis:

While applying the above models, the Accountants realised that proper Valuation as per Human Resources Accounting is not possible unless the contributions of the Individuals as a Group are taken into consideration. An Individual's expected service tenure in the organisation is difficult to predict

but on a group basis it is relatively easier to estimate the percentage of people in a group likely to leave the organisation in the future.

This model of Human Resource Accounting attempted to calculate the present value of all existing employees in such in each rank.

Such Present Value is ascertained with the help of the following steps:

- a. Ascertain the number of employees in each rank- Estimate the probability that an employee will be in his rank within the organisation or will be terminated in the next period. This probability will be estimated for a specified time period.
- b. Ascertain the economic value of an employee in a specified rank during each time period.
- c. The present value of existing employees in each rank is obtained by multiplying the above three factors and applying an appropriate discount rate.

Limitations:

- i. Although this process simplifies the process valuation of Human Resource Accounting by considering a group of employees as a valuation base, but this method ignores the exceptional qualities of certain skilled employees.
- ii. Thus, the performance of a group may be seriously affected in the event of exit of a single individual.

10.3 APPROACHES TO HUMAN RESOURCE ACCOUNTING

There are different angles to HRA, regarding components of costs, investment and value related to employees of an organization. There are two approaches to assign monetary values to these aspects, the cost approach and the economic value approach. The cost approach involves the expenditures incurred by a company regarding an employee like costs of recruitment, selection, placement, training and development, etc.

On the other hand, the economic value approach regards employees as assets and measures the economic value added by the employees to the organization's total worth. It aims to measure the benefits created by HR.

1. The Cost Approach:

I. The Historical Cost Method:

According to this method, all the costs incurred in recruitment, selection, placement, training and development of employees are taken into account while evaluating the value of human resources. Some of these costs are direct costs like salaries while costs in terms of time spent in training and development are indirect costs.

This method is simple and easy to understand, though it suffers from many demerits; the biggest one being that since training and development costs are taken into account while valuing employees, highly skilled employees requiring lesser training will be valued lower than those requiring more training.

II. The Opportunity Cost Method:

This method calculates what would have been the returns if the money spent on HR was spent on something else. It was Hekimian and Jones who had advocated this method, also known as the Market Value Method.

This is not a very objective method and therefore is only used for internal reporting. One serious limitation of this method is that it totally disregards the fact that well-trained employees can be easily hired from outside sources, and it would be difficult to measure the opportunity costs related to them.

III. The Replacement Cost Method:

Replacement cost refers to the costs that would have to be incurred if the existing employees were to be replaced by identical ones. When an employee leaves the organization, costs of recruiting, selecting, placing and training the new employee would have to be incurred in order to replace him.

The replacement costs can be viewed from two angles: personal replacement costs and positional replacement costs. Personal replacement cost is the cost that would have to be incurred to replace an employee with a substitute who can provide the same set of services that the employee being replaced might have rendered at various positions he would have occupied during his tenure.

Positional replacement costs are the costs incurred to replace the set of services rendered by an employee in a particular position. This takes into account the position the employee is currently holding as well as the future positions expected to be held by him. The major weakness of this method is that it is highly subjective.

2. The Economic Value Approach:

I. Flamholtz's Model of Determinants of Individual Value to Formal Organizations:

According to Flamholtz, the value of an individual to an organization is determined by the services he is expected to render. The current value of an employee is the present worth of the services that he is likely to render to the organization in future.

As an employee moves from one position to another within the organization, the set of services provided by him changes. While calculating the current value of the individual, the present cumulative value of all the possible services that may be rendered by him during his tenure with the organization is taken.

There are two dimensions to this value:

(i) Expected conditional value- This is the worth that could be possibly realized from the services of an individual over the period of his productive work life in the organization.

(ii) Expected realizable value- The expected realizable value depends upon the expected conditional value of an employee and the probability that the individual will remain in the organization for the duration of his productive work life. Since the employees may leave the organization any time they wish, it is important to ascertain the chances of their turnover.

II. Flamholtz's Stochastic Rewards Valuation Model:

This model considers the movement of employees in an organization through various roles. This process of progressing through organizational states is called a stochastic process. The stochastic rewards valuation model measures a person's expected conditional value and expected realizable value.

In any organization, employees generate value as they move along organizational roles and render a set of services in different capacities. It is presumed that any employee would move from one state to another over duration of time; in this model the separation of an employee from his workplace is also considered a state. This is a very sophisticated and complex model that requires extensive information for determining the value of individuals.

III. The Lev and Schwartz Model:

According to this model, the value of human resources is calculated as the present value of estimated future earnings discounted by the rate of return on investment (cost of capital).

The mathematical formula for calculation of value of human resources is as follows:

$$V_y = \frac{I(t)}{(1+r)^{t-y}}$$

Where,

V = the value of an individual 'y' years old.

I(t) = the individual's annual earnings up to retirement.

t = retirement age.

r = a discount rate specific to the cost of capital to the company.

This is the most commonly used method for HRA used by most companies in India.

IV. Hekimian and Jones Competitive Bidding Model:

In this method, the managers bid against each other for the human resources already available in an organization. The highest bid is taken as the value of the employee. This is a highly subjective method as there are no set criteria to evaluate the employees. The value of an employee is based solely on the judgement of the managers.

3. Non-Monetary Methods:

The value of human resources can be measured by non-monetary methods as well. These methods may be used to supplement monetary methods.

I. Skills inventory – This is a simple listing of the education, knowledge, experience, skills of the organization's human resources.

II. Performance evaluation methods – This includes methods like simple ranking method, paired comparison, check lists, graphic rating scales, etc.

III. Potential assessment – It refers to the identification of hidden skills, talents and abilities in a person which even he may be unaware of. It determines an employee's capacity for promotion and advancement.

IV. Attitude measurements – These measurements assess employees' attitudes towards their jobs, remuneration, work environment, etc. in order to determine their levels of satisfaction or dissatisfaction.

10.4 SUMMARY

- Human resources accounting (HRA) is one of the latest concepts adopted by few corporations in our country. Most of the corporations have realised that human resources are their most precious resources. So, it is required to taken some measures to develop their human resources but also taken measures to accelerate their values. The traditional accounting practices simply ignored the value of human factors in the organization and preferred to treat it as an expense and expendable factors.
- This fundamentally lopsided attitude towards human resources goes against the interest of the employees decisively.
- For instance, the cost of training incurred to update the skills and knowledge of the employees were treated only as expenses and not as an investment.
- Although human resource accounting is still in its infancy as far as its development is concerned, there are a few approaches available to the study of human resource accounting.
- However, none of these approaches has so far found universal acceptance, because they have inbuilt contradictions, incompleteness or inability. These approaches have thus far failed to fulfill the basic requirements of traditional accounting concepts and practices like the double-entry concept.
- It is still extremely difficult to determine the actual value of the human resource of the organization through the different methods and accounting techniques have already proposed for human resource accounting.

10.5 KEY WORDS

- Compliance: Adherence to laws, court decisions, regulations, executive orders, and other legal mandates governing affirmative action and equal employment opportunity.
- Direct threat: A significant risk; a high probability of substantial harm to the health or safety of the employee or others.
- Formal training: A structured program to develop or increase job-related skills and abilities. Typically, classroom training as well as on-the-job training fall into this category.
- Fringe benefits: Employment compensation other than wages or salary, including, for example, annual and sick leave, medical insurance, life insurance, retirement benefits, profit sharing, and bonus points.
- Recruitment (or relevant) area: The geographic location(s) from which an agency or organization unit draws applicants for employment.

10.6 LEARNING ACTIVITY

1. Explain the methods for valuation of human assets?

2. State the areas to be focused for effective human capital investment.

10.7 UNIT-END QUESTIONS

A. Descriptive Questions

1. Describe historical cost approach.
2. Explain replacement cost approach.
3. Discuss opportunity cost approach.
4. Explain Hekimian and Jones Competitive Bidding Model.
5. Discuss the Lev and Schwartz Model.

B. Multiple Choice Questions

1. When the cost incurred on recruiting, training and developing the employees is considered for determining the value of employees, it is called
 - a. Replacement cost approach
 - b. Historical cost approach
 - c. Opportunity cost approach
 - d. None of these

2. The opportunity cost approach in human resource accounting was introduced by
 - a. Hekimian and Jones
 - b. Rensis Likert
 - c. Eric G. Flamholtz
 - d. William C. Pyle

3. The aggregate payment approach in human resource accounting was developed by
 - a. Myers and Flowers
 - b. Hermanson
 - c. S. K. Chakraborty
 - d. none of the above

4. The value of human resources is the function of the average salary of the employees and their average employment tenure in the organization. This is the essence of the
 - a. aggregate payment model

- b. five-dimensional model
- c. causal, intervening and end-result model
- d. unpurchased goodwill model

5. Fixing the value of an employee depending upon his productivity, promotability transferability and retainability is the core of the

- a. certainty equivalent model
- b. stochastic reward valuation model
- c. human asset multiplier model
- d. present value of future earnings model

Answer.

1. b2. a3. c4. a5. b

10.8 SUGGESTED READINGS

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