

ACCOUNTING STANDARDS AND GUIDANCE NOTES

BASIC CONCEPTS

- **ACCOUNTING STANDARDS**

A standard means a generally accepted model or an ideal. Accounting standards are therefore generally accepted **model** accounting practices. Unlike GAAPs, accounting standards are written statements of accounting rules or guidelines or practices for preparing the uniform financial statements. Accounting standards are therefore specific codified rules of accounting to be adopted for treatment of items such as valuation of fixed assets, valuation of inventories, depreciation, cash flow statement etc. The purpose or focus of accounting standards is to convey the same meaning of any accounting concept to all users of accounting information so that the same meaning is derived by studying the financial statements. These standards are issued in India by the Institute of Chartered Accountants of India (ICAI). Thus, Accounting Standards (ASs) are written policy documents issued by expert accounting body or by government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions in the financial statements.

- **GUIDANCE NOTES**

Guidance Notes are primarily designed to provide guidance to members of ICAI on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. In a situation where certain matters are covered both by an Accounting Standard and a Guidance Note, issued by the Institute of Chartered Accountants of India, the Guidance Note or the relevant portion thereof will be considered as superseded from the date of the relevant Accounting Standard coming into effect, unless otherwise specified in the Accounting Standard.

Similarly, in a situation where certain matters are covered by a recommendatory Accounting Standard and subsequently, an Accounting Standard is issued which also covers those matters, the recommendatory Accounting Standard or the

Financial Reporting

relevant portion thereof will be considered as superseded from the date of the new Accounting Standard coming into effect, unless otherwise specified in the new Accounting Standard.

In a situation where certain matters are covered by a mandatory Accounting Standard and subsequently, an Accounting Standard is issued which also covers those matters, the earlier Accounting Standard or the relevant portion thereof will be considered as superseded from the date of the new Accounting Standard becoming mandatory, unless otherwise specified in the new Accounting Standard.

Question 1

Write short note on the advantages and disadvantages of setting of Accounting Standards.

Answer

The Accounting Standards seek to describe the accounting principles, the valuation techniques and the methods of applying the accounting principles in the preparation and presentation of financial statements so that they may give a true and fair view. The ostensible purpose of the standard setting bodies is to promote the dissemination of timely and useful financial information to investors and certain other parties having an interest in companies' economic performance.

The advantages or benefits of accounting standards may be summarized as follows:

- (i) **To improve the credibility and reliability of financial statements:** The accounting standards create an environment of confidence amongst the users of the accounting information by providing a uniform structure of uniform guidelines which provide credibility and reliability to the accounting information. In this way the financial statements present a true and fair view of the financial position and operating results (profit or loss) of a business organisation.
- (ii) **Comparability:** The value of accounting information is enhanced (increased) if it can be compared easily in the same line of business activity. The comparability is possible only when same accounting standards are used in the preparation of the financial statements of different firms in the same industry. It is a positive step to protect the interests of the users of the accounting information.
- (iii) **Benefits to accountants and auditors:** The accounting standards provide a basis for uniform accounting practices. In this way there is a less possibility of frauds to be committed by accountants. There is more transparency in the accounting information. Since the accounting profession follows the accounting standards without any exception, they are helpful not only to an accounting entity but to the accountants and auditors too. Any type of misinformation can lead to strict action against the accountants as well as auditors.
- (iv) **Additional disclosures:** There are certain areas where important information is not required to be disclosed by law. Standards require such additional disclosure such as the methods of depreciation used, change of method of method of depreciation etc. which help the users of

financial statements such as investors, bankers, creditors etc. to take important financial decisions.

- (v) **Evaluation of managerial ability:** Accounting standards are useful in measuring the efficiency of management regarding the profitability, liquidity, solvency and general progress of the enterprise. In the absence of accounting standards, it would be difficult to evaluate the managerial efficiency, because there is no basis of comparing the financial results of one enterprise with that of another. Each enterprise would evolve its own rules or standards to suit its purpose and users of accounting information would fail to get a true and fair view of the functioning of an enterprise.
- (vi) **Helpful to Government:** The government officials will find the financial information more useful for purposes of economic planning, market analysis and tax collections if it is based on established accounting standards.
- (vii) **Reform in accounting theory:** The development of accounting standards has been very helpful in reforming accounting theory and practice in respect of accounting measurements and financial Information.

However, there are some disadvantages of setting of accounting standards:

- (i) **Difficult choice:** Alternative solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult.
- (ii) **Mechanical approach:** There may be a trend towards rigidity and away from flexibility in applying the accounting standards.
- (iii) **Different from law:** Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.

Question 2

- (a) *Briefly indicate the items, which are included in the expression “borrowing cost” as explained in AS 16.*
- (b) *Explain the difference between direct and indirect methods of reporting cash flows from operating activities with reference to Accounting Standard 3(AS 3) revised.*
- (c) *Write short note on Effect of Uncertainties on Revenue Recognition.*

Answer

- (a) **Borrowing costs :** Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds.

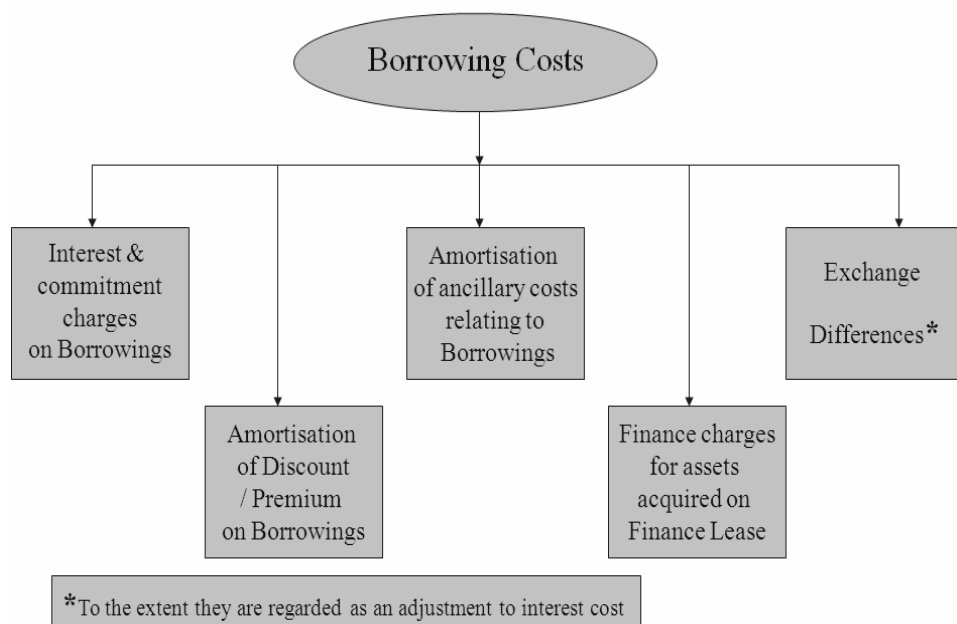
As per para 4 of AS 16 on Borrowing Costs, borrowing costs may include :

- (a) interest and commitment charges on bank borrowings and other short-term and long-term borrowings;
- (b) amortisation of discounts or premiums relating to borrowings ;

Financial Reporting

- (c) amortisation of ancillary costs incurred in connection with the arrangement of borrowings;
- (d) finance charges in respect of assets acquired under finance leases or under other similar arrangements; and
- (e) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Components of Borrowing Costs



- (b)** As per para 18 of AS 3 (Revised) on Cash Flow Statements, an enterprise should report cash flows from operating activities using either:
- (a) the direct method whereby major classes of gross cash receipts and gross cash payments are disclosed; or
 - (b) the indirect method, whereby net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method and is, therefore, considered more appropriate than the indirect method. Under the direct method,

information about major classes of gross cash receipts and gross cash payments may be obtained either:

- (a) from the accounting records of the enterprise; or
- (b) by adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial enterprise) and other items in the statement of profit and loss for:
 - (i) changes during the period in inventories and operating receivables and payables;
 - (ii) other non-cash items; and
 - (iii) other items for which the cash effects are investing or financing cash flows.

Under the indirect method, the net cash flow from operating activities is determined by adjusting net profit or loss for the effects of:

- (a) changes during the period in inventories and operating receivables and payables;
- (b) non-cash items such as depreciation, provisions, deferred taxes, and unrealized foreign exchange gains and losses; and
- (c) all other items for which the cash effects are investing or financing cash flows.

Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the operating revenues and expenses, excluding non-cash items disclosed in the statement of profit and loss and the changes during the period in inventories and operating receivables and payables.

(c) Effect of Uncertainties on Revenue Recognition

Para 9 of AS 9 on "Revenue Recognition" deals with the effect of uncertainties on Revenue Recognition. The para states:

1. Recognition of revenue requires that revenue is measurable and at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.
2. Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc. revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. When there is uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even, though payments are made by instalments.

Financial Reporting

3. When the uncertainty relating to collectability arises subsequent to the time of sale or rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.
4. An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits; the recognition of revenue is postponed.
5. When recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue of the period in which it is properly recognized.

Question 3

Write short notes on:

- (a) *Impairment of asset and its application to inventory.*
- (b) *Treatment of borrowing costs.*
- (c) *Accounting for investment by a holding company in subsidiaries.*
- (d) *Concept of Materiality.*
- (e) *NACAS.*

Answer

- (a) The objective of AS 28 'Impairment of Assets' is to prescribe the procedures that an enterprise applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and this Statement requires the enterprise to recognize an impairment loss.

- ◆ If carrying amount $\leq$ Recoverable amount : **Asset is not impaired**
- ◆ If carrying amount $>$ Recoverable amount : **Asset is impaired**

Impairment Loss = Carrying Amount – Recoverable Amount

Recoverable amount is the higher of net selling price and its value in use

This standard should be applied in accounting for the impairment of all assets, other than (i) inventories (AS 2, Valuation of Inventories); (ii) assets arising from construction contracts (AS 7, Accounting for Construction Contracts); (iii) financial assets, including investments that are included in the scope of AS 13, Accounting for Investments; and (iv) deferred tax assets (AS 22, Accounting for Taxes on Income). AS 28 does not apply to inventories, assets arising from construction contracts, deferred tax assets or investments because other accounting standards applicable to these assets already

contain specific requirements for recognizing and measuring the impairment related to these assets.

- ◆ If carrying amount $\leq$ Recoverable amount : **Asset is not impaired**
- ◆ If carrying amount $>$ Recoverable amount : **Asset is impaired**

Impairment Loss = Carrying Amount – Recoverable Amount

Recoverable amount is the higher of net selling price and its value in use

(b) According to AS 16,

Meaning of borrowing costs: are interest and other costs incurred by an enterprise in connection with the borrowing of funds.

What it Includes- Borrowing costs may include: (i) interest and commitment charges on bank borrowings and other short-term and long-term borrowings; (ii) amortization of discounts or premiums relating to borrowings; (iii) amortization of ancillary costs incurred in connection with the arrangement of borrowings; (iv) finance charges in respect of assets acquired under finance leases or under other similar arrangements; and (v) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Treatment as per AS 16

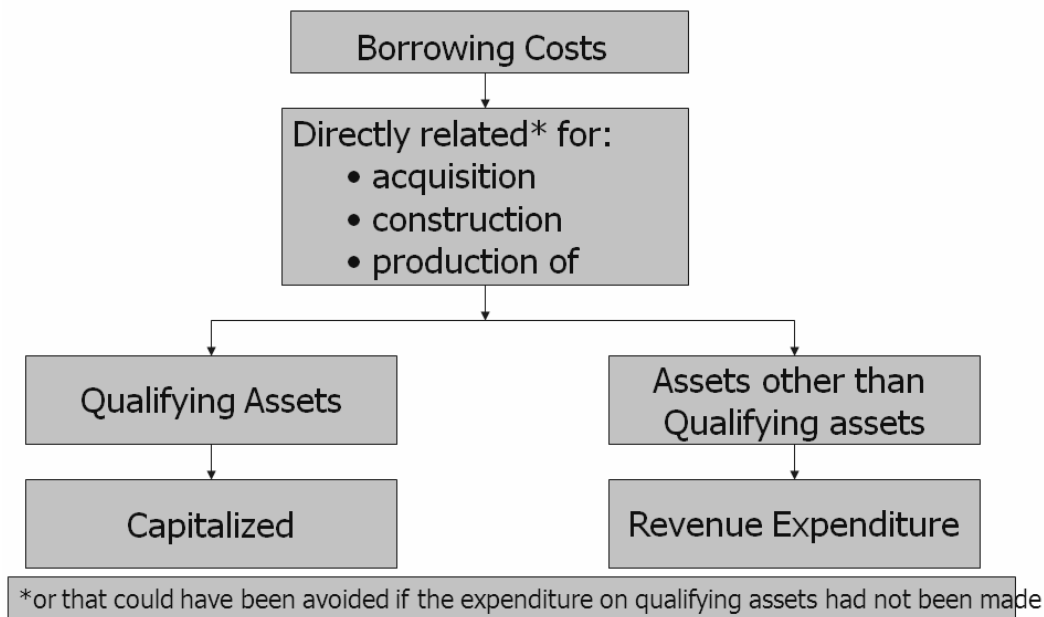
- **When to capitalize-** Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset* should be capitalized as part of the cost of that asset.

The capitalization of borrowing costs as part of the cost of a qualifying asset should commence when the conditions as mentioned below as specified in AS 16 are satisfied.

- Expenditure for the acquisition, construction or production of a qualifying asset is being incurred
- Borrowing costs are being incurred
- Activities that are necessary to prepare the asset for its intended use or sale are in progress
- **When to expense off-** Other borrowing costs should be recognized as an expense in the period in which they are incurred.

* A qualifying asset is an asset that necessarily takes a substantial period of time¹ to get ready for its intended use or sale.

Treatment of Borrowing Costs



- (c) Investments by a holding company in the shares of its subsidiary company are normally considered as long term investments. Indian holding companies show investment in subsidiary just like any other investment and generally classify it as trade investment. As per AS 13 'Accounting for Investments', investments are classified as long term and current investments. A current investment is an investment that by its nature is readily realizable and is intended to be held for more than one year from the date of acquisition. A long term investment is one that is not a current one.

Costs of investment include besides acquisition charges, expenses such as brokerage, fees and duties. If an investment is acquired wholly or partly by an issue of shares or other securities, the acquisition cost is determined by taking the fair value of the shares/securities issued. If an investment were to be acquired in exchange – part or whole – for another asset, the acquisition cost of the investment is determined with reference to the value of the other asset exchanged. Dividends received out of incomes earned by a subsidiary before the acquisition of the shares by the holding company and not treated as income but treated as recovery of cost of the assets (investment made in the subsidiary). The carrying cost for current investment is the lower of cost or fair/market value whereas investment in the shares of the subsidiary (treated as long term) is carried normally at cost.

- (d) Para 17 of AS 1 'Disclosure of Accounting Policies', states that financial statements should disclose all material items, i.e., items the knowledge of which might influence the decisions of the user of the financial statements. Materiality depends on the size of item or error judged in the particular circumstances of its omission or misstatement. From a positive perspective, materiality has to do with the significance of an item or event to warrant attention in the accounting process. From a negative view point, materiality is critical because otherwise a great deal of time might be spent on trivial matters in the accounting process. Individual judgments are required to assess materiality, or to decide what the appropriate minimum quantitative criteria are to be set for given situations. What is material to one organization, may not be material for another organization.

For example, a long term investor is interested in the current value of fixed asset like building, while the banker may not consider it significant for a short-term loan. Similarly a pair of scissors, ball pens, sharpeners, waste-paper baskets could be used for a number of years but still it is treated as an expense and not an asset. The omission of "paise" in the financial statements is also due to their insignificant effect to the users of the financial statement in making a decision.

Example

(Requirements as to Profit & Loss Account; Part II of Schedule VI of Companies Act).

- In giving break-up of purchases, stocks and turnover, items like spare parts and accessories, the list of which is too large to be included in the break-up, may be grouped under suitable headings without quantities, provided all those items, which in value individually account for 10% or more of the total value of purchases, stocks or turnover as the case may be, are shown as separate and distinct items with quantities thereof in the break-up.
- Any item under which the expenses exceed 1 per cent of total revenue of the company or Rs. 5,000, whichever is higher, are shown as a separate and distinct item against appropriate account head in the Profit & Loss Account and are not combined with any other item shown under .Miscellaneous Expenses..

The relevance of information is affected by its materiality. Information is material if its misstatements (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.

- (e) Under Section 210 A of the Companies Act 1956, the Central Government, by notification, has constituted a committee to advise the Central Government on the formulation of accounting policies and accounting standards for adoption by companies

Financial Reporting

or class of companies specified under the Act. The Advisory Committee shall consist of the following members, namely :

- (i) **a Chairperson** who shall be a person of eminence well versed in accountancy, finance, business administration, business law, economics or similar discipline;
- (ii) **one member each** nominated by the Institute of Chartered Accountants of India constituted under the Chartered Accountants Act, 1949, the Institute of Cost and Works Accountants of India constituted under the Cost and Works Accountants Act, 1959 and the Institute of Company Secretaries of India constituted under the Company Secretaries Act, 1980;
- (iii) **one representative each** of the Central Government, Reserve Bank of India , Comptroller and Auditor-General of India to be nominated by it;
- (iv) a **person** who holds or has held the office of **professor in accountancy**, finance or business management in any university or deemed university;
- (v) the **Chairman of the Central Board of Direct Taxes** constituted under the Central Boards of Revenue Act, 1963 or his nominee;
- (vi) **two members** to represent the chambers of commerce and industry to be nominated by the Central Government, and
- (vii) **one representative** of the **Securities and Exchange Board of India** to be nominated by it.

The Advisory Committee shall give its recommendations to the Central Government on such matters of accounting policies and standards and auditing as may be referred to it for advice from time to time. The members of the Advisory Committee shall hold office for such terms as may be determined by the Central Government at the time of their appointment and any vacancy in the membership in the Committee shall be filled by the Central Government in the same manner as the member whose vacancy occurred was filled.

Question 4

Write short notes on:

- (a) *Reversal of an Impairment Loss.*
- (b) *Timing differences and Permanent differences as per AS 22.*
- (c) *Treatment of refund of Government grants.*

Answer

- (a) As per AS 28 on Impairment of Assets, an enterprise should assess at each balance sheet date whether there is any indication that an impairment loss recognised for an asset in prior accounting periods may no longer exist or may have decreased. If any such indication exists, the enterprise should estimate the recoverable amount of that asset.

- ◆ If carrying amount $\leq$ Recoverable amount : **Asset is not impaired**
- ◆ If carrying amount $>$ Recoverable amount : **Asset is impaired**

Impairment Loss = Carrying Amount – Recoverable Amount

Recoverable amount is the higher of net selling price and its value in use

In assessing whether there is any indication that an impairment loss recognized for an asset in prior accounting periods may no longer exist or may have decreased, an enterprise should consider, as a minimum, the following indications:

External sources of information

- (a) the asset's market value has increased significantly during the period;
- (b) significant changes with a favourable effect on the enterprise have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the enterprise operates or in the market to which the asset is dedicated;
- (c) market interest rates or other market rates of return on investments have decreased during the period, and those decreases are likely to affect the discount rate used in calculating the asset's value in use and increase the asset's recoverable amount materially.

Internal sources of information

- (d) significant changes with a favourable effect on the enterprise have taken place during the period, or are expected to take place in the near future, to the extent to which, or manner in which, the asset is used or is expected to be used. These changes include capital expenditure that has been incurred during the period to improve or enhance an asset in excess of its originally assessed standard of performance or a commitment to discontinue or restructure the operation to which the asset belongs; and
- (e) evidence is available from internal reporting that indicates that the economic performance of the asset is, or will be, better than expected.

- ◆ Reversal is not required if value in use increases in subsequent year merely due to pattern of cash flow but not due to increase in the earning potential of the asset

- (b) In current practices, Companies In general prepare books of accounts as per Companies Act, generating Accounting Profit/Loss and Income Tax Act, generating Taxable Profit/Loss. Accounting income and taxable income for a period are seldom the same.

Permanent differences are those which arise in one period and do not reverse subsequently. For e.g., an income exempt from tax or an expense that is not allowable as a deduction for tax purposes.

Financial Reporting

Timing differences are those which arise in one period and are capable of reversal in one or more subsequent periods. For e.g., Depreciation, Sales Tax , Bonus etc., U/s 43B

- (c) As per Para 11 of AS 12 "Accounting for Government Grants", government grant that becomes refundable should be treated as an extraordinary item. The amount refundable in respect of a government grant related to revenue is applied first against any unamortized deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement. The amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. In the first alternative, *i.e.*, where the book value of the asset is increased, depreciation on the revised book value is provided prospectively over the residual useful life of the asset. Where a grant which is in the nature of promoters' contribution becomes refundable, in part or in full, to the government on non-fulfillment of some specified conditions, the relevant amount recoverable by the government is reduced from the capital reserve.

Question 5

Write short notes on:

- (i) *Disclosure of carrying amounts of financial assets and financial liabilities in Balance Sheet*
- (ii) *Financial guarantee contract*
- (iii) *De-recognition of financial liability*

Answer

- (i) As per AS 32, carrying amounts of each of the following categories, as defined in AS 30, should be **disclosed either on the face of the balance sheet or in the notes**:
- (a) **financial assets at fair value** through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with AS 30;
 - (b) held-to-maturity investments;
 - (c) loans and receivables;
 - (d) available-for-sale financial assets;
 - (e) **financial liabilities at fair value** through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with AS 30; and
 - (f) financial liabilities measured at amortized cost.

- (ii) According to para 8.6 of AS 30, A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.
- (iii) In accordance with paragraphs 43 to 45 of AS 30, An entity should remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished i.e., when the obligation specified in the contract is discharged or cancelled or expires.

An exchange between an existing borrower and lender of debt instruments with substantially different terms should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, should be recognized in the statement of profit and loss.

Question 6

- (i) *What are the disclosure and presentation requirements of AS 24 for discontinuing operations?*
- (ii) *What are the different forms of joint ventures? Elucidate the presentation and disclosure norms of Joint Ventures under AS 27.*
- (iii) *Explain the provisions relating to combining of construction contracts.*
- (iv) *Who are related parties under AS 18? What are the related party disclosure requirements?*
- (v) *Give four examples of activities that do not necessarily satisfy criterion (a) of paragraph 3 of AS 24, but that might do so in combination with other circumstances.*

Answer

- (i) An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event (as defined in paragraph 15) occurs:
 - (a) a description of the discontinuing operation(s);
 - (b) the business or geographical segment(s) in which it is reported as per AS 17, Segment Reporting;

Financial Reporting

- (c) the date and nature of the initial disclosure event;
 - (d) the date or period in which the discontinuance is expected to be completed if known or determinable;
 - (e) the carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled;
 - (f) the amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period;
 - (g) the amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto; and
 - (h) the amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period.
- (ii) Joint ventures take many different forms and structures. This Statement identifies three broad types – jointly controlled operations, jointly controlled assets and jointly controlled entities – which are commonly described as, and meet the definition of, joint ventures. The following characteristics are common to all joint ventures:
- (a) two or more venturers are bound by a contractual arrangement; and
 - (b) the contractual arrangement establishes joint control.

A venturer should disclose the aggregate amount of the following contingent liabilities, unless the probability of loss is remote, separately from the amount of other contingent liabilities:

- (a) any contingent liabilities that the venturer has incurred in relation to its interests in joint ventures and its share in each of the contingent liabilities which have been incurred jointly with other venturers;
- (b) its share of the contingent liabilities of the joint ventures themselves for which it is contingently liable; and
- (c) those contingent liabilities that arise because the venturer is contingently liable for the liabilities of the other venturers of a joint venture.

A venturer should disclose the aggregate amount of the following commitments in respect of its interests in joint ventures separately from other commitments:

- (a) any capital commitments of the venturer in relation to its interests in joint ventures and its share in the capital commitments that have been incurred jointly with other venturers; and
- (b) its share of the capital commitments of the joint ventures themselves.

A venturer should disclose a list of all joint ventures and description of interests in significant joint ventures. In respect of jointly controlled entities, the venturer should also disclose the proportion of ownership interest, name and country of incorporation or residence.

A venturer should disclose, in its separate financial statements, the aggregate amounts of each of the assets, liabilities, income and expenses related to its interests in the jointly controlled entities.

(iii) When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

- (a) separate proposals have been submitted for each asset;
- (b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
- (c) the costs and revenues of each asset can be identified.

A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:

- (a) the group of contracts is negotiated as a single package;
- (b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
- (c) the contracts are performed concurrently or in a continuous sequence.

(iv) Parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

If there have been transactions between related parties, during the existence of a related party relationship, the reporting enterprise should disclose the following:

- (i) the name of the transacting related party;
- (ii) a description of the relationship between the parties;
- (iii) a description of the nature of transactions;
- (iv) volume of the transactions either as an amount or as an appropriate proportion;
- (v) any other elements of the related party transactions necessary for an understanding of the financial statements;
- (vi) the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and
- (vii) amounts written off or written back in the period in respect of debts due from or to related parties.

Financial Reporting

(v) Para 3 of AS 24 “Discontinuing Operations” explains the criteria for determination of discontinuing operations. According to Paragraph 9 of AS 24, examples of activities that do not necessarily satisfy criterion (a) of paragraph 3, but that might do so in combination with other circumstances, include:

- (i) Gradual or evolutionary phasing out of a product line or class of service;
- (ii) Discontinuing, even if relatively abruptly, several products within an ongoing line of business;
- (iii) Shifting of some production or marketing activities for a particular line of business from one location to another; and
- (iv) Closing of a facility to achieve productivity improvements or other cost savings.

An example in relation to consolidated financial statements is selling a subsidiary whose activities are similar to those of the parent or other subsidiaries.

Question 7

Distinguish between :

- (i) *Integral foreign operation and Non-integral foreign operation.*
- (ii) *Operating lease and Non-operating lease.*

Answer

(i)

	Integral Foreign Operation	Non-Integral Foreign (NFO) Operation (NFO)
Meaning	It is a foreign operation, the activities of which are an integral part of those of the reporting enterprise.	It is a foreign operation that is not an integral Foreign Operation.
Business	The business of IFO is carried on as if it were an extension of the reporting enterprise's operations.	The business of NFO is carried on in a substantially independent manner by accumulating cash and other monetary items, incurring expenses, generating income and arranging borrowings, in its local currency.
Example	Sale of goods imported from the reporting enterprise and remittance of proceeds to the reporting enterprise.	Production in a foreign country out of resources available in such nation independent of the reporting enterprise.

Currencies operated	Generally, IFO carries on business in a single foreign currency, i.e. of the country where it is located.	NFO business may also enter into transactions in foreign currencies, including transactions in the reporting currency.
Cash flows from operations	Cash flows from operations of the reporting enterprise are directly and immediately affected by a change in the exchange rate between the reporting currency and the currency in the country of IFO.	Change in the exchange rate between the reporting currency and the local currency, has little or no direct effect on the present and future Cash Flows from Operations of either the NFO or the reporting enterprise.
Effect of Change in Exchange Rate	Change in the exchange rate affects the individual monetary items held by the IFO rather than the reporting enterprise's Net Investment in the IFO.	Change in the exchange rate affects the reporting enterprise's net investment in the NFO rather than the individual monetary and non-monetary items held by that NFO.

(ii) **Basis of Classification:** Leases are classified based on the extent to which risks and rewards incident to ownership of a leased asset lie with the Lessor or the Lessee.

- ◆ Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions.
- ◆ Rewards may be represented by the expectation of profitable operation over the economic life of the asset and of gain from appreciation in value or realisation of residual value.

As per AS 19 "Accounting for Lease", Lease may be of two types: a) Finance Lease b) Operating Lease.

Finance Lease is a lease which transfers substantially all the risks and rewards incidental to ownership of an asset to the lessee by the lessor but not the legal ownership.

Operating lease is a lease which does not transfers substantially all the risks and rewards incidental to ownership. To be precise, it is a lease other than "Financial Lease".

Question 8

Write short notes on:

- (i) Graded vesting under an employee stock option plan.

Financial Reporting

- (ii) *Presentation of MAT credit in the financial statements.*

Answer

- (i) **Graded vesting under an employee stock option plan**

In case the options/shares granted under an employee stock option plan do not vest on one date but have graded vesting schedule, total plan should be segregated into different groups, depending upon the vesting dates. Each of such groups would be having different vesting period and expected life and, therefore, each vesting date should be considered as a separate option grant and evaluated and accounted for accordingly. For example, suppose an employee is granted 100 options which will vest @ 25 options per year at the end of the third, fourth, fifth and sixth years. In such a case, each tranche of 25 options would be evaluated and accounted for separately.

- (ii) **Presentation of MAT credit in the financial statements**

Balance Sheet

Where a company recognizes MAT credit as an asset on the basis of the considerations specified in the Guidance Note on Accounting for Credit Available in respect of Minimum Alternate Tax under the Income Tax Act, 1961, the same should be presented under the head 'Loans and Advances' since, there being a convincing evidence of realization of the asset, it is of the nature of a pre-paid tax which would be adjusted against the normal income tax during the specified period. The asset may be reflected as 'MAT credit entitlement'.

In the year of set-off of credit, the amount of credit availed should be shown as a deduction from the 'Provision for Taxation' on the liabilities side of the balance sheet. The unavailed amount of MAT credit entitlement, if any, should continue to be presented under the head 'Loans and Advances' if it continues to meet the considerations stated in paragraph 11 of the Guidance Note.

Profit and Loss Account

According to paragraph 6 of Accounting Standards Interpretation (ASI) 'Accounting for Taxes on Income in the context of Section 115JB of the Income-tax Act, 1961', issued by the Institute of Chartered Accountants of India, MAT is the current tax. Accordingly, the tax expense arising on account of payment of MAT should be charged at the gross amount, in the normal way, to the profit and loss account in the year of payment of MAT. In the year in which the MAT credit becomes eligible to be recognized as an asset in accordance with the recommendations contained in this Guidance Note, the said asset should be created by way of a credit to the profit and loss account and presented as a separate line item therein.

Question 9

- (a) *Discuss the concept of cost v/s fair value with reference to Indian Accounting Standards.*

- (b) What are the types of Employees benefits and what is the objective of Introduction of this Standard i.e. AS-15?

Answer

- (a) Cost vs. Fair value

Cost basis: The term cost refers to cost of purchase, costs of conversion on other costs incurred in bringing the goods to its present condition and location. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Fair value: Fair value of an asset is the amount at which an enterprise expects to exchange an asset between knowledgeable and willing parties in an arm's length transaction.

Indian Accounting Standards are generally based on historical cost with a very few exceptions:

AS 2 "Valuation of Inventories" – Inventories are valued at net realizable value (NRV) if cost of inventories is more than NRV.

AS 10 "Accounting for Fixed Assets" – Items of fixed assets that have been retired from active use and are held for disposal are stated at net realizable value if their net book value is more than NRV.

AS 13 "Accounting for Investments" – Current investments are carried at lower of cost and fair value. The carrying amount of long term investments is reduced to recognize the permanent decline in value.

AS 15 "Employee Benefits" – The provision for defined benefits is made at fair value of the obligations.

AS 26 "Intangible Assets" – If an intangible asset is acquired in exchange for shares or other securities of the reporting enterprise, the asset is recorded at its fair value, or the fair value of the securities issued, whichever is more clearly evident.

AS 28 "Impairment of Assets" – Provision is made for impairment of assets.

On the other hand IFRS and US GAAPs are more towards fair value. Fair value concept requires a lot of estimation and to the extent, it is subjective in nature.

- (b) There are four types of employee benefits according to AS 15 (Revised 2005). They are:
- (a) short-term employee benefits, such as wages, salaries and social security contributions (e.g., contribution to an insurance company by an employer to pay for medical care of its employees), paid annual leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non-monetary benefits

Financial Reporting

(such as medical care, housing, cars and free or subsidised goods or services) for current employees;

- (b) post-employment benefits such as gratuity, pension, other retirement benefits, post-employment life insurance and post-employment medical care;
- (c) other long-term employee benefits, including long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation; and
- (d) termination benefits.

Because each category identified in (a) to (d) above has different characteristics, this Statement establishes separate requirements for each category.

The objective of AS 15 is to prescribe the accounting and disclosure for employee benefits. The statement requires an enterprise to recognise:

- (a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and
- (b) an expense when the enterprise consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

Question 10

XYZ Ltd., with a turnover of Rs.35 lakhs and borrowings of Rs.10 lakhs during any time in the previous year, wants to avail the exemptions available in adoption of Accounting Standards applicable to companies for the year ended 31.3.2008. Advise the management the exemptions that are available as per Companies (AS) Rules, 2006.

If XYZ is a partnership firm is there any other exemptions additionally available.

Answer

This case deals with the issue of Applicability of Accounting Standards.

Whether AS are applicable or not, in general following test shall be applied:

Applicability of Accounting Standards

First Test:

Are Equity or Debt Securities are Listed or in the process of Listing?

Is this Banking Co. or a Co-operative Bank or Financial Institution or Enterprise carrying on Insurance Business?

Turnover excluding "other income" is exceeding 50 crores?

Borrowings exceeded 10 Crores at any time during the year?

Holding or Subsidiary of any of the above?

Second Test:

Is the Turnover (excluding. Other income) exceeding 40 lakhs but not 50 Crores?

Borrowings exceeded 1 Crores but not 10 Crores at any time during the year?

Holding or Subsidiary of any of the above?

If answer of all of the above is No, this implies that the given enterprise is small and medium sized enterprise (SME).

Decision:

XYZ Ltd. is a small and medium sized enterprise (SME) company as per Companies (AS) Rules, 2006. The following relaxations and exemptions are available to XYZ Ltd.

1. AS 3 "Cash Flow Statements" is not mandatory.
2. AS 17 "Segment Reporting" is not mandatory.
3. SMEs are exempt from some paragraphs of AS 19 "Leases".
4. SMEs are exempt from disclosures of diluted EPS (both including and excluding extraordinary items).
5. SMEs are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique under AS 28 "Impairment of Assets".
6. SMEs are exempt from disclosure requirements of paragraphs 66 and 67 of AS 29 "Provisions, Contingent Liabilities and Contingent Assets".
7. SMEs are exempt from certain requirements of AS 15 "Employee Benefits".
8. Accounting Standards 21, 23, 27 are not applicable to SMEs.

If XYZ is not a company and it will be Partnership Firm as given in the case, then, it will be treated as a level III enterprise instead of level II enterprise; XYZ Ltd. will be exempt from requirements of AS 18 "Related Party Disclosures" and AS 24 "Discontinuing Operations".

Question 11

Omega Company Ltd. has to pay delayed cotton clearing charges over and above the negotiated price for taking delayed delivery of cotton from the Suppliers' Godown. Up to 2008-09, the company has regularly included such charges in the valuation of closing stock. This being in the nature of interest the company has decided to exclude it from closing stock valuation for the year 2009-2010. This would result into decrease in profit by Rs. 7.60 lakhs. How would you deal with the following in the annual accounts of a company for the year ended 31st March, 2010?

Financial Reporting

Answer

Para 29 of AS 5 (Revised) 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies' states that a change in an accounting policy should be made only if

- a. It is required by statute, or
- b. for compliance with an accounting standard, or
- c. if it is considered that the change would result in a more appropriate presentation of the financial statements of an enterprise.

Therefore the change in the method of stock valuation is justified in view of the fact that the change is in line with the recommendations of AS 2 (Revised) 'Valuation of Inventories' and would result in more appropriate preparation of the financial statements.

Disclosure : As per AS 2, this accounting policy adopted for valuation of inventories including the cost formulae used should be disclosed in the financial statements in Notes to Accounts.

Also, appropriate disclosure of the change and the amount by which any item in the financial statements is affected by such change is necessary as per AS 1, AS 2 and AS 5. Therefore, the under mentioned note should be given in the annual accounts.

"In compliance with the Accounting Standards issued by the ICAI, delayed cotton clearing charges which are in the nature of interest have been excluded from the valuation of closing stock unlike preceding years. Had the company continued the accounting practice followed earlier, the value of closing stock as well as profit before tax for the year would have been higher by Rs. 7.60 lakhs."

Question 12

Sagar Limited belongs to the engineering industry. The Chief Accountant has prepared the draft accounts for the year ended 31.03.2010. You are required to advise the company on the following items from the viewpoint of finalization of accounts, taking note of the mandatory accounting standards.

- (a) *The company undertook a contract for building a crane for Rs. 10 lakhs. As on 31.03.2010 it incurred a cost of Rs. 1.5 lakhs and expects that there will be Rs. 9 lakhs more for completing the crane. It has received so far Rs. 1 lakh as progress payment.*
- (b) *The company received an actuarial valuation for the first time for its pension scheme which revealed a surplus of Rs. 6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to Rs. 2 lakhs instead of Rs. 5 lakhs. The average remaining life of the employees is estimated to be 6 years.*

Answer

- (a) Para 21 of AS 7 (Revised) 'Construction Contracts' provides that when the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognized as revenue and expenses

respectively with reference to the stage of completion of the contract activity at the reporting date.

Para 35 of AS 7 states that when it is probable that total contract cost will exceed total contract revenue, the expected losses should be recognized as an expense irrespective of :

- Whether or not work has commenced
- Stage of completion of contract
- The amount of profit on other contracts which are not treated as a single contract

Thus, when Estimated Contract Costs > Total Contract Revenue

Expected Loss = Work Certified + Work uncertified + estimated cost to complete the project - Total value of contract

Thus in the given case ,the foreseeable loss of Rs. 50,000 (expected cost Rs. 10.5 lakhs less contract revenue Rs. 10 lakhs) should be recognized as an expense in the year ended 31st March, 2010.

The following disclosures should also be given in the financial statements:

- the amount of contract revenue recognized as revenue in the period;
 - the aggregate amount of costs incurred and loss recognized upto the reporting date;
 - amount of advances received;
 - amount of retentions; and
 - gross amount due from/due to customers Amount*
- (b) According to para 92 of AS 15 (Revised 2005) 'Employee Benefits', actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. Therefore, surplus amount of Rs. 6 lakhs is required to be credited to the profit and loss statement of the current year.

Question 13

A Ltd. acquired 25% of shares in B Ltd. as on 31.3.2009 for Rs. 3 lakhs. The Balance Sheet of B Ltd. as on 31.3.2009 is given below:

	Rs.
Share Capital	5,00,000
Reserves and Surplus	<u>5,00,000</u>
	<u>10,00,000</u>

* Amount due from/to customers = contract costs + Recognised profits – Recognised losses – Progress billings = 1.5 + Nil – 0.5 – 1.0 = Nil.

Financial Reporting

Fixed Assets	5,00,000
Investments	2,00,000
Current Assets	<u>3,00,000</u>
	<u>10,00,000</u>

During the year ended 31.3.2010 the following are the additional information available:

- (i) A Ltd. received dividend from B Ltd., for the year ended 31.3.2009 at 40% from the Reserves.
 - (ii) B Ltd., made a profit after tax of Rs. 7 lakhs for the year ended 31.3.2010.
 - (iii) B Ltd., declared a dividend @ 50% for the year ended 31.3.2010 on 30.4.2010.
- A Ltd. is preparing Consolidated Financial Statements in accordance with AS – 21 for its various subsidiaries. Calculate:
- (i) Goodwill if any on acquisition of B Ltd.'s shares.
 - (ii) How A Ltd., will reflect the value of investment in B Ltd., in the Consolidated Financial Statements?
 - (iii) How the dividend received from B Ltd. will be shown in the Consolidated Financial Statements?

Answer

In terms of AS 23 B Ltd. will be considered as an associate company of A Ltd. as shares acquired represent to more than 20%.

(i) Calculation of Goodwill	<i>Rs.in lakhs</i>
Cost of investment	3.00
Less: Share in the value of Equity of B.Ltd. as at the date of investment [25% of Rs.10 lakhs (Rs.5 lakhs + Rs. 5 lakhs)]	<u>2.50</u>
Goodwill	<u>0.50</u>

(ii) A Ltd.**Consolidated Profit and Loss Account for the year ended 31st March, 2010**

	<i>Rs. in lakhs</i>
By Share of profits in B Ltd.	1.75
By Dividend received from B Ltd.	0.50
Transfer to investment A/c	<u>0.50</u> Nil

(iii)

A Ltd.

Consolidated Balance Sheet as on 31.3.2010

Rs. in lakhs

Investment in B Ltd.

Share in B Ltd.'s Equity 2.50

Less: Dividend received 0.50

2.00

Share of Profit for year 2009 – 2010 1.75

3.75

Add: Goodwill 0.50 4.25**Working Notes:**

1. Dividend received from B Ltd. amounting to Rs. 0.50 lakhs will be reduced from investment value in the books of A Ltd. However goodwill will not change.
2. B Ltd. made a profit of Rs. 7 lakhs for the year ended 31st March, 2010. A Ltd.'s share in the profits of Rs. 7 lakhs is Rs. 1.75 lakhs. Investment in B Ltd. will be increased by Rs. 1.75 lakhs and consolidated profit and loss account of A Ltd. will be credited with Rs. 1.75 lakhs in the consolidated financial statement of A Ltd.
3. Dividend declared on 30th April, 2010 will not be recognized in the consolidated financial statements of A Ltd.

Question 14

SM company has taken a Transit Insurance Policy. Suddenly in the year 2009-2010 the percentage of accident has gone up to 7% and the company wants to recognize insurance claim as revenue in 2009-2010 in accordance with relevant Accounting Standards. Do you agree? Explain in brief, as per the relevant Accounting Standards.

Answer**When to Recognize Revenue:**

- Revenue recognition is mainly concerned with the **timing of recognition of revenue** in the profit and loss account.
- Where **there is no uncertainty** as to **ultimate collection**, revenue is **recognised at the time of sale or rendering of services**, as the case may be even though payments are made by installments.
- The amount of revenue is usually determined by agreement between the parties to the transaction

Financial Reporting

It may be appropriate to recognize revenue only when it is reasonably certain that the ultimate collection will be made.

In the given case, SM company wants to suddenly recognize Insurance claim because it has increased over the previous year. **But, there are uncertainties involved in the settlement of the claim.** Also, the claim does not seem to be in the course of ordinary activity of the company.

Hence, SM company is not advised to recognize the Insurance claim as revenue.

Question 15

State, how you will deal with the following matters in the accounts of U Ltd. for the year ended 31st March, 2010 with reference to Accounting Standards:

- (i) *The company finds that the stock sheets of 31.3.2009 did not include two pages containing details of inventory worth Rs. 14.5 lakhs.*
- (ii) *The company had spent Rs. 45 lakhs for publicity and research expenses on one of its new consumer product, which was marketed in the accounting year 2009-2010, but proved to be a failure.*

Answer

- (i) Paragraph 4 of Accounting Standard 5 on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, defines Prior Period items as "income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods".

Rectification of error in stock valuation is a prior period item vide Para 4 of AS 5. Rs.14.5 lakhs must be added to the opening stock of 1/4/2009. It is also necessary to show Rs. 14.5 lakhs as a prior period adjustment in the Profit and loss Account below the line. Separate disclosure of this item as a prior period item is required as per Para 15 of AS 5.

- (ii) In the given case, the company spent Rs. 45 lakhs for publicity and research of a new product which was marketed but proved to be a failure. It is clear that in future there will be no related further revenue/benefit because of the failure of the product. Thus according to paras 41 to 43 of AS 26 'Intangible Assets', the company should charge the total amount of Rs. 45 lakhs as an expense in the profit and loss account.

Question 16

- (a) *Venus Ltd. has an asset, which is carried in the Balance Sheet on 31.3.2010 at Rs. 500 lakhs. As at that date the value in use is Rs. 400 lakhs and the net selling price is Rs. 375 lakhs.*

From the above data:

- (i) *Calculate impairment loss.*
- (ii) *Prepare journal entries for adjustment of impairment loss.*

- (iii) Show, how impairment loss will be shown in the Balance Sheet.
- (b) Bottom Ltd. entered into a sale deed for its immovable property before the end of the year. But registration was done with registrar subsequent to Balance Sheet date. But before finalization, is it possible to recognize the sale and the gain at the Balance Sheet date? Give your view with reasons.
- (c) In view of the provisions of Accounting Standard 25 on Interim Financial Reporting, on what basis will you calculate, for an interim period, the provision in respect of defined benefit schemes like pension, gratuity etc. for the employees?

Answer

- (a) (i) Recoverable amount is higher of value in use Rs. 400 lakhs and net selling price Rs. 375 lakhs.

∴ Recoverable amount = Rs. 400 lakhs

Impairment loss = Carried Amount – Recoverable amount

= Rs. 500 lakhs – Rs. 400 lakhs = Rs. 100 lakhs.

(ii) Journal Entries

Particulars		Dr. Amount Rs. in lakhs	Cr. Amount Rs. in lakhs
(i) Impairment loss account	Dr.	100	
To Asset			100
(Being the entry for accounting impairment loss)			
(ii) Profit and loss account	Dr.	100	
To Impairment loss			100
(Being the entry to transfer impairment loss to profit and loss account)			

(iii) Balance Sheet of Venus Ltd. as on 31.3.2010

	Rs. in lakhs
Asset less depreciation	500
Less: Impairment loss	<u>100</u>
	<u>400</u>

- (b) Yes, both sales and gain of Bottom Ltd. should be recognized. In accordance with AS 9, at the Balance Sheet date and what was pending was merely a formality to register the deed. It is clear that significant risk and rewards of ownership had passed before the

Financial Reporting

balance sheet date. Further the registration post the balance sheet date confirms the condition of sale at the balance sheet date as per AS 4.

- (c) Accounting Standard 25 suggests that provision in respect of defined benefit schemes like pension and gratuity for an interim period should be calculated based on the year-to-date basis by using the actuarially determined rates at the end of the prior financial year, adjusted for significant market fluctuations since that time and for significant curtailments, settlements or other significant one-time events.

Question 17

In May, 2009 Speed Ltd. took a bank loan to be used specifically for the construction of a new factory building. The construction was completed in January, 2010 and the building was put to its use immediately thereafter. Interest on the actual amount used for construction of the building till its completion was Rs. 18 lakhs, whereas the total interest payable to the bank on the loan for the period till 31st March, 2010 amounted to Rs. 25 lakhs. Can Rs. 25 lakhs be treated as part of the cost of factory building and thus be capitalized on the plea that the loan was specifically taken for the construction of factory building?

Answer

AS 16 clearly states that capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use are completed. Therefore, interest on the amount that has been used for the construction of the building upto the date of completion (January, 2010) i.e. Rs. 18 lakhs alone can be capitalized. It cannot be extended to Rs. 25 lakhs.

Question 18

The Chief Accountant of Sports Ltd. gives the following data regarding its six segments:

	Rs. In lakhs						
Particulars	M	N	O	P	Q	R	Total
Segment Assets	40	80	30	20	20	10	200
Segment Results	50	-190	10	10	-10	30	-100
Segment Revenue	300	620	80	60	80	60	1,200

The Chief accountant is of the opinion that segments "M" and "N" alone should be reported. Is he justified in his view? Discuss.

Answer

As per para 27 of AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:

- (i) Its revenue from sales to external customers and from other transactions with other segments is 10% or more of the total revenue- external and internal of all segments; or

- (ii) Its segment result whether profit or loss is 10% or more of:
 - (1) The combined result of all segments in profit; or
 - (2) The combined result of all segments in loss, whichever is greater in absolute amount; or

- (iii) Its segment assets are 10% or more of the total assets of all segments.

If the total external revenue attributable to reportable segments constitutes less than 75% of total enterprise revenue, additional segments should be identified as reportable segments even if they do not meet the 10% thresholds until at least 75% of total enterprise revenue is included in reportable segments.

- (a) On the basis of turnover criteria segments M and N are reportable segments.
- (b) On the basis of the result criteria, segments M, N and R are reportable segments (since their results in absolute amount is 10% or more of Rs.200 lakhs).
- (c) On the basis of asset criteria, all segments except R are reportable segments.

Since all the segments are covered in atleast one of the above criteria all segments have to be reported upon in accordance with Accounting Standard (AS) 17. Hence, the opinion of chief accountant is wrong.

Question 19

Victory Ltd. purchased goods on credit from Lucky Ltd. for Rs.250 crores for export. The export order was cancelled. Victory Ltd. decided to sell the same goods in the local market with a price discount. Lucky Ltd. was requested to offer a price discount of 15%. The Chief Accountant of Lucky Ltd. wants to adjust the sales figure to the extent of the discount requested by Victory Ltd. Discuss whether this treatment is justified.

Answer

Lucky Ltd. had sold goods to Victory Ltd on credit worth for Rs.250 crores and the sale was completed in all respects. Victory Ltd's decision to sell the same in the domestic market at a discount does not affect the amount recorded as sales by Lucky Ltd. The price discount of 15% offered by Lucky Ltd. after request of Victory Ltd. was not in the nature of a discount given during the ordinary course of trade because otherwise the same would have been given at the time of sale itself. Now, as far Lucky Ltd is concerned, there appears to be an uncertainty relating to the collectability of the debt, which has arisen subsequent to the time of sale therefore, it would be appropriate to make a separate provision to reflect the uncertainty relating to collectability rather than to adjust the amount of revenue originally recorded. Therefore, such discount should be written off to the profit and loss account and not shown as deduction from the sales figure.

Question 20

- (a) *A company had imported raw materials worth US Dollars 6,00,000 on 5th January, 2010, when the exchange rate was Rs.43 per US Dollar. The company had recorded the*

Financial Reporting

transaction in the books at the above mentioned rate. The payment for the import transaction was made on 5th April, 2010 when the exchange rate was Rs.47 per US Dollar. However, on 31st March, 2010, the rate of exchange was Rs.48 per US Dollar. The company passed an entry on 31st March, 2010 adjusting the cost of raw materials consumed for the difference between Rs.47 and Rs.43 per US Dollar.

In the background of the relevant accounting standard, is the company's accounting treatment correct? Discuss.

- (b) *A private limited company manufacturing fancy terry towels had valued its closing stock of inventories of finished goods at the realisable value, inclusive of profit and the export cash incentives. Firm contracts had been received and goods were packed for export, but the ownership in these goods had not been transferred to the foreign buyers.*

Comment on the valuation of the stocks by the company.

Answer

- (a) As per AS 11 (revised 2003), 'The Effects of Changes in Foreign Exchange Rates', monetary items denominated in a foreign currency should be reported using the closing rate at each balance sheet date. The effect of exchange difference should be taken into profit and loss account. Sundry creditors is a monetary item, hence should be valued at the closing rate i.e., Rs.48 at 31st March, 2010 irrespective of the payment for the same subsequently at lower rate in the next financial year. The difference of Rs.5 (48-43) per US dollar should be shown as an exchange loss in the profit and loss account for the year ended 31st March, 2010 and is not to be adjusted against the cost of raw- materials. In the subsequent year, the company would record an exchange gain of Re.1 per US dollar, i.e., the difference between Rs.48 and Rs.47 per US dollar. Hence, the accounting treatment adopted by the company is incorrect.
- (b) Accounting Standard 2 "Valuation of Inventories" states that inventories should be valued at lower of historical cost and net realizable value. AS 9 on "Revenue Recognition" states, "at certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases, when sale is assured under forward contract or a government guarantee or when market exists and there is a negligible risk of failure to sell, the goods invoiced are often valued at Net-realizable value."

Terry Towels do not fall in the category of agricultural crops or mineral ores. Accordingly, taking into account the facts stated, the closing stock of finished goods (Fancy terry towel) should have been valued at lower of cost and net-realizable value and not at net realizable value. Further, export incentives are recorded only in the year the export sale takes place. Therefore, the policy adopted by the company for valuing its closing stock of inventories of finished goods is not correct.

Question 21

- (a) A company with a turnover of Rs.250 crores and an annual advertising budget of Rs.2 crore had taken up the marketing of a new product. It was estimated that the company would have a turnover of Rs. 25 crores from the new product. The company had debited to its Profit and Loss account the total expenditure of Rs.2 crore incurred on extensive special initial advertisement campaign for the new product.

Is the procedure adopted by the company correct?

- (b) A company deals in petroleum products. The sale price of petrol is fixed by the government. After the Balance Sheet date, but before the finalisation of the company's accounts, the government unexpectedly increased the price retrospectively. Can the company account for additional revenue at the close of the year? Discuss.
- (c) Mohur Ltd. has equity capital of Rs.40,00,000 consisting of fully paid equity shares of Rs.10 each. The net profit for the year 2009-10 was Rs.60,00,000. It has also issued 36,000, 10% convertible debentures of Rs.50 each. Each debenture is convertible into five equity shares. The tax rate applicable is 30%. Compute the diluted earnings.

Answer

- (a) According to paras 55 and 56 of AS 26 'Intangible Assets', "expenditure on an intangible item should be recognised as an expense when it is incurred unless it forms part of the cost of an intangible asset".

In the given case, advertisement expenditure of Rs. 2 crores had been taken up for the marketing of a new product which may provide future economic benefits to an enterprise by having a turnover of Rs.25 crores. Here, no intangible asset or other asset is acquired or created that can be recognised. Therefore, the accounting treatment by the company of debiting the entire advertising expenditure of Rs.2 crores to the Profit and Loss account of the year is correct.

- (b) According to para 8 of AS 4 (Revised 1995), the unexpected increase in sale price of petrol by the government after the balance sheet date cannot be regarded as an event occurring after the Balance Sheet date, which requires an adjustment at the Balance Sheet date, since it does not represent a condition present at the balance sheet date. The revenue should be recognized only in the subsequent year with proper disclosures. The retrospective increase in the petrol price should not be considered as a prior period item, as per AS 5, because there was no error in the preparation of previous period's financial statements.

- (c) Interest on Debentures @ 10% for the year $36,000 \times 50 \times \frac{10}{100}$
 = Rs.1,80,000
 Tax on interest @ 30% = Rs.54,000

Financial Reporting

$$\begin{aligned}\text{Diluted Earnings (Adjusted net profit)} &= (60,00,000 + 1,80,000 - 54,000) \\ &= \text{Rs. } 61,26,000\end{aligned}$$

Question 22

- (a) *During the course of the last three years, a company owning and operating Helicopters lost four Helicopters. The company Accountant felt that after the crash, the maintenance provision created in respect of the respective helicopters was no longer required, and proposed to write back to the Profit and Loss account as a prior period item.*

Is the Company's proposed accounting treatment correct? Discuss.

- (b) *Mr. 'X' as a contractor has just entered into a contract with a local municipal body for building a flyover. As per the contract terms, 'X' will receive an additional Rs.2 crore if the construction of the flyover were to be finished within a period of two years of the commencement of the contract. Mr. X wants to recognize this revenue since in the past he has been able to meet similar targets very easily.*

Is X correct in his proposal? Discuss.

- (c) *A Company is in the process of setting up a production line for manufacturing a new product. Based on trial runs conducted by the company, it was noticed that the production lines output was not of the desired quality. However, company has taken a decision to manufacture and sell the sub-standard product over the next one year due to the huge investment involved.*

In the background of the relevant accounting standard, advise the company on the cut-off date for capitalization of the project cost.

- (d) *A Company has an inter-segment transfer pricing policy of charging at cost less 10%. The market prices are generally 25% above cost. Is the policy adopted by the company correct?*

Answer

- (a) The balance amount of maintenance provision written back to profit and loss account, no longer required due to crash of the helicopters, is not a prior period item because there was no error in the preparation of previous periods' financial statements. The term 'prior period items', as defined in AS 5 (revised) "Net Profit or Loss for the Period, Prior Period Items and Changes In Accounting Policies", refer only to income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. As per paragraph 8 of AS 5, extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived. The amount so written-back (If material) should be disclosed as an extraordinary item as per AS 5.

- (b) According to para 14 of AS 7 (Revised) 'Construction Contracts', incentive payments are additional amounts payable to the contractor if specified performance standards are met or exceeded. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract. Incentive payments are included in contract revenue when: (i) the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and (ii) the amount of the incentive payment can be measured reliably. In the given problem, the contract has not even begun and hence the contractor (Mr. X) should not recognize any revenue of this contract.
- (c) As per provisions of AS 10 'Accounting for Fixed Assets', expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalized as an indirect element of the construction cost. However, the expenditure incurred after the plant has begun commercial production *i.e.*, production intended for sale or captive consumption, is not capitalized and is treated as revenue expenditure even though the contract may stipulate that the plant will not be finally taken over until after the satisfactory completion of the guarantee period. In the present case, the company did stop production even if the output was not of the desired quality, and continued the sub-standard production due to huge investment involved in the project. Capitalization should cease at the end of the trial run, since the cut-off date would be the date when the trial run was completed.
- (d) AS 17 'Segment Reporting' requires that inter-segment transfers should be measured on the basis that the enterprise actually used to price these transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements. Hence, the enterprise can have its own policy for pricing inter-segment transfers and hence, inter-segment transfers may be based on cost, below cost or market price. However, whichever policy is followed, the same should be disclosed and applied consistently. Therefore, in the given case inter-segment transfer pricing policy adopted by the company is correct if, followed consistently.

Question 23

P Ltd. has 60% voting right in Q Ltd. Q Ltd. has 20% voting right in R Ltd. Also, P Ltd. directly enjoys voting right of 14% in R Ltd. R Ltd. is a listed company and regularly supplies goods to P Ltd. The management of R Ltd. has not disclosed its relationship with P Ltd.

How would you assess the situation from the viewpoint of AS 18 on Related Party Disclosures?

Answer

P Ltd. has direct economic interest in R Ltd to the extent of 14%, and through Q Ltd. in which it is the majority shareholders, it has further control of 12% in R Ltd. (60% of Q Ltd's 20%). These two taken together (14% + 12%) make the total control of 26%.

Financial Reporting

Para 10 of AS 18 'Related Party Disclosures', defines *related party* as one that has at any time during the reporting period, the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

Here, *Control* is defined as ownership directly or indirectly of more than one-half of the voting power of an enterprise; and *Significant Influence* is defined as participation in the financial and/or operating policy decisions of an enterprise but not control of those policies.

In the present case, control of P Ltd. in R Ltd. directly and through Q Ltd., does not go beyond 26%. However, as per para 12 of AS 18, significant influence may be exercised as an investing party (P Ltd.) holds, directly or indirectly through intermediaries 20% or more of the voting power of the R Ltd. As R Ltd. is a listed company and regularly supplies goods to P Ltd. therefore, related party disclosure, as per AS 18, is required.

Question 24

X Ltd. began construction of a new building on 1st January, 2010. It obtained Rs.1 lakh special loan to finance the construction of the building on 1st January, 2010 at an interest rate of 10%. The company's other outstanding two non-specific loans were:

<i>Amount</i>	<i>Rate of Interest</i>
<i>Rs.5,00,000</i>	<i>11%</i>
<i>Rs.9,00,000</i>	<i>13%</i>

The expenditure that were made on the building project were as follows:

	<i>Rs.</i>
<i>January 2010</i>	<i>2,00,000</i>
<i>April 2010</i>	<i>2,50,000</i>
<i>July 2010</i>	<i>4,50,000</i>
<i>December 2010</i>	<i>1,20,000</i>

Building was completed by 31st December, 2010. Following the principles prescribed in AS-16 'Borrowing Cost,' calculate the amount of interest to be capitalized and pass one Journal Entry for capitalizing the cost and borrowing cost in respect of the building.

Answer

(i) Computation of average accumulated expenses	Rs.
Rs. 2,00,000 x 12 / 12	= 2,00,000
Rs. 2,50,000 x 9 / 12	= 1,87,500
Rs. 4,50,000 x 6 / 12	= 2,25,000
Rs. 1,20,000 x 1 / 12	= <u>10,000</u>
	<u>6,22,500</u>

(ii) Calculation of average interest rate other than for specific borrowings

Amount of loan (in Rs.)	Rate of interest	Amount of interest (in Rs.)
5,00,000	11% =	55,000
9,00,000	13% =	<u>1,17,000</u>
14,00,000		<u>1,72,000</u>
Weighted average rate of interest		= 12.285% (approx)
$(\frac{1,72,000}{14,00,000} \times 100)$		

(iii) Interest on average accumulated expenses

		Rs.
Specific borrowings (Rs. 1,00,000 X 10%)	=	10,000
Non-specific borrowings (Rs. 5,22,500* X 12.285%)	=	<u>64,189</u>
Amount of interest to be capitalized	=	<u>74,189</u>

(iv) Total expenses to be capitalized for building

	Rs.
Cost of building Rs.(2,00,000 + 2,50,000 + 4,50,000 + 1,20,000)	10,20,000
Add: Amount of interest to be capitalised	<u>74,189</u>
	<u>10,94,189</u>

(v) Journal Entry

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
31.12.2010	Building account	Dr. 10,94,189	
	To Bank account		10,94,189
	(Being amount of cost of building and borrowing cost thereon capitalized)		

Question 25

- (a)** U.K. International Ltd. is developing a new production process. During the financial year ending 31st March, 2009, the total expenditure incurred was Rs.50 lakhs. This process met the criteria for recognition as an intangible asset on 1st December, 2008. Expenditure incurred till this date was Rs.22 lakhs. Further expenditure incurred on the process for the financial year ending 31st March, 2010 was Rs.80 lakhs. As at 31st March, 2010, the recoverable amount of know-how embodied in the process is estimated to be Rs.72 lakhs. This includes estimates of future cash outflows as well as inflows.

* (Rs. 6,22,500 – Rs. 1,00,000)

Financial Reporting

You are required to calculate:

- (i) *Amount to be charged to Profit and Loss A/c for the year ending 31st March, 2009 and carrying value of intangible as on that date.*
- (ii) *Amount to be charged to Profit and Loss A/c and carrying value of intangible as on 31st March, 2010.*

Ignore depreciation.

- (b) *Mini Ltd. took a factory premises on lease on 1.4.07 for Rs.2,00,000 per month. The lease is operating lease. During March, 2008, Mini Ltd. relocates its operation to a new factory building. The lease on the old factory premises continues to be live upto 31.12.2010. The lease cannot be cancelled and cannot be sub-let to another user. The auditor insists that lease rent of balance 33 months upto 31.12.2010 should be provided in the accounts for the year ending 31.3.2008. Mini Ltd. seeks your advice.*

Answer**(a) As per AS 26 'Intangible Assets'**

- (i) For the year ending 31.03.2009

- (1) Carrying value of intangible as on 31.03.2009:

At the end of financial year 31st March 2009, the production process will be recognized (i.e. carrying amount) as an intangible asset at a cost of Rs. 28 lakhs (expenditure incurred since the date the recognition criteria were met, i.e., on 1st December 2008).

- (2) Expenditure to be charged to Profit and Loss account:

The Rs. 22 lakhs is recognized as an expense because the recognition criteria were not met until 1st December 2009. This expenditure will not form part of the cost of the production process recognized in the balance sheet.

- (ii) For the year ending 31.03.2010

- (1) Expenditure to be charged to Profit and Loss account:

	<i>(Rs. in lakhs)</i>
Carrying Amount as on 31.03.2009	28
Expenditure during 2009 – 2010	<u>80</u>
Total book cost	108
Recoverable Amount	<u>72</u>
Impairment loss	<u>36</u>
Rs. 36 lakhs to be charged to Profit and loss account for the year ending 31.03.2010.	

(2) Carrying value of intangible as on 31.03.2010:

	(Rs. in lakhs)
Total Book Cost	108
Less: Impairment loss	<u>36</u>
Carrying amount as on 31.03.2010	<u>72</u>

- (b) In accordance with AS 29 'Provisions, Contingent Liabilities and Contingent Assets' and ASI 30 'Applicability of AS 29 to Onerous Contracts', if an enterprise has a contract that is onerous, the present obligation under the contract should be recognized and measured as a provision. In the given case, the operating lease contract has become onerous* as the economic benefit of lease contract for next 33 months up to 31.12.2010 will be nil. However, the lessee, Mini Ltd., has to pay lease rent of Rs. 66,00,000 (i.e. 2,00,000 p.m. for next 33 months).

Therefore, provision on account of Rs.66,00,000 is to be provided in the accounts for the year ending 31.03.08. Hence auditor is right.

Question 26

From the following information of Beta Ltd. calculate Earning Per Share (EPS) in accordance with AS-20:

	(Rs.)	
	Year 31.3.10	Year 31.3.09
1. Net profit before tax	3,00,000	1,00,000
2. Current tax	40,000	30,000
Tax relating to earlier years	24,000	(13,000)
Deferred tax	30,000	10,000
3. Profit after tax	<u>2,06,000</u>	<u>73,000</u>
4. Other information:		
(a) Profit includes compensation from Central Government towards loss on account of earthquake in 2007 (non-taxable)	1,00,000	NIL
(b) Outstanding convertible 6% Preference shares 1,000 issued and paid on 30.9.2008. Face value Rs.100, Conversion ratio 15 equity shares for every preference share.		
(c) 15% convertible debentures of Rs.1,000 each total face value Rs.1,00,000 to be converted into 10 Equity shares per debenture issued and paid on 30.6.2008.		
(d) Total no. of Equity shares outstanding as on 31.3.2010, 20,000 including 10,000 bonus shares issued on 1.1.2010, face value Rs.100.		

* For a contract to qualify as an onerous contract, the unavoidable costs of meeting the obligation under the contract should exceed the economic benefits expected to be received under it.

Financial Reporting

Answer

(a) Calculation of Earning Per Share (EPS) of Beta Ltd.

		Rs. Year ended 31.3.10	Rs. Year ended 31.3.09
1.	A. Earning after extra ordinary items (2,06,000 – 6,000) (73,000 – 3,000)	2,00,000	70,000
	B. No. of Equity Shares	20,000	20,000
	C. Basic Earnings Per share [A/B]	10.00	3.50
	A. Earning before extra ordinary items	1,00,000	70,000
	B. No. of Equity Shares	20,000	20,000*
	C. Basic Earnings Per share [A/B]	5.00	3.50
2.	Tax Rate applicable		
	$40,000 + 30,000/2,00,000$	35%	
	$30,000 + 10,000/1,00,000$		40%
3.	A. Dividend on Weighted Average Preference Shares	6,000	3,000
	B. Incremental shares	15,000	7,500
	C. EPS on Incremental Shares [A/B]	0.40	0.40
		(dilutive)	(dilutive)
4.	Convertible Debentures		
	A. Increase in earnings		
	$(1,00,000 \times \frac{15}{100} \times .65)$	9,750	
	$1,00,000 \times \frac{15}{100} \times .60 \times \frac{9}{12}$		6,750
	B. Increase in shares	1,000	750
	C. Increase in EPS [A/B]	9.75	9.00
		(Anti dilutive)	(Anti dilutive)

* Since the bonus issue is without consideration, the issue is treated as if it had occurred prior to the beginning of the year 2009.

It is anti-dilutive as it increases the EPS from continuing ordinary operations (Para 39, AS 20)

Calculation of Diluted EPS		Year ended 31.3.10	Year ended 31.3.09
		Rs.	Rs.
A.	Profit from continuing ordinary activities before Preference Dividend	1,06,000	73,000
	No. of ordinary equity shares	20,000	20,000
	Adjustment for dilutive potential of 6% convertible pref. shares	15,000	7,500
B.	Total no. of shares	35,000	27,500
C.	Diluted EPS from continuing ordinary operations [A/B]	3.02	2.65
D.	Profit including extra ordinary items	2,06,000	73,000
E.	Adjusted No. of shares	35,000	27,500
F.	Diluted EPS including extra ordinary items [D/E]	5.88	2.65

Disclosure of EPS in accordance with AS 20 in the Profit and Loss Account

Earning per share (Face value Rs.100)	31.3.10 (Rs.)	31.3.09 (Rs.)
Basic EPS from continuing ordinary operations	5.00	3.50
Diluted EPS from continuing ordinary operations	3.02	2.65

Question 27

- (a) *Golden Eagle Ltd., has been successful jewellers for the past 100 years and sales are against cash only. The company diversified into apparels. A young senior executive was put in charge of Apparels business and sales increased 5 times. One of the conditions for sales that dealers can return the unsold stocks within one month of the end of season. Sales return for the year was 25% of sales. Suggest a suitable Revenue Recognition Policy with references to AS-9.*
- (b) *A company has a scheme for payment of settlement allowance to retiring employees. Under the scheme, retiring employees are entitled to reimbursement of certain travel expenses for class they are entitled to as per company rule and to a lump-sum payment to cover expenses on food and stay during the travel. Alternatively employees can claim a lump sum amount equal to one month pay last drawn.*

The company's contentions in this matter are:

- (i) *Settlement allowance does not depend upon the length of service of employee. It is restricted to employee's eligibility under the Travel rule of the company or where option for lump-sum payment is exercised, equal to the last pay drawn.*

Financial Reporting

- (ii) *Since it is not related to the length of service of the employees, it is accounted for on claim basis.*

State whether the contentions of the company are correct as per relevant Accounting Standard. Give reasons in support of your answer.

Answer

- (a) As per AS 9 "Revenue recognition", revenue recognition is mainly concerned with the timing of recognition of revenue in statement of profit and loss of an enterprise. The amount of revenue arising on a transaction is usually determined by the agreement between the parties involved in the transaction. When uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

Effect of Uncertainty- In the case of the jewellery business the company is selling for cash and returns are negligible. Hence, revenue can be recognized on sales. **On the other hand, in Apparels Industry, the dealers have a right to return the unsold goods within one month of the end of the season.** In this case, the company is bearing the risk of sales return and therefore, the company should not recognize the revenue to the extent of 25% of its sales. The company may disclose suitable revenue recognition policy in its financial statements separately for both Jewellery and Apparels business.

- (b) The present case falls under the category of defined benefit scheme under Para 49 of AS 15 (Revised) "Employee Benefits". The said para encompasses cases where payment promised to be made to an employee at or near retirement presents significant difficulties in the determination of periodic charge to the statement of profit and loss. The contention of the Company that the settlement allowance will be accounted for on claim basis is not correct even if company's obligation under the scheme is uncertain and requires estimation. In estimating the obligation, assumptions may need to be made regarding future conditions and events, which are largely outside the company's control. Thus,
- (1) Settlement allowance payable by the company is a defined retirement benefit, covered by AS 15 (Revised).
 - (2) A provision should be made every year in the accounts for the accruing liability on account of settlement allowance. The amount of provision should be calculated according to actuarial valuation.
 - (3) Where, however, the amount of provision so determined is not material, the company can follow some other method of accounting for settlement allowances.

Question 28

- (a) *The borrowings profile of Santra Pharmaceuticals Ltd. set up for the manufacture of antibiotics at Navi Mumbai is as under:*

Accounting Standards and Guidance Notes

Date	Nature of borrowings	Amount borrowed	Purpose of borrowings	Incidental expenses
		Rs.		
1 st January, 2008	15% demand loan	60 lakhs	Acquisition of fixed assets	8.33%
1 st July, 2008	14.5% Term loan	40 lakhs	Acquisition of plant and machinery	5%
1 st October, 2008	14% bonds	50 lakhs	Acquisition of fixed assets	8%

The incidental expenses consist of commission and service charges for arranging the loans and are paid after rounding off to the nearest lakh.

Fixed assets considered as qualifying assets are as under:

	Rs.
Sterile Manufacturing shed	10,00,000
Plant and machinery (total)	90,00,000
Other fixed assets	10,00,000

The Project is completed on 1st January, 2009 and is ready for commercial production. Show the capitalization of the borrowing costs.

- (b) A company is engaged in the business of ship building and ship repair. On completion of the repair work, a work completion certificate is prepared and countersigned by ship owner (customer). Subsequently, invoice is prepared based on the work completion certificate describing the nature of work done together with the rate and the amount. Customer scrutinizes the invoice and any variation is informed to the company. Negotiations take place between the company and the customer. Negotiations may result in a deduction being allowed from the invoiced amount either as a lumpsum or as a percentage of the invoiced amount. The accounting treatment followed by the company is as follows:

- When the invoice is raised, the customer's account is debited and ship repair income account is credited with the invoiced amount.
- Deduction, if any, arrived after negotiation is treated as trade discount by debiting the ship repair income account.
- At the close of the year, negotiation in respect of certain invoices had not been completed. In such cases, based on past experience, a provision for anticipated loss is created by debiting the Profit and Loss account. The provision is disclosed in Balance Sheet.

Following two aspects are settled in the negotiations:

- Errors in billing arising on account of variation between the quantities as per work completion certificate and invoice and other clerical errors in preparing the invoice.

Financial Reporting

- (ii) Disagreement between the company and customer about the rate/cost on which prior agreement has not been reached between them.

Comment:

- (i) Whether the accounting treatment of deduction as trade discount is correct? If not, state the correct accounting treatment.
- (ii) Whether the disclosure of the provision for anticipated loss in Balance Sheet is correct; if not, statement correct accounting treatment.

Answer**(a) Specific Borrowings**

14.5% Term Loan for acquisition of Plant & Machinery	Rs.
Interest from 1st July, 2008 to 31st December, 2008	
$= \text{Rs. } 40,00,000 \times 14.5\% \times \frac{6}{12}$	2,90,000
Incidental Expenses	<u>2,00,000</u>
Total	<u>4,90,000</u>

General Borrowings

15% Demand Loan	
Interest from 1st January, 2008 to 31st December, 2008	9,00,000
$= \text{Rs. } 60,00,000 \times 15\%$	
Incidental Expenses	<u>5,00,000</u>
Sub Total (A)	<u>14,00,000</u>

14% Bonds

Interest from 1st October, 2008 to 31st December, 2008	
$= \text{Rs. } 50,00,000 \times 14\% \times \frac{3}{12}$	1,75,000
Incidental Expenses	<u>4,00,000</u>
Sub Total (B)	<u>5,75,000</u>
Total General Borrowing Cost (A+B)	19,75,000
Total Average Outstanding Borrowings will be as under:	
$\frac{(60,00,000 \times 12 + 50,00,000 \times 3)}{12}$	72,50,000

$$\text{Weighted Average Borrowing Cost (WABC)} = \frac{\text{Total Borrowing Cost} \times 100}{\text{Total Average Outstanding}} = \frac{19,75,000 \times 100}{72,50,000} = 27.24\%$$

Allocation of General Borrowing Fund

Item	Cost	Specific Borrowing	Net of specific borrowing
Sterile Manufacturing Shed	10,00,000	Nil	10,00,000
Plant & Machinery	90,00,000	40,00,000	50,00,000
Other Fixed Assets	10,00,000	Nil	10,00,000

Item	Expenditure on qualifying asset out of general borrowing	Capitalization Rate	Cost eligible for capitalization
Sterile Manufacturing Shed	10,00,000	27.24	2,72,400
Plant & Machinery	50,00,000	27.24	13,62,000
Other Fixed Assets	10,00,000	27.24	2,72,400

Borrowing Costs to be Capitalized

Assets	Specific Borrowing Cost	General Borrowing Cost	Total
Sterile Manufacturing shed	Nil	2,72,400	2,72,400
Plant & Machinery	4,90,000	13,62,000	18,52,000
Other Fixed Assets	Nil	2,72,400	2,72,400
Total	4,90,000	19,06,800*	23,96,800

- (b) (i) As per AS 9 "Revenue Recognition", revenue is recognized at the time when the invoice is raised to the customers; however the treatment of deduction as trade discount is not as per AS 9. Considering the treatment prescribed by AS 4 "Contingencies and Events occurring after the Balance Sheet Date", the correct treatment of the difference between the invoice amount and finally settled amount should be under:

The adjustment of the difference between the invoiced amount and the amount finally settled against "Ship Repair Income" account is in order. Events occurring up

* Borrowing cost capitalized on general borrowings is Rs.19,06,800 which is less than the actual borrowing cost.

Financial Reporting

to the date of approval of the accounts by the Board of Directors should be taken into consideration in determining the amount of adjustment to be made in this regard. The description of the difference as "trade discount" is not appropriate.

- (ii) In respect of ship repair jobs for which negotiations between the ship owners and the company are not over, the accounting treatment is not appropriate. Instead, the amount of difference between the invoiced amount and the amount likely to be finally settled (as estimated on the basis of past experience) should be adjusted in the "Ship Repair Income" by a corresponding credit to the accounts of the respective ship owners. Consequently, the figure of sundry debtors included in the balance sheet would be net of adjustment for such difference. In other words, the amount of the difference would be neither shown under the head provisions nor shown as a deduction from the sundry debtors in the balance sheet.

Question 29

- (a) *Good Drugs and Pharmaceuticals Ltd. acquired a sachet filling machine on 1st April, 2009 for Rs.60 lakhs. The machine was expected to have a productive life of 6 years. At the end of financial year 2009-2010 the carrying amount was Rs.41 lakhs. A short circuit occurred in this financial year but luckily the machine did not get badly damaged and was still in working order at the close of the financial year. The machine was expected to fetch Rs.36 lakhs, if sold in the market. The machine by itself is not capable of generating cash flows. However, the smallest group of assets comprising of this machine also, is capable of generating cash flows of Rs.54 crore per annum and has a carrying amount of Rs.3.46 crore. All such machines put together could fetch a sum of Rs.4.44 crore if disposed. Discuss the applicability of Impairment loss.*
- (b) *EXOX Ltd. is in the process of finalizing its accounts for the year ended 31st March, 2008. The company seeks your advice on the following:*
- (i) *The Company's sales tax assessment for assessment year 2005-06 has been completed on 14th February, 2008 with a demand of Rs.2.76 crore. The company paid the entire due under protest without prejudice to its right of appeal. The Company files its appeal before the appellate authority wherein the grounds of appeal cover tax on additions made in the assessment order for a sum of 2.10 crore.*
- (ii) *The Company has entered into a wage agreement in May, 2008 whereby the labour union has accepted a revision in wage from June, 2007. The agreement provided that the hike till May, 2008 will not be paid to the employees but will be settled to them at the time of retirement. The company agrees to deposit the arrears in Government Bonds by September, 2008.*

Answer

- (a) As per provisions of Para 91(b) of AS 28 "Impairment of Assets", impairment loss is not to be recognized for a given asset if its cash generating unit (CGU) is not impaired. In the

given question, the related cash generating unit which is group of asset to which the damaged machine belongs is not impaired; and the recoverable amount is more than the carrying amount of group of assets. Hence there is no need to provide for impairment loss on the damaged sachet filling machine.

- (b) (i) Since the company is not appealing against the addition of Rs. 0.66 crore the same should be provided for in its accounts for the year ended on 31st March, 2008. The amount paid under protest can be kept under the heading 'Loans & Advances' and disclosed along with the contingent liability of Rs.2.10 crore.
- (ii) The arrears for the period from June, 2007 to March, 2008 are required to be provided for in the accounts of the company for the year ended on 31st March, 2008.

Question 30

AS Ltd. leased a machine to SB Ltd. on the following terms:

	(Rs. In lakhs)
Fair value of the machine	4.00
Lease term	5 years
Lease Rental Per annum	1.00
Guaranteed Residual value	0.20
Expected Residual value	0.40
Internal Rate of Return	15%

Depreciation is provided on straight line method at 10 per cent per annum. Ascertain Unearned Financial Income. Necessary Journal entries in the books of the Lessee in first year may be shown.

Answer

As per AS 19 on Leases, **unearned finance income** is the difference between (a) the **gross investment** in the lease and (b) the present value of minimum lease payments under a finance lease from the standpoint of the lessor; and any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

Where:

- (a) **Gross investment** in the lease is the aggregate of (i) minimum lease payments from the stand point of the lessor and (ii) any unguaranteed residual value accruing to the lessor.

$$\begin{aligned}
 \text{Gross investment} &= \text{Minimum lease payments} + \text{Unguaranteed residual value} \\
 &= [\text{Total lease rent} + \text{Guaranteed residual value (GRV)}] + \text{Unguaranteed residual value (URV)} \\
 &= [(\text{Rs. } 1,00,000 \times 5 \text{ years}) + \text{Rs. } 20,000] + \text{Rs. } 20,000 \\
 &= \text{Rs. } 5,40,000 \text{ (a)}
 \end{aligned}$$

Financial Reporting

- (b) Table showing present value of (i) Minimum lease payments (MLP) and (ii) Unguaranteed residual value (URV).

Year	M.L.P. inclusive of URV Rs.	Internal rate of return (Discount factor @ 15%)	Present Value Rs.
1	1,00,000	0.8696	86,960
2	1,00,000	0.7561	75,610
3	1,00,000	0.6575	65,750
4	1,00,000	0.5718	57,180
5	1,00,000	0.4972	49,720
	<u>20,000 (GRV)</u>	0.4972	<u>9,944</u>
	5,20,000		3,45,164 (i)
	<u>20,000 (URV)</u>	0.4972	<u>9,944 (ii)</u>
	<u>5,40,000</u>	(i) + (ii)	<u>3,55,108 (b)</u>

$$\begin{aligned}
 \text{Unearned Finance Income} &= (a) - (b) \\
 &= \text{Rs. } 5,40,000 - \text{Rs. } 3,55,108 \\
 &= \text{Rs. } 1,84,892
 \end{aligned}$$

Journal Entries in the books of SB Ltd.

	Rs.	Rs.
<i>At the inception of lease</i>		
Machinery account	Dr. 3,45,164*	
To AS Ltd.'s account		3,45,164*
(Being lease of machinery recorded at present value of minimum lease payments)		

* As per para 11 of AS 19, the lessee should recognize the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of lease. However, if the fair value of the leased asset exceeds the present value of minimum lease payments from the standpoint of lessee, the amount recorded should be the present value of these minimum lease payments. Therefore, in this case, as the fair value of Rs. 4,00,000 is more than the present value amounting Rs. 3,45,164, the machinery has been recorded at Rs. 3,45,164 in the books of SB Ltd. (the lessee) at the inception of the lease. According to para 13 of the standard, at the inception of the lease, the asset and liability for the future lease payments are recognised in the balance sheet at the same amounts.

At the end of the first year of lease

Finance charges account (Refer Working Note)	Dr.	51,775	
To AS Ltd.'s account			51,775
(Being the finance charges for first year due)			
AS Ltd.'s account	Dr.	1,00,000	
To Bank account			1,00,000
(Being the lease rent paid to the lessor which includes outstanding liability of Rs. 48,225 and finance charge of Rs. 51,775)			
Depreciation account [£]	Dr.	34,516	
To Machinery account			34,516
(Being the depreciation provided @ 10% p.a. on straight line method)			
Profit and loss account	Dr.	86,291	
To Depreciation account			34,516
To Finance charges account			51,775
(Being the depreciation and finance charges transferred to profit and loss account)			

Working Note:

Table showing apportionment of lease payments by SB Ltd. between the finance charges and the reduction of outstanding liability

Year	Outstanding liability (opening balance)	Minimum lease payments	Finance charges	Reduction in principal amount	Outstanding liability (closing balance)
	Rs.	Rs.	Rs.	Rs.	Rs.
1	3,45,164	1,00,000	51,775	48,225	2,96,939
2	2,96,939	1,00,000	44,541	55,459	2,41,480
3	2,41,480	1,00,000	36,222	63,778	1,77,702
4	1,77,702	1,00,000	26,655	73,345	1,04,357
5	1,04,357	1,00,000	15,654	84,346	20,011*

[£] Depreciation has been provided on the basis that the machine has been leased at the beginning of the year.

* The difference between this figure and guaranteed residual value (Rs. 20,000) is due to approximation in computing the interest rate implicit in the lease.

Financial Reporting

Question 31

Pankaj Ltd. is a company engaged in manufacture of Nuclear Power Stations. The Company usually resorts to long term Foreign Currency borrowings for its fund requirements. The Company had on 1st April, 2005 borrowed U.S. \$100 million from Global Fund Consortium based in Washington, USA. The funds were used by Pankaj Ltd. for purposes OTHER THAN acquiring 'Depreciable Capital Assets'. The loan carries an interest rate of 3 per cent on reducing balance and is repayable in two instalments, the first one due on 1st April, 2010 and the next on 1st April, 2012. The interest due on the loan has been paid in full on 31st March of each year. The exchange rate on the date of borrowing was 1 U.S. \$ = INR 40.

The accounting treatment followed by the Company for the subsequent three years with exchange rates prevailing on those dates were as under:

Year ended	Exchange Rate	Accounting Treatment
31 st March, 2006	1 US \$ = 41	Forex Loss of Rs.10 crore charged to Profit and Loss account;
31 st March, 2007	1 US \$ = 39	Forex gain of Rs.20 crore recognised in Profit and Loss Account;
31 st March, 2008	1 US \$ = 48	Forex Loss of Rs.90 crore charged to Profit and Loss account;

Note: Interest payment were charged to Profit and Loss account of each year at transaction value on payment dates.

Pankaj Ltd. is in the process of finalising its accounts for the year ended 31st March, 2009 and understands that AS 11 has been amended and opts to follow the Companies (Accounting Standards) Amendment Rules, 2009.

- (i) *You are required to show treatment of the Forex Losses/gains in the light of the above amendment to AS 11 for the years 2005-06; 06-07; 07-08 & 08-09. The exchange rate to 1 US Dollar on 31st March, 2009 is Rs.50. Assuming that the rates of Exchange on 31st March, 2010 and 31st March, 2011 will be Rs.51 and Rs.52 respectively the accounting for the Forex Losses/gains may also be shown for these years also.*
- (ii) *What are the disclosure requirements to be complied with by Pankaj Ltd. as a result of having opted to follow the amendment in the Companies (Accounting Standard) Rules, 2006.*
- (iii) *Would your answer to (i) above be different if Pankaj Ltd. was not a Company and were a Co-operative Society.*

Answer

Central Govt. in consultation with National advisory Committee on Accounting Standards made an amendment to AS 11 "The Effects of Changes in Foreign Exchange Rates" vide Notification No. G.S.R.225(E), dated 31st March, 09 in the form of Companies (Accounting Standards) Amendment

Rules, 2009. According to the Notification, any exchange gain or loss resulting from the translation of foreign currency monetary items not attributable to a depreciable asset should be accumulated in the Foreign Currency Monetary Item Translation Difference (FCMITD) Account and should be written off over the useful life of the assets but not beyond 31st March, 2011. The treatment availed at the option of the company shall be irrevocable and shall be exercised till 31st March, 2011. Any difference pertaining to accounting periods which commenced on or after 7th December, 2006, previously, recognised in the profit and loss account before the exercise of the option shall be reversed in case of non-depreciable asset by transfer to Foreign Currency Monetary Item Translation Difference (FCMITD) Account, and by debit or credit, as the case may be, to the general reserve.

(i) **Table showing the Treatment of Forex Losses/gains as per amendment to AS 11**

Year ended	Opening Balance in FCMITD A/c (Rs. in crores)	Exchange Gain/ (Loss) (Rs. in crores)	Total (Rs. in crores)	Amount Recognised in P&L A/c (Rs. in crores)	Closing Balance in FCMITD A/c (Rs. in crores)
31 st March, 06	Nil	(10)	(10)	(10)	NIL
31 st March, 07	NIL	20		20	NIL
31 st March, 08	NIL	(90)		(22.50) ¹	(67.50)
31 st March, 09	(67.50)	(20)	(87.50)	(29.17) ²	(58.33)
31 st March, 10	(58.33)	(10)	(68.33)	(34.17) ³	(34.16)
31 st March, 11	(34.16)	(10)	(44.16)	(44.16) ⁴	NIL

(ii) **Disclosure Requirements:**

1. The company has chosen to avail the option provided by way of amendment in the Companies (AS) Amendment Rules, 2009.
2. According to AS 1 "Disclosure of Accounting Policies", Exercise of option due to amendment in AS 11 is a change in accounting policy.
3. The amount amortized to profit and loss account and the amount carried forwarded in each year till 31st March, 2011 should be disclosed.

(iii) Notification No. G.S.R.225(E) is relevant only for companies. If Pankaj Ltd., is a co-operative society, then the said notification would not be applicable. In that case, option to amortise FOREX losses over the period till 31.03.2011 will not be available to it. The amounts charged to Profit and loss account would be same as shown in the column carrying the heading "Exchange gain/Loss" in the table given under (i).

¹ Total loss of Rs.90 crores will be amortised over 4 years till 2011. The amount of Rs.67.50 crores would be credited to General reserve and debited to FCMITD Account in the year 2008-09.

² Amount written off in 2008-09 is 29.17 crores [1/4 of Rs. 90 crores + 1/3 of Rs. 20 crores]

³ Amount written off in 2009-10 is 34.17 crores [1/4 of Rs. 90 crores + 1/3 of Rs. 20 crores + 1/2 of Rs. 10 crores]

⁴ Entire balance including exchange loss of current year is fully amortized.

Financial Reporting

Question 32

- (a) On 30.6.2010, Asmitha Ltd. incurred Rs. 2,00,000, net loss from disposal of a business segment. Also, on 30.7.2010, the company paid Rs. 60,000 for property taxes assessed for the calendar year 2010. How the above transactions should be included in determination of net income of Asmitha Ltd. for the six months interim period ended on 30.9.2010.
- (b) M/s XYZ Ltd. has three segments namely X, Y, Z. The total Assets of the Company are Rs. 10.00 crs. Segment X has Rs. 2.00 crs., segment Y has Rs. 3.00 crs. and segment Z has Rs. 5.00 crs. Deferred tax assets included in the assets of each segments are X- Rs. 0.50 crs., Y—Rs. 0.40 crs. and Z—Rs. 0.30 crs. The accountant contends that all the three segments are reportable segments. Comment.
- (c) M/s Dinesh & Company signed an agreement with workers for increase in wages with retrospective effect. The out-flow on account of arrears was for 2005-06—Rs. 10.00 lakhs, for 2006-07—Rs. 12.00 lakhs and for 2007-08—Rs. 12.00 lakhs. This amount is payable in September, 2008. The accountant wants to charge Rs. 22.00 lakhs as prior period charges in financial statement for 2008-09. Discuss.
- (d) M/s Prima Co. Ltd. sold goods worth Rs. 50,000 to M/s Y and Company. M/s Y and Co. asked for discount of Rs. 8,000 which was agreed by M/s Prima Co. Ltd. the sale was effected and goods were despatched. After receiving, goods worth Rs. 7,000 was found defective, which they returned immediately. They made the payment of Rs. 35,000 to M/s Prima Co. Ltd. Accountant booked the sales for Rs. 35,000. Please discuss.
- (e) Himalayas Ltd. is showing an intangible Asset at Rs. 72 lakhs as on 01.04.2007 and that item was required for Rs. 96 lakhs on 01.04.2004 and that item was available for use from that date. Himalayas Ltd. has been following the policy of amortisation of the intangible asset over a period of 12 years on straight line basis. Comment on the accounting treatment of the above with reference to relevant accounting standard.

Answer

- (a) According to Para 10 of AS 25 "Interim Financial Reporting", If an enterprise prepares and presents a complete set of financial statements in its interim financial report, the form and content of those statements should conform to the requirements as applicable to annual complete set of financial statements. As on 30.9.2010, Asmitha Ltd., would report the entire Rs.2,00,000 loss on the disposal of its business segment since the loss was incurred during interim period. A cost charged as an expense in an annual period should be allocated to Interim periods on accrual basis. Since Rs.60,000 Property Tax payment relates to entire calendar year 2010, Rs.30,000 would be reported as an expense for six months ended on 30th September, 2010 while remaining Rs.30,000 would be reported as prepaid expenses.
- (b) According to AS 17 "Segment Reporting", segment assets do not include income tax assets. Therefore, the revised total assets are 8.8 crores [10 crores – (0.5+0.4+0.3)].

Segment X holds total assets of 1.5 crores (2 crores – 0.5 crores); Segment Y holds 2.6 crores (3 crores – 0.4 crores); and Segment Z holds 4.7 crores (5 crores – 0.3 crores). Thus all the three segments hold more than 10% of the total assets, all segments are reportable segments.

- (c) According to AS 5(Revised) “Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies”, the term prior period item refers only to income or expenses which arise in the current period as a result of errors or omission in the preparation of the financial statements of one or more prior periods. The term does not include other adjustments necessitated by circumstances, which though related to prior periods are determined in the current period. The full amount of wage arrears paid to workers will be treated as an expense of current year and it will be charged to profit and loss account as current expenses and not as prior period expenses.

It may be mentioned that additional wages is an expense arising from the ordinary activities of the company. Although abnormal in amount, such an expense does not qualify as an extraordinary item. However, as per Para 12 of AS 5 (Revised), when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

- (d) As per Para 4.1 of AS 9 “Revenue Recognition”, revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends.

In the given case, M/s Prima Co. Ltd. should record the sales at gross value of Rs.50,000. Discount of Rs.8,000 in price and goods returned worth Rs.7,000 are to be adjusted by suitable provisions. M/s Prime Co. Ltd. might have sent the credit note of Rs. 15,000 to M/s Y & Co. to account for these adjustments. The contention of the accountant to book the sales for Rs.35,000 is not correct.

- (e) As per Para 63 of AS 26 “Intangible Assets”, the depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.

Himalayas Ltd. has been following the policy of amortisation of the intangible asset over a period of 12 years on straight line basis. The period of 12 years is more than the maximum period of 10 years specified under AS 26. Accordingly, Himalayas Ltd. would be required to restate the carrying amount of intangible asset as on 1.4.2007 at Rs.96 lakhs less Rs. 28.8 lakhs ($\text{Rs. } 9.6 \text{ lakhs} \times 3 \text{ years}$) = Rs. 67.2 lakhs. If amortisation had been as per AS 26, the carrying amount would have been Rs.67.2 lakhs. The difference of Rs. 4.8 lakhs i.e. ($\text{Rs. } 72 \text{ lakhs} - 67.2 \text{ lakhs}$) would be required to be adjusted against

Financial Reporting

the opening balance of revenue reserves. The carrying amount of Rs.67.2 lakhs would be amortized over 7 (10 less 3) years in future.

Question 33

(a) From the following details of an asset

- (i) Find out impairment loss
- (ii) Treatment of impairment loss
- (iii) Current year depreciation

Particulars of asset:

Cost of asset	Rs.56 lakhs
Useful life period	10 years
Salvage value	Nil
Current carrying value	Rs. 27.30 lakhs
Useful life remaining	3 years
Recoverable amount	Rs.12 lakhs
Upward revaluation done in last year	Rs.14 lakhs

- (b) Rainbow Limited borrowed an amount of Rs.150 crores on 1.4.2008 for construction of boiler plant @ 11% p.a. The plant is expected to be completed in 4 years. Since the weighted average cost of capital is 13% p.a., the accountant of Rainbow Ltd. capitalized Rs.19.50 crores for the accounting period ending on 31.3.2009. Due to surplus fund out of Rs.150 crores, an income of Rs.3.50 crores was earned and credited to profit and loss account. Comment on the above treatment of accountant with reference to relevant accounting standard.
- (c) Suraj Limited wishes to obtain a machine costing Rs.30 lakhs by way of lease. The effective life of the machine is 14 years, but the company requires it only for the first 5 years. It enters into an agreement with Ashok Ltd., for a lease rental for Rs.3 lakhs p.a. payable in arrears and the implicit rate of interest is 15%. The chief accountant of Suraj Limited is not sure about the treatment of these lease rentals and seeks your advise.
- (d) Omega Limited is working on different projects which are likely to be completed within 3 years period. It recognizes revenue from these contracts on percentage of completion method for financial statements during 2006, 2007 and 2008 for Rs.11,00,000, Rs.16,00,000 and Rs.21,00,000 respectively. However, for Income-tax purpose, it has adopted the completed contract method under which it has recognized revenue of Rs.7,00,000, Rs.18,00,000 and Rs.23,00,000 for the years 2006, 2007 and 2008 respectively. Income-tax rate is 35%. Compute the amount of deferred tax asset/liability for the years 2006, 2007 and 2008.

- (e) While preparing its final accounts for the year ended 31st March, 2009, a company made a provision for bad debts @ 5% of its total debtors. In the last week of February 2009, a debtor for 2 lakhs had suffered heavy loss due to earthquake. The loss was not covered by any insurance policy. In April, 2009, the debtor became bankrupt. Can the company provide for full loss arising out of insolvency of debtor in the final accounts for year ended 31st March, 2009?

Answer

- (a) According to AS 28 "Impairment of Assets", an impairment loss on a revalued asset is recognised as an expense in the statement of profit and loss. However, an impairment loss on a revalued asset is recognised directly against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset.

Impairment Loss and its treatment	Rs.
Current carrying amount (including revaluation amount of Rs.14 lakhs)	27,30,000
Less: Current recoverable amount	<u>12,00,000</u>
Impairment Loss	<u>15,30,000</u>
Impairment loss charged to revaluation reserve	14,00,000
Impairment loss charged to profit and loss account	1,30,000

After the recognition of an impairment loss, the depreciation (amortization) charge for the asset should be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

In the given case, the carrying amount of the asset will be reduced to Rs.12,00,000 after impairment. This amount is required to be depreciated over remaining useful life of 3 years (including current year). Therefore, the depreciation for the current year will be Rs.4,00,000.

- (b) Para 10 of AS 16 'Borrowing Costs' states "To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings." The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. Hence, in the above case, treatment of accountant of Rainbow Ltd. is incorrect. The amount of borrowing costs capitalized for the financial year 2008-09 should be calculated as follows:

Actual interest for 2008-09 (11% of Rs.150 crores)	Rs.16.50 crores
Less: Income on temporary investment from specific borrowings	<u>Rs. 3.50 crores</u>
Borrowing costs to be capitalized during year 2008-09	<u>Rs. 13.00 crores</u>

Financial Reporting

- (c) As per AS 19 'leases', a lease will be classified as finance lease if at the inception of the lease, the present value of minimum lease payment* amounts to at least substantially all of the fair value of leased asset. In a finance lease, lease term should be for the major part of the economic life of the asset even if title is not transferred. In the given case, the implicit rate of interest is given at 15%. The present value of minimum lease payments at 15% using PV- Annuity Factor can be computed as:

Annuity Factor (Year 1 to Year 5 Rs.3 lakhs each year) Rs.3.36 lakhs (approx.)

Present Value of minimum lease payments Rs.10.08 lakhs (approx.)

Thus present value of minimum lease payments is Rs.10.08 lakhs and the fair value of the machine is Rs.30 lakhs. In a finance lease, lease term should be for the major part of the economic life of the asset even if title is not transferred. However, in the given case, the effective useful life of the machine is 14 years while the lease is only for five years. Therefore lease agreement is an operating lease. Lease payments under an operating lease should be recognized as an expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

- (d) **Omega Limited.**

Calculation of Deferred Tax Asset/Liability

Year	Accounting Income	Taxable Income	Timing Difference (balance)	Deferred Tax Liability (balance)
2006	11,00,000	7,00,000	4,00,000	1,40,000
2007	16,00,000	18,00,000	2,00,000	70,000
2008	21,00,000	23,00,000	NIL	NIL
	<u>48,00,000</u>	<u>48,00,000</u>		

- (e) As per Para 8.2 and 13 of Accounting Standard 4 'Contingencies and Events occurring after the Balance Sheet Date, assets and liabilities should be adjusted for events occurring after the date of balance sheet, that provide additional evidence to assist estimation of amounts relating to conditions existing at the Balance Sheet Date. Therefore, in the given case, full provision for bad debt amounting Rs.2 lakhs should be made to cover the loss arising due to insolvency in the final accounts for the year ended 31st March, 2009 as earthquake took place before the balance sheet date.

* In calculating the present value of the of minimum lease payments, the discount rate is the interest rate implicit in the lease.

Question 34

- (a) The following data apply to 'X' Ltd. defined benefit pension plan for the year ended 31.03.09, calculate the actual return on plan assets :

- Benefits paid	2,00,000
- Employer contribution	2,80,000
- Fair market value of plan assets on 31.03.09	11,40,000
- Fair market value of plan assets as on 31.03.08	8,00,000

- (b) U.S.A Ltd. purchased raw material @ Rs. 400 per kg. Company does not sell raw material but uses in production of finished goods. The finished goods in which raw material is used are expected to be sold at below cost. At the end of the accounting year, company is having 10,000 kg of raw material in stock. As the company never sells the raw material, it does not know the selling price of raw material and hence can not calculate the realizable value of the raw material for valuation of inventories at the end of the year. However replacement cost of raw material is Rs. 300 per kg. How will you value the inventory of raw material?
- (c) Moon Ltd. entered into agreement with Sun Ltd. for sale of goods of Rs.8 lakhs at a profit of 20 % on cost. The sale transaction took place on 1st February, 2009. On the same day Sun Ltd. entered into another agreement with Moon Ltd. to resell the same goods at Rs. 10.80 lakhs on 1st August, 2009. State the treatment of this transaction in the financial statements of Moon Ltd. as on 31.03.09. The pre-determined re-selling price covers the holding cost of Sun Ltd. Give the Journal Entries as on 31.03.09 in the books of Moon Ltd.

Answer

- (a)
- | | |
|---|-----------------------|
| | Rs. |
| Fair value of plan assets on 31.3.08 | 8,00,000 |
| Add: Employer contribution | 2,80,000 |
| Less: Benefits paid | <u>2,00,000</u> |
| (A) | <u>8,80,000</u> |
| Fair market value of plan assets at 31.3.09 | (B) <u>11,40,000</u> |
| Actual return on plan assets | (B-A) <u>2,60,000</u> |
- (b) As per Para 24 of AS 2 (Revised) "Valuation of Inventories", materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value. Therefore, in this case, USA Ltd. will value the stock of raw material at Rs. 30,00,000 (10,000 Kg. @ Rs.300 per kg.).

Financial Reporting

- (c) In the given case, Moon Ltd. concurrently agreed to repurchase the same goods from Sun Ltd. on 1st Feb., 2009. Also the re-selling price is pre-determined and covers purchasing and holding costs of Sun Ltd. Hence, the transaction between Moon Ltd. and Sun Ltd. on 1st Feb., 2009 should be accounted for as financing rather than sale. The resulting cash flow of Rs.9.60 lakhs received by Moon Ltd., cannot be considered as revenue as per AS 9 "Revenue Recognition".

Journal Entries in the books of Moon Ltd.

			<i>Rs. in lakhs</i>
1.02.09	Bank Account	Dr.	9.60
	To Advance from Sun Ltd*.		9.60
	(Being advance received from Sun Ltd amounting [Rs.8 lakhs + 20% of Rs. 8 lakhs= 9.60 lakhs] under sale and re-purchase agreement)		
31.03.09	Financing Charges Account	Dr.	0.40
	To Sun Ltd.		0.40
	(Financing charges for 2 months at Rs.1.20 lakhs [10.80 – 9.60] i.e. 1.2 lakhs x 2/6)		
31.03.09	Profit and Loss Account	Dr.	0.40
	To Financing Charges Account		0.40
	(Being amount of finance charges transferred to P& L Account)		

* The balance of Sun Ltd. account will be disclosed as an advance under the heading liabilities in the balance sheet of Moon Ltd. as on 31st March, 2009.

EXERCISES**Question 1**

Summarize the recommendations of the Institute of Chartered Accountants of India regarding accounting treatment of excise duty.

Question 2

A company obtained term loan during the year ended 31st March, 2010 in an extent of Rs. 650 lakhs for modernisation and development of its factory. Buildings worth Rs. 120 lakhs were completed and Plant and Machinery worth Rs. 350 lakhs were installed by 31st March, 2010. A sum of Rs. 70 lakhs has been advanced for Assets the installation of which is expected in the following year. Rs. 110 lakhs has been utilised for Working Capital requirements. Interest paid on the loan of Rs. 650 lakhs during the year 2009-2010 amounted to Rs. 58.50 lakhs. How should the interest amount be treated in the Accounts of the Company?

[Answer: Interest to be capitalized Rs. 48.6 lakhs, Interest to be charged to profit and loss account Rs. 9.9 lakhs]

Question 3

A Limited Company finds that the stock sheets as on 31.3.2009 had included twice an item the cost of which was Rs. 20,000. You are asked to suggest, how the error would be dealt with in the accounts of the year ended 31.3.2010.

[Answer: Rs. 20,000 should be deducted from opening stock in the profit and loss account. and Rs. 20,000 should be charged as prior period adjustment in the profit and loss account for the year ended 31st March 2010 in accordance with para 15 of AS 5 (Revised)]

Question 4

M Ltd. Group has three divisions A, B and C. Details of their turnover, results and net assets are given below:

	Rs. ('000)
Division A	
Sales to B	3,050
Other Sales (Home)	60
Export Sales	<u>4,090</u>
	<u>7,200</u>
Division B	
Sales to C	30

Financial Reporting

Export Sales to Europe	<u>200</u>
	<u>230</u>
Division C	
Export Sales to America	<u>180</u>
Divisions	

	Head Office Rs. ('000)	A Rs('000)	B Rs.('000)	C Rs.('000)
Operating Profit or Loss before tax		160	20	(8)
Re-allocated cost from Head Office		48	24	24
Interest cost		4	5	1
Fixed assets	50	200	40	120
Net current assets	48	120	40	90
Long-term liabilities	38	20	10	120

Prepare a Segmental Report for publication in M Ltd. Group.

Question 5

Arrange and redraft the following Cash Flow Statement in proper order keeping in mind the requirements of AS 3:

	Rs. (in lacs)	Rs.(in lacs)
Net Profit		60,000
Add: Sale of Investments		70,000
Depreciation on Assets		11,000
Issue of Preference Shares		9,000
Loan raised		4,500
Decrease in Stock		<u>12,000</u>
		1,66,500
Less: Purchase of Fixed Assets	65,000	
Decrease in Creditors	6,000	
Increase in Debtors	8,000	
Exchange gain	8,000	
Profit on sale of investments	12,000	

Redemption of Debenture	5,700	
Dividend paid	1,400	
Interest paid	<u>945</u>	<u>1,07,045</u>
		59,455
Add: Opening cash and cash equivalent		<u>12,341</u>
Closing cash and cash equivalent		<u>71,796</u>

[Answer: Net cash from operating activities Rs. 49,000 lakhs, Net cash from Investing activities Rs. 5,000 lakhs , Net cash from financing activities Rs. 5,455 lakhs]

Question 6

Lessee Ltd. took a machine on lease from Lessor Ltd., the fair value being Rs.7,00,000. The economic life of the machine as well as the lease term is 3 years. At the end of each year Lessee Ltd. pays Rs.3,00,000. Guaranteed Residual Value (GRV) is Rs.22,000 on expiry of the lease. Implicit Rate of Return (IRR) is 15% p.a. and present value factors at 15% are 0.869, 0.756 and 0.657 at the end of first, second and third years respectively.

Calculate the value of machine to be considered by Lessee Ltd. and the interest (Finance charges) in each year.

[Answer: Value of machine will be taken as Rs.6,99,054; Finance charges- year 1 Rs. 1,04,858 , year 2 Rs. 75,587, year 3 Rs. 41,925]

Question 7

A Cosmetic articles producing company provides the following information:

	Cold Cream	Vanishing Cream
January, 2009 – September, 2009 per month	2,00,000	2,00,000
October, 2009 – December, 2009 per month	1,00,000	3,00,000
January, 2010- March, 2010 per month	0	4,00,000

The company has enforced a gradual change in product-line on the basis of an overall plan. The Board of Directors of the company has passed a resolution in March, 2009 to this effect. The company follows calendar year as its accounting year. Should this be treated as a discontinuing operation? Give reasons in support of your answer.

[Answer: Change over is not a discontinuing operation.]

INTERNATIONAL ACCOUNTING STANDARDS, INTERNATIONAL FINANCIAL REPORTING STANDARDS, THEIR INTERPRETATIONS AND US GAAPS - AN OVERVIEW

BASIC CONCEPTS

IFRS are considered a "principles-based" set of standards. In fact, they establish broad rules rather than dictating specific treatments.

International Financial Reporting Standards comprise:

- International Financial Reporting Standards (IFRS) - standards issued after 2001
- International Accounting Standards (IAS) - standards issued before 2001
- Interpretations originated from the International Financial Reporting Interpretations Committee (IFRIC) - issued after 2001
- Standing Interpretations Committee (SIC) - issued before 2001
- Framework for the Preparation and Presentation of Financial Statements

Question 1

Briefly explain the following terms:

- (i) IFRS
- (ii) Convergence of Accounting Standards with IFRS
- (iii) Need for IFRS.

Answer

- (i) IFRS: The term IFRS refers to the International Financial Reporting Standards issued by International Accounting Standard Board (IASB). IFRS is a set of international accounting standards stating how particular types of transactions and other events should be reported in financial statements.

Financial Reporting

International Financial Reporting Standards (IFRS) are the globally accepted accounting standards adopted by International Accounting Standard Board (IASB) earlier known International Accounting Standard Committee (IASC).

IFRSs being principle-based standards have distinct advantage that the transactions can not be manipulated easily to achieve a particular accounting.

The basic objective of IFRS are as follows:

- to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions;
- to promote the use and rigorous application of those standards;

It also encompasses the International Accounting Standards (IAS) issued by the International Accounting Standard Committee (IASC). Interpretations of IASs and IFRSs are developed by the International Financial Reporting Interpretations Committee (IFRIC). IFRIC is the new name for the Standing Interpretations Committee (SIC) approved by the IASC Foundation Trustees in March 2002. IFRS includes these interpretations also.

- (ii) **Convergence of Accounting Standards with IFRS:** In general, convergence of Accounting Standards (AS) with International Financial Reporting Standards (IFRS) means to achieve harmony with IFRS. The term convergence can be considered as “to design and maintain national accounting standards in a way that financial statements prepared in accordance with rational AS are in convergence with IFRS”. IAS I require financial statements to comply with all requirements of IFRS. This does not mean that IFRS should be adopted word by word. The local standard setters can add disclosure requirements or can remove some requirements which do not create non compliance with IFRS. Thus, convergence with IFRS means adoption of IFRS with exceptions wherever necessary. Thus, as today IFRS is being used in over 100 countries and it is expected that by 2014, all major countries will have adopted IFRS to some extent,so it is imperative that India shall also adopt IFRS to ensure harmony in preparation and presentation of Financial Statements
- (iii) Indian Accounting Standards and Generally Accepted Accounting Principles (GAAP) are sufficient relevant and clear when compared to global standards. But with the globalization of business requiring foreign capital and investors, there is need for financial reporting standards acceptable to most of the including India. IFRS are recognised in many parts of the world including the European Union, Hong Kong, Australia, Russia, South Africa Singapore and Pakistan, The US is also taking steps to coverage its GAAP with IFRS.

IAS, IFRS, their Interpretations and US GAAPs- An Overview

It has also been recognised that the use of the IFRS concepts can considerably improve the quality of financial reporting and boost international investors' confidence. IFRS are more flexible, dynamic and responsive to changes in and can be applied to all types of industries and across many countries.

Question 2

Write short note on some key differences between IAS, US GAAP and Indian AS with respect to :

- (i) *Fixed Assets*
- (ii) *Changes in Accounting Policy and Prior period items.*
- (iii) *Inventory*

Answer**(i) Fixed Assets**

	IAS	US GAAPs	Indian AS
Definition	Tangible Items that are held for use in the production or supply of goods or service, for rentals to others, or for administrative purpose; and are expected to be used during more than one period.	Fixed assets are carried at historical cost. Only downward revaluation is permitted for impairment. Exchange fluctuations on loans taken for purchase of fixed assets are expensed when incurred.	Fixed Asset is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the ordinary course of business.
Initial Measurement of cost	Initial measurement of cost also includes a) Fair value gains or losses on qualifying cash flow hedges relating to the purchase of Property, Plant and Equipment (PPE) in a foreign currency b) Cost of dismantling and removing the item or restoring the site on which PPE is located.	Similar to IFRS except hedge gains or losses on qualifying cash flow hedges are not included	No specific guideline on the Measurement of gains/ losses on qualifying cash flow hedges and capitalization of dismantling and site restoration cost

Financial Reporting

Capitalization	It mandates component Accounting. Each major part of the plant to be depreciated separately	Does not require a component approach for depreciation	AS 10 does not require full adoption of component Accounting. It is stated that accounting of asset may be improved through allocation of cost to various parts of the asset
Determination of Depreciation	The depreciation amount of an item of PPE is allocated on a systematic basis over its useful life.	Similar to IFRS .	Higher of the following : a) Depreciation as per the rate specified in the Schedule XIV of the Companies Act. b) Depreciation as determined based on estimated useful life of the assets
Depreciation Method	A variety of depreciation methods can be used to allocate the depreciable amount on systematic basis over its useful life.	Similar to IFRS.	Either SLM or WDV can be followed.
Change in Depreciation Method	Changes in the depreciation method are considered as change in accounting Estimate. Prospective effect in current period is made.	Similar to IFRS.	Changes in the depreciation method are considered as change in accounting Policies and effects to be quantified and disclosed. Retrospective effect in computation of depreciation is given.
Review of Useful Life and Residual Value	Re-assessment of useful life and residual value is required at least at each financial year end	Similar to IFRS.	AS 10 does not specify any such requirement.

IAS, IFRS, their Interpretations and US GAAPs- An Overview

Subsequent Costs	Cost of replacement is to be capitalized. The carrying amounts of those parts that are replaced is to be derecognized.	Similar to IFRS.	Replacement cost is expensed. No requirement for decapitalizing the carrying amount of replaced items
Major inspection cost and overhaul expenditure	The cost of major inspection and overhaul expenses are to be capitalized.	Similar to IFRS.	The expenditure that increases the benefit over previously assessed capacity is capitalized. The inspection cost and overhaul expenses are expensed.
Revaluation	If an entity adopts the revaluation model, revaluation is required to be made with regular period to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.	Similar to IFRS.	No specific requirement on frequency of revaluation.
Group Revaluation	If an item of PPE is revalued, then the entire class of PPE to which that asset belongs to be revalued.	Similar to IFRS.	Revaluation Approach is adhoc in nature.
Depreciation on revaluation	Depreciation on revalued portion cannot be recouped out of revaluation reserve.		Depreciation on revalued portion can be recouped out of revaluation reserve.

Financial Reporting

(ii) Changes in Accounting Policy and Prior period items

	IAS	US GAAPs	Indian AS
Definition of Prior Period Errors	Broad definition of Prior Period items includes all the items in the financial statements.		AS 5 covers only Income and Expenses in the definition of prior period items.
Prior Period Errors	Prior Period errors are to be corrected retrospectively and restate the opening balances of assets, liability and equity	Reported as a prior period adjustment in current year results. Comparatives are not required to restate.	Similar to IFRS.
Extraordinary Item	It prohibits disclosure of any items as Extraordinary Items.		Separate disclosure is required as per AS 5.
Impending Changes	It requires disclosure of any impending change in accounting policy.	Similar to IFRS.	It does not require such Disclosure.
Absence of standard or interpretation	It provides specific guidance on the selection of accounting policies where there is no IFRS or interpretation that specifically applies to a transaction.		No specific guidance under AS 5.

(iii) Inventory

	IAS	US GAAPs	Indian AS
Scope	IAS 2 includes provisions relating to the work in progress of a service provider.	Similar to Indian GAAP.	AS 2 excludes work in progress arising in the normal course of business of service provider. Hence there is no guidance for the same.

IAS, IFRS, their Interpretations and US GAAPs- An Overview

Applicability	IAS 2 does not apply to inventories held by commodity traders.	Similar to Indian GAAP.	There is no scope exemption in AS 2 for any inventory held by commodity traders.
Inventory Valuation	Inventories are carried at the lower of cost or net realizable value.	Lower of cost or market subject to upper/lower limit of NRV.	Inventories are carried at the lower of cost or net realizable value.
Frequency of Assessment of NRV	A new assessment of Net Realizable Value is required to be made in each Reporting period		No specific guidance in AS 2.
Write Down	Reversal is required for a subsequent increase in value of inventory previously written down.	Reversal of write down of inventory is not permitted.	Reversal is required for a subsequent increase in value of inventory previously write down.
Cost Formula Application	The following cost formula allowed : a) FIFO Method b) Weighted Average Cost LIFO method is not allowed.	The following cost formula allowed : a) FIFO Method b) Weighted Average Cost c) LIFO Method	The following cost formula allowed : a) FIFO Method b) Weighted Average Cost LIFO method is not allowed.
Consistency in cost formula application	The same cost formula is used for all inventories that have a similar nature and use to the entity.	The same cost formula is used for all inventories that have a similar nature and use to the entity.	Not specified. However consistency is a fundamental principle.
Cost of Inventory	Cost of inventory excludes only Selling Cost, not Distribution Cost.	Similar to AS 2.	Cost of inventory does not include Selling & Distribution Cost as per AS 2.

Financial Reporting

Purchase under Deferred Settlement Terms	Difference between the purchase price of inventory for normal credit terms and the amount paid for deferred settlement terms is recognized as interest Expense.		Inventories purchased on deferred settlement terms are not explicitly dealt within the accounting standard on inventories.
Disclosure Requirements	Disclosure requirements are same except the following : a) Any write down and reversal of any write down b) Circumstances they led to reversal of a write down c) Carrying amount of inventory that are pledged as securities.		No specific requirements for disclosure.

Question 3

State the treatment of the following items with reference to 'Indian Accounting Standards' (AS) and International Financial Reporting Standards (IFRS):

- (i) Extra ordinary items
- (ii) Contingencies.

Answer

Indian Accounting Standards	International Financial Reporting Standards
Extraordinary Items	
Events or transactions, clearly distinct from the ordinary activities of the entity, which are not expected to recur frequently and regularly, are termed as extra-ordinary items. Disclosure of the nature and amount of such item is required in the income statement to perceive the impact of current and future profits.	Not allowed.

Contingencies	
Contingent Liabilities are disclosed unless the probability of outflows is remote.	Unrecognized possible losses and possible gains are disclosed.
Contingent gains are neither recognized nor disclosed.	

Question 4

State the treatment of the following items with reference to Indian Accounting Standards and IFRS:

- (i) Discontinued operations – definition and measurement
- (ii) Acquired intangible assets.

Answer**Treatment under Indian Accounting Standard and IFRS**

		Indian Accounting Standards	IFRS
(i)	Discontinuing operation-definition and measurement	Operations and cash flows that can be clearly distinguished for financial reporting and represent major line of business or geographical area of operations are discontinued operations. Measurement of discontinued operations is based on AS 24.	Definition of discontinued operations under IFRS is similar to Indian Accounting Standards. However, it also includes a subsidiary acquired exclusively with a view to resale. Discontinued operations are measured at lower of carrying amount and fair value less cost to sell.
(ii)	Acquired intangible assets	If recognition criteria are satisfied then it can be capitalized. All intangibles are amortized over useful life with rebuttable presumption of not exceeding 10 years. Revaluations are not permitted.	If recognition criteria are satisfied then it can be capitalized. It is amortized over useful life. Intangibles assigned an indefinite useful life are not amortized but reviewed at least annually for impairment. Revaluations are permitted in rare circumstances.

Financial Reporting

Question 5

State the treatment of the following items with reference to Indian Accounting Standards, IFRS and US GAAPs:

- (i) Impairment of Assets
- (ii) Business Combinations

Answer

Treatment under Indian AS, IFRS and USGAAPs

(i) Impairment of assets

	Indian AS	IFRS	USGAAPs
Timing of impairment review	Annually	Annually	Whenever events or changes in circumstances indicate that the carrying amount may not be recovered.
Asset is impaired if	Recoverable amount < Carrying amount	Recoverable amount < Carrying amount	Fair value < Carrying amount
Recoverable amount/Fair Value	Recoverable amount is higher of Net Selling Price and Value in use	Recoverable amount is higher of Net Selling Price Value in use	Fair Value is the amount at which an asset or liability could be bought or settled in a current transaction between willing parties
Cash flows for calculating value in use/fair value	Use discounted cash flows for calculating the value in use	Use discounted cash flows for calculating the value in use	Use discounted cash flows for calculating the fair value
Reversal of impairment loss	Whenever there is a change in the economic conditions	Whenever there is a change in the economic conditions	Prohibited

(ii) Business combinations

Business combinations	No particular Standard has been issued by ICAI till date. However all business acquisitions are business	All business acquisitions are Combinations as per IFRS 3	All business acquisitions are Combinations.
------------------------------	--	--	---

IAS, IFRS, their Interpretations and US GAAPs- An Overview

	combinations except pooling of interest method for certain amalgamations		
Date of acquisition	Date specified by the court or the purchase agreement	When control transferred	When assets received or equity issued
Valuation of assets and liabilities	In pooling of interests method-book value. In purchase method book value or fair value	Fair value	Fair value
Treatment of goodwill	Estimate the useful life and amortize accordingly	Capitalize and test for impairment	Capitalize and test for impairment
Negative goodwill	Disclose as capital reserve	Recognized in the income statement	Reduce fair value of non-monetary assets
Reverse acquisition	Acquisition accounting is based on form. Legal Acquirer is treated as acquirer and legal acquiree is treated as acquiree for legal as well as accounting purpose.	Acquisition accounting is based on substance. Accordingly legal acquirer is treated as acquiree and legal acquiree is treated as acquirer.	Similar to IFRS

Question 6

Explain the treatment of the following items with reference to Indian AS, IAS/IFRS and US GAAPs:

- Presentation of associate results;*
- Definition of joint venture;*
- Definition of subsidiary.*

Financial Reporting**Answer****(a) Presentation of associate results**

ASs	IFRS/IAS	US GAAPs
In consolidated financial statements; equity method is used. Share of post-tax results is shown. In standalone financials; at cost less impairment.	In consolidated financial statements; equity method is used. Share of post-tax results is shown. In standalone financial; at cost or at fair value in accordance with IAS 39.	In consolidated financial statements; similar to IFRS.

(b) Definition of joint venture

Contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control. Exclusion if it meets the definition of a subsidiary	Contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control. Exclusion if investment is held-for-sale.	A corporation owned and operated by small group of businesses as a separate and specific business or project for the mutual benefit of the members of the group.
--	---	--

(c) Definition of subsidiary

Definition of subsidiary is based on voting control or control over the composition of the board of directors. The existence of currently exercisable potential voting rights is not taken into consideration.	Control is presumed to exist when parent owns, directly or indirectly through subsidiaries, more than one half of an entity's voting power. The existence of currently exercisable potential voting rights is also taken into considerations. A parent could have control over an entity in circumstances where it holds less than 50% of the voting rights of an entity.	Similar to IFRS. However, a bipolar consolidation model is used, which distinguishes between a variable interest model and a voting interest model. Control can be direct or indirect and may exist with a lesser percentage of ownership (voting interest model).
--	---	---

Question 7

Explain the differences between IGAAP, USGAAP and IFRS with regard to

- (a) *True & Fair View;*
- (b) *Comparative Position;*
- (c) *Reporting Elements.*

IAS, IFRS, their Interpretations and US GAAPs- An Overview

Answer

- (a) **True & Fair View:** Under IFRS and IGAAP framework, there is an assumption that adoption of IFRS /IGAAP leads to a true and fair presentation, there is no such assumption under US GAAP.
- (b) **Comparative Position:** Under IGAAP and IFRS, comparative financial figures are to be provided for one previous years, whereas under USGAAP (SEC requirement for listed companies) comparatives are to be provided for two previous years except for Balance Sheet.
- (c) **Reporting Elements** - IFRS prescribes the minimum structure and content of financial statement including Statement of Changes in equity (in addition to Balance sheet, Income statement, Cash flow statement ,notes comprising significant accounting Policy and other explanatory notes). Under US GAAP in addition to statement of changes in Equity, Statement of Comprehensive Income is required. Both of these statements are not required under IGAAP.

Question 8

Explain the differences between IGAAP,USGAAP and IFRS with regard to Financial Statements.

Answer**Balance Sheet**

Basis of Difference	IFRS	IGAAP	US GAAP
Format	IFRS does not prescribe any format, but stipulates minimum line items like PPE, Investment property, Intangible assets, Financial assets, Biological assets, Inventory, receivables, etc.	IGAAP provides two format of Balance Sheet- Horizontal and Vertical format (Part I of schedule VI to the Companies Act, 1956).	US GAAP also does not prescribe any format , but Rule S-X of SEC stipulates for listed companies minimum line items to be disclosed either on face of Balance sheet or Notes to Accounts.
Order	Under IFRS, line items are presented in increasing order of liquidity.	In IGAAP, line items are presented in increasing order of liquidity.	Under US GAAP, items in assets and liabilities are presented in decreasing order of liquidity.
Consolidation	Consolidation of Financial statements		Under US GAAP consolidation of

Financial Reporting

	of subsidiaries is not compulsory until it is required under some other law or regulation		results of Subsidiaries and Variable interest entity (FIN 46R) is compulsory
Current/Non Current	An organisation has an option to adopt Current or Non current classification of assets and liabilities	No such requirement	Bifurcation into current & non-current items is compulsorily required.

Profit and Loss Statement

Basis of Difference	IFRS	IGAAP	US GAAP
Format	IFRS does not prescribe any standard format for income statement but prescribes minimum disclosure includes revenue, finance costs, share of post tax results of JV and associates using equity method.	Under Indian GAAP no format is prescribed, but minimum line items have been specified in Part II of schedule VI to Companies Act, 1956 including Aggregate Turnover, Gross Service revenue for Commission paid to Sole selling agent, Brokerage and discount on sales etc.	There is no prescribed format, SEC guidelines Rule S-X prescribe minimum line items to be shown on the face of income statement & suggest 2 alternatives a) a single step format where expenses are classified by function and b) a Multiple step format where Cost of sales is deducted from sales.
Prior Period Items	A prior period item/error should be corrected by retrospective effect by restatement of opening balance of assets, liabilities or equities	Requires separate disclosure of prior period in the current financial statement & no restatement of retained earnings are required.	Mandates retrospective application of error and requires restatement of comparative opening balance with suitable footnote disclosure.
Discounting	IFRS provides that where the inflow of cash is significantly deferred without interest, discounting is needed.	There is no concept of discounting under IGAAP.	US GAAP also permits discounting in certain cases for instance discounting is done in case of loans, debentures, bonds and upfront fees.

IAS, IFRS, their Interpretations and US GAAPs- An Overview

Change in accounting policy	IFRS requires retroactive application for the earliest period practical and adjustment of opening retained earning.	Under IGAAP, effect for change in accounting policy is given with prospective effect, if the same is material.	Requires prospective application of change in accounting policy and proforma disclosure of effect on income before extraordinary items on the face of income statement as separate section. Only in specific case retrospective is applicable
Bifurcation of Cost	There is no specific provision in this regard	There is no specific provision in this regard. There are certain disclosure requirements under varied AS which should be complied.	Total cost is required to be shown separately under: a) Cost of Sales b) Selling and Administration c) R & D
Extra ordinary Events	Disclosure is prohibited	Distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly. The nature and the amount of each extraordinary item should be separately disclosed in the statement of P & L in a manner that its impact on current profit or loss can be perceived.	Nature should be both: a) Infrequent b) Unusual Disclosed separately on the face of Income Statement net of Taxes after results from operations

Financial Reporting

Cash Flow Statement

Basis of Difference	IFRS	IGAAP	US GAAP
Exemptions	No exemptions.	Unlisted enterprises, enterprises with a turnover less than Rs.500 million and those with borrowings less than Rs.100 million	Limited exemptions for certain investment entities.
Direct/Indirect Method	Both allowed.	Both allowed. Listed companies- Indirect method Insurance companies- Direct Method.	Both allowed.
Periods to be presented	2 years	2 years	3 years
Interest paid	Operating and financing activity	Financing. In case of a financial enterprise, operating activities	Operating activity (to be disclosed by way of a note)
Interest received	Operating or investing activity	Investing. In the case of a financial enterprise, operating activity.	Operating activity
Dividends paid	Operating or financing	Financing	Financing
Tax payments	Operating	Operating	Operating(to be disclosed by way of a note)
Dividends received	Operating or investing	Investing. In the case of a financial enterprise, operating activity.	Operating

EXERCISES

Question 1

Write short notes on:

- (a) IASB.
- (b) FASB.
- (c) US GAAPs
- (d) AICPA

Question 2

Explain significant differences and similarities between Indian Accounting Standards, IAS/IFRS and US GAAPs on the issues of

- (a) Changes in accounting policies.
- (b) Inventories.

CORPORATE FINANCIAL REPORTING

BASIC CONCEPTS

Meaning of Financial Reporting

Corporate financial disclosure through published annual reports plays an important role in the efficient allocation of limited resources of a country as most of the investors make their decision based on such fundamental analysis. Adequacy of disclosure cannot be tested accurately and precisely since no definite test to measure it exists in financial reporting. But when information is reported outside the business enterprise, adequacy of disclosure can be tested through questionnaire. The basis of the test is the extent to which the items of information are helpful to users in making economic decision. The quantum and quality of information will vary according to the needs of the users. The preparation and publication of a company's annual report on practices and internal structures of corporate governance used by that same company may prove very useful to the shareholders or qualified investors. It may, however, be emphasized that financial reporting does not imply unidirectional and unlimited flow of all kinds of information. How companies can improve their disclosures to investors is an important one as it is perceived by different persons in different ways. Financial reporting is the communication of financial information of an enterprise to the external world. Measurement and disclosure are two dimensions of reporting process and these two aspects are interrelated. Together, they give corporate reporting its substance.

Corporate accounting Disclosure or financial reporting can be defined as a process through which a business enterprise communicates accounting and financial information with external parties.

Meaning of Financial Statements

After the financial year is over, it is essential to stop and look at the performance during the year. It is necessary to know whether it has been **a good or a bad year**. It can be known with the help of accounting records. With the help of these records some statements are prepared. *One of these statements shows whether the business has earned profit during the year or has suffered a loss. The other statement shows the financial position at the end of the year.* These statements are known as:

- (i) **Income Statement or Trading and Profit & Loss Account** which shows the profit or loss arising from the operation of business during the year.
- (ii) **Balance Sheet or Statement of Financial Position or Position Statement.** This statement shows the financial position of a business as at the end of the accounting

Financial Reporting

period. This statement consists of details of assets and liabilities of the business at particular **point of time**.

“The financial statements provide a summary of the accounts of business enterprise the balance sheet reflecting the assets, liabilities and capital as on a certain date the income statement showing the results of operations during a certain period.”

– **John N. Myer**

There is one more statement that shows the cash movement and that is cash flow statement.

A complete set of financial statements normally consists of a Balance Sheet, a Profit & Loss A/c and a Cash Flow Statement together with notes, statements and other explanatory materials that form integral parts of the financial statements. The component parts of financial statements are interrelated because they reflect different aspects of same transactions or other events.

Thus, Financial statements are a central feature of financial reporting. Principal financial statements are:

1. Balance Sheet (or statement of financial position).
2. Profit & Loss Account (or statement of earnings or income statement).
3. Cash Flow Statement (or statement of cash flows).

Such financial statements are called *general purpose financial statements*.

ICAI Conceptual Framework earmarks four principal qualitative characteristics viz., understandability, relevance, reliability and comparability. **According to the ICAI Conceptual Framework, materiality is not a principal qualitative characteristic.** , materiality is considered as a threshold limit, which needs to be judged before referring to any other qualities of any information provided in financial statements. If any piece of information does not fulfill the threshold criteria, it need not be considered further.

Content of Annual Report

A typical corporate annual report usually contains

- a balance sheet, profit and loss account, cash flow and / funds flow statement, and directors' report.
- Besides, the details of information and additional information are provided in the schedules and notes on accounts, which form parts of financial statements.
- Annual reports often contain useful supplementary financial and statistical data as well as management comments.
- Many companies in India now include Management Discussion and Analysis report, corporate governance report, chairman's statement, historical summary, operating positions, highlights of important data etc.

Question 1

What are the main limitations of financial statements?

Answer

Limitations of Financial Statements:

- (i) **Financial statements provide mostly historical data:** Elements of financial statements, i.e., assets, liabilities, income and expenses are measured mostly using historical cost. So in the balance sheet, most of the assets do not represent their current values. Users of accounts cannot understand the real value of the reporting entity from such balance sheet.

Under the historical cost accounting framework impliedly money capital is maintained - not the real value of capital. Thus the profit and loss statement does not represent real profit/loss.

Thus, under inflationary environment, traditional historical cost -based financial statement fail to reflect operating result and financial position of the reporting entity.
- (ii) **Financial Statements ignore substance and simply recognise form:** In India, financial statements are prepared recognising legal form of the transactions and ignoring the substance. **For example**, when the reporting entity uses assets on finance lease basis, value of such assets are not shown in the balance sheet. So the balance sheet fails to show the assets used for revenue generation. They may mislead the users of accounts about the degree of asset-turnover of the entity.
- (iii) **Financial statements are essentially based on going concern assumption:** AS-1 'Disclosure of Accounting Policies' suggests that going concern is a fundamental accounting assumption, a departure from which should be disclosed. In practice, the assumption has been applied universally. *Even if the reporting entity has become a sick industrial undertaking and waits for BIFR judgement, still its financial statements are prepared following going concern assumption showing its assets and liabilities at historical cost which is highly illogical and totally misleading.*
- (iv) **Financial Statements do not reflect cash flow:** In India, financial statements do not include a cash flow report to explain movement of cash during the accounting period. As such, there exists a big gulf between accrual profit and operational cash flow. However, now the listed companies/entities whose annual accounts are approved by the shareholders after 31.3.1995, are required to give a cash flow statement (as prescribed by SEBI) in their Annual Report.
- (v) **Financial statements are over-generalized:** Users of accounts are many; prominent among those are shareholders – existing and potential, employees, lenders and other suppliers, government/regulatory agencies, managers and the public at large. Every section has specific data requirement for making economic decisions. Sometimes the

Financial Reporting

interests of different sections may be conflicting in nature. Financial statements cannot meet the specific data requirement of the users. These are general purpose statements.

- (vi) **Not free from Bias:** The accountant has to make a choice out of various alternative accounting method e.g., methods of inventory valuation, depreciation, goodwill valuation. Since the subjectivity is inherent in personal judgement, the financial statements are, therefore not free from bias.
- (vii) **Variation in Accounting Practices:** As there are variations in accounting practices followed by different firms, a valid comparison of their financial statements is not possible.
- (viii) **Qualitative Aspects Ignored:** Financial statements portray the position in monetary terms. Financial statements do not consider nonmonetary aspects like efficiency of management, customer case etc.
- (ix) **Ignore the price level changes:** Different assets are shown at the historical cost. It therefore, ignores the price level changes or present value of the assets.

Question 2

Briefly explain the qualitative characteristics of Financial Statements.

Answer

Qualitative characteristics are the attributes that make the information provided in the financial statements useful to the users. The four principal qualitative characteristics are: (i) Understandability, (ii) Relevance, (iii) Reliability and (iv) Comparability.

- (i) **Understandability:** An essential, quality of the information provided in the financial statement is that it is readily understandable by the users. For this purpose, users are deemed to have reasonable knowledge of business and economic activities. However, information about complex matters should be included in the financial statements which is relevant to the users of accounts for their economic decision making although this may be too difficult for certain users to understand.
- (ii) **Relevance:** To be useful, information must be relevant to the decision making needs of all the users. Information has the quality of relevance when it influences the economic decisions of users by helping them to evaluate past, present or future events or confirming, or correcting their past evaluations.

Relevance of information is affected by its nature and materiality. In some cases, the nature of information alone is sufficient to determine its relevance. In other cases, both the nature and materiality are important:

- (iii) **Reliability:** To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which, it either purports to represent or could reasonably be expected to represent.

Reliability of the financial statement information is dependent on faithful representation, substance over form, neutrality, prudence, and completeness. If information is to represent faithfully the transactions and other events, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely by their legal form. To be reliable, the information contained in financial statement must be neutral i.e. free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a pre-determined result or outcome. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty. To be reliable, information in financial statements must also be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

- (iv) **Comparability:** Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position and performance. An important implication of this qualitative characteristic is that users should be informed of the accounting policies employed in the preparation of the financial statements, any changes in those policies and the effects of such changes.

Question 3

One of the important factors generally considered for awarding shields and plaques in India for 'best presented accounts' is that the information presented in the accounts make useful disclosures.

What are actually looked into in this regard?

Answer

A financial report of an enterprise is arguably the most important medium of dissemination of such information. With a view to promote better standards in the presentation of information in the financial report, the Institute of Chartered Accountants of India has been holding an annual competition for the **ICAI Awards for Excellence in Financial Reporting** (earlier known as 'Competition for the Best Presented Accounts').

ICAI List of documents forming part of Annual Report

- Balance Sheet
- Profit and Loss Account
- Director's Report
- Chairman's Statement or speech at the Annual General Meeting
- Declaration that the Annual Report submitted have been circulated to the shareholders.

Financial Reporting

In order to ascertain whether the nature and quality of information presented in the accounts make useful disclosures, the following features are generally looked into:

1. Statement of changes in financial position.
2. Sufficient details of revenues / expenses for financial analysis e.g. distinction between manufacturing cost, selling cost and administration cost.
3. Use of vertical form as against the conventional T form; judicious use of schedules, use of sub-totals, manner of showing comparative figures, ease of getting at figures.
4. To what extent additional financial information is provided to the readers through charts and graphs.
5. Financial highlights and ratios including earnings per share.
6. Inclusion of one or more bits of information like value added statement, break up of operations, organization chart, location of factories / branches, human resource accounting, inflation adjusted accounts, social accounts etc.

Question 4

What are the objectives of financial reporting?

Answer

The following are the objectives of financial reporting:

- (i) **Useful Information to Users**-To provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.
- (ii) **Assess Prospective Cash Inflows**-To provide information to help investors, creditors, and others to assess the amount, timing and uncertainty of prospective net cash inflows to the related enterprise.
- (iii) **Information about the economic resources of an enterprise** -To provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events and circumstances that change resources and claims to those resources.
- (iv) **Financial Performance**- To provide information about an enterprise's financial performance during a period. To give information about an enterprise's performance provided by measures of earnings and its components .
- (vi) **Information about Utilization of Cash**- To provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, including cash dividends and other distributions of enterprise's resources to owners, and about other factors that may affect an enterprise's liquidity or solvency.

- (vii) **How Responsibility is Discharged-** To provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it.
- (viii) **Decision making-** To provide information that is useful to managers and directors in making decisions in the interest of owners.

Question 5

The following balances are extracted from the books of Raj Ltd., a real estate company, on 31st March, 2010:

	Dr.	Cr. (Rs.'000)
Sales		2,760
Purchases of materials	1,218	
Share capital fully paid		100
Land purchased in the year as stock	73	
Leasehold premises	42	
Creditors		463
Debtors	735	
Directors' salaries	39	
Wages	111	
Work in progress on 01.04.2009	210	
Sub-contractors' cost	894	
Equipment, Fixtures and Fittings at cost on 01.04.2009	264	
Stock on 01.04.2009	59	
Profit and Loss Account, Credit Balance on 01.04.2009		128
Secured Loan		112
Bank Overdraft		105
Interest on Loan and Overdraft	22	
Depreciation on Equipment on 01.04.2009		164
Administration Expenses	147	
Office Salaries	<u>18</u>	
	<u>3,832</u>	<u>3,832</u>

You also obtain the following information:

- (a) On 31st March, 2010, stock on hand including the land acquired during the year, is valued at Rs. 1,42,000. Work in progress at that date is valued at Rs. 1,40,000.
- (b) On 1st October, 2009 the company moved to new premises. The premises are on a 12 years lease and the lease premium paid amounted to Rs. 42,000. The company used

Financial Reporting

sub-contract labour of Rs. 40,000 and materials at cost of Rs. 38,000 in the refurbishment of the premises. These are to be considered as part of the cost of leasehold premises.

- (c) *A review of the debtors reveals specific doubtful debts of Rs. 35,000 and the directors wish to provide for these together with a general provision based on 2% of the balance.*
- (d) *Depreciation on equipment, fixtures and fittings is provided at 15% on the written down value.*
- (e) *Raj Ltd. sued Bright Ltd. for supplying defective materials which has been written off as valueless. The Directors are confident that Bright Ltd. will agree for a settlement of Rs. 50,000.*
- (f) *The directors propose a dividend of 25%. Ignore dividend distribution tax.*
- (g) *Rs. 20,000 is to be provided as audit fee.*
- (h) *The company will provide 10% of the pre tax profit as bonus to employees in the accounts before charging the bonus.*
- (i) *Income tax to be provided at 50% of the profits.*

You are required:

- (i) *to prepare the company's financial statements for the year ended 31st March, 2010 as near as possible to proper form of company final accounts; and*
- (ii) *to prepare a set of Notes to accounts including significant accounting policies.*

Notes: *Workings should form part of your answer.*

Previous year figures can be ignored.

Figures are to be rounded off to nearest thousands.

Answer

Raj Ltd.

Balance Sheet as at 31st March, 2010

(Rs. in thousands)

I SOURCES OF FUNDS

(1) Shareholders' funds:

(a) Capital	100
(b) Reserves and surplus(175.85+9)	<u>184.85</u>

		284.85
(2)	Loan funds:	
(a)	Secured loans	112
(b)	Unsecured loans	—
		<u>112</u>
	TOTAL	<u>396.85</u>
II	APPLICATION OF FUNDS	
(1)	Fixed assets:	
(a)	Gross block	384
(b)	Less: Depreciation	<u>184</u>
(c)	Net block	200
(d)	Capital work in progress	—
		200
(2)	Investments	—
(3)	Current assets, loans and advances:	
(a)	Inventories	282
(b)	Sundry debtors	686
(c)	Cash and bank balances	—
(d)	Other current assets	—
(e)	Loans and advances	—
		<u>968</u>
	Less: Current Liabilities and Provisions:	
(a)	Liabilities	588
(b)	Provisions	<u>183.15</u>
		<u>771.15</u>
	Net current assets	196.85
(4)	Miscellaneous expenditure (to the extent not written off or adjusted)	—
	TOTAL	<u>396.85</u>
	Contingent Liabilities	Nil

Financial Reporting

Profit and Loss Account
for the year ended 31st March, 2010*(Rs. in thousands)***INCOME**

Sales 2,760

EXPENDITURE

Manufacturing Expenses 2,205

Other Expenses 297

Interest 22

Depreciation on Fixed Assets 202,544

Profit before Taxation 216

Provision for Tax 130

Net Profit 86

Balance brought forward from previous year 128

Profit Available for Appropriation 214

Appropriations

Amount transferred to General Reserve* (10% of 86) 9

Proposed Equity Dividend 25

Amount transferred to CDT** (16.609% of 25) 4.15 38.15Balance Carried Forward 175.85

* As per Companies (Transfer of Profits to Reserves) Rules, the amount to be transferred to the reserves shall not be less than 10% of the current profits since proposed dividend exceeds 20% of the paid up capital. In this answer, it has been assumed that Rs. 9,000 have been transferred to General Reserve. The students may transfer any amount based on a suitable percentage not less than 10%.

** Dividend distributed by an Indian Company is exempt from income-tax in the hands of many shareholders. The Indian Company is liable to pay Dividend Distribution Tax (DDT) @ 16.609 percent (i.e. inclusive of surcharge and education cess) on such dividends)

NOTES ON ACCOUNTS FOR THE YEAR ENDED 31ST MARCH, 2010

1. **Accounting Policies:** The Accounts have been prepared primarily on the historical cost convention. The significant accounting policies followed by the Company are stated below:
- (a) *Fixed Assets:* Fixed assets are shown at cost less depreciation. Cost comprises the purchase price and other attributable expenses.
 - (b) *Depreciation on Fixed Assets:* Depreciation on equipment, fixtures and fittings has been provided on written down value method at 15% per annum. Lease-hold premises/improvements are being amortised over the lease period.
 - (c) *Inventories:* Inventories are valued at the lower of historical cost or the net realizable value.
2. **Other Matters:**
- (a) The cost of leasehold premises includes the cost of refurbishment to the extent of Rs. 78,000 (Materials Rs. 38,000 + Labour Rs. 40,000).
 - (b) Bright Ltd. has been sued for supplying defective materials. Settlement of Rs. 50,000 is hopeful however it has not been recognized in the accounts as it represents contingent gain.

Working Notes:(Rs. in
thousands)

(1) Manufacturing Expenses

Stocks at Commencement:

Opening Stock	59	
Opening Work-in-progress	<u>210</u>	269
Purchases of Materials (1,218 – 38)		1,180
Purchase of Land		73
Wages		111
Sub-contractors' cost (894 – 40)		<u>854</u>
		2,487
Less: Stocks at close:		
Closing Stock	142	
Closing Work-in-progress	<u>140</u>	<u>282</u>
		<u>2,205</u>

Financial Reporting

(2)	Other Expenses	
	Administration Expenses	147
	Office Salaries	18
	Directors' Salaries	39
	Provision for Doubtful Debts [35 + 2% of (735 – 35)]	49
	Audit Fees	20
	Bonus (See Working Note 3)	<u>24</u>
		<u>297</u>
(3)	Bonus	
	Sales	2,760
	Less: Manufacturing Expenses	2,205
	Other Expenses (excluding bonus)	273
	Depreciation	20
	Interest	<u>22</u>
		<u>2,520</u>
	Pre-tax Profit	<u>240</u>
	Bonus (10%)	<u>24</u>
(4)	Fixed Assets	
(a)	Gross block	
	Equipment, Fixtures and Fittings	264
	Leasehold Premises (42 + 40 + 38) **	<u>120</u>
		<u>384</u>

** According to AS 19 'Leases' (issued in 2001), the leases are classified as finance lease and operating lease. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. An operating lease is a lease other than finance lease. At the inception of lease, assets under finance lease are capitalized in the books of the lessee with the corresponding liability of lease obligations as against the operating lease wherein lease payments are recognized as an expense in the profit and loss account on a systematic basis (i.e. straight line) over the lease term without capitalizing the asset. The person (lessor/lessee) presenting the leased asset in his balance sheet should also consider the additional requirements of AS 6 and AS 10.

(b) Depreciation		
Equipment, Fixtures and Fittings		
as on 1.4.2009	164	
For the year [15% on (264 – 164)]	<u>15</u>	179
Cost of Leasehold Premises written off**		5
$[(42 + 40 + 38) \times 1/12 \times 1/2]$		<u>—</u>
		<u>184</u>
(5) Provision for Taxation		
Profit as per Profit and Loss Account		216
Add back: Provision for doubtful debts	49	
Cost of Leasehold premises written off	5	
Dep. on equipment, fixtures and fittings	<u>15</u>	<u>69</u>
		285
Less: Depreciation under Income-tax Act		<u>25</u>
		<u>260</u>
Provision for Tax (@ 50%)		130
(It has been assumed that depreciation calculated under Income-tax Act amounts to Rs. 25,000)		
(6) Current Liabilities		
(a) Sundry creditors		463
(b) Bank overdraft		105
(c) Audit fees		<u>20</u>
		<u>588</u>
(7) Provisions		
(a) Provision for taxation		130
(b) Proposed dividend		25
(c) Provision for bonus		<u>24</u>
		<u>179</u>

Financial Reporting

Question 6

On 30th September, 2007 Beta Enterprises Ltd. was incorporated with an Authorised Capital of Rs. 50 lakhs. Its first accounts were closed on 31st March, 2008 by which time it had become a listed company with an issued subscribed and paid up Capital of Rs. 40 lakhs in 4,00,000 Equity Shares of Rs. 10 each.

The company started off with two lines of business namely 'Engineering Division' and 'Chemicals Division', with equal asset base with effect from 1st April, 2008. The 'Ceramics Division' was added by the company on 1st April, 2009. The following data is gathered from the books of account of Beta Enterprises Ltd. :

Trial Balance as on 31st March, 2010

(Rupees in 000's)

	Dr.	Cr.
Engineering Division sales	–	6,000
Cost of Engineering Division sales	2,600	–
Chemicals Division sales	–	8,000
Cost of sales of Chemicals Division	4,300	–
Ceramics Division Sales	–	1,500
Cost of sales of Ceramics Division	900	–
Administration costs	2,000	–
Distribution costs	1,500	–
Dividend-Interim	1,200	–
Fixed Assets at cost	9,000	–
Depreciation on Fixed Assets	–	1,500
Stock on 31st March, 2010	400	–
Trade Debtors	440	–
Cash at Bank	160	–
Trade Creditors	–	500
Equity Share Capital in shares of Rs. 10 each	–	4,000
Retained Profits	<u>–</u>	<u>1,000</u>
	<u>22,500</u>	<u>22,500</u>

Additional Information:

- (a) Administration costs should be split between the Divisions in the ratio of 5 : 3 : 2.
- (b) Distribution costs should be spread over the Divisions in the ratio of 3 : 1 : 1.
- (c) Directors have proposed a Final Dividend of Rs. 8 lakhs.
- (d) Some of the users of Ceramics Division are unhappy with the product and have lodged claims against the company for damages of Rs. 7.5 lakhs. The claim is hotly contested by the company on legal advice.
- (e) Fixed Assets worth Rs. 30 lakhs were added in the Ceramics Division on 1.4.2009.
- (f) Fixed Assets are written off over a period of 10 years on straight line basis in the books. However for Income tax purposes depreciation at 20% on written down value of the assets is allowed by Tax Authorities.
- (g) Income tax rate may be assumed at 35%.
- (h) During the year Engineering Division has sold to Alpha Ltd. goods having a sales value of Rs. 25 lakhs. Mr. Gamma, the Managing Director of Beta Enterprises Ltd. owns 100% of the issued Equity Shares of Alpha Ltd. The sales made to Alpha Ltd. were at normal selling price of Beta Enterprises Ltd.

You are required to prepare Profit and Loss Account for the year ended 31st March, 2010 and the Balance Sheet as at the date. Your answer should include notes and disclosures as per Accounting Standards.

Answer**Beta Enterprises Ltd.****Profit and Loss Account for the year ending 31st March, 2010**

		Rs. '000
Sales		15,500
Cost of Sales		<u>(7,800)</u>
		7,700
Distribution costs		(1,500)
Administration costs		<u>(2,000)</u>
Profit before tax		4,200
Provision for tax	1,239	
Deferred tax (35% of Rs. 660)	<u>231</u>	<u>(1,470)</u>
Profit after tax		2,730
Amount transferred to General Reserve*		
(10% of 2730)		(273)
Amount transferred to CDT*(16.609% of 2000)		(332.20)

Financial Reporting

Dividends (Rs.1,200 + Rs. 800)	(2000)
Profit for the year	124.8
Retained profit brought forward (Rs. 1,000 – Rs. 210)	<u>790</u>
Retained Profit carried forward	<u>914.80</u>

Beta Enterprises Ltd.
Balance Sheet as at 31st March, 2010

<i>Liabilities</i>	<i>Amount</i>	<i>Assets</i>	<i>Amount</i>
	<i>Rs.'000</i>		<i>Rs.'000</i>
<i>Share Capital</i>		<i>Fixed Assets</i>	
Issued and subscribed		Gross block	9,000
4,00,000 shares of Rs.10 each, fully paid up	4,000	Less: Depreciation	<u>1,500</u> 7,500
<i>Reserves and Surplus</i>		<i>Current Assets, Loans and Advances</i>	
Retained profits	914.8	(a) Current assets	
Reserve	273	Stock	400
<i>Deferred Tax Liability</i>	441		
<i>Current liabilities and Provisions</i>		Debtors	440
(a) Current liabilities		Cash at bank	<u>160</u> 1,000
Creditors	500	(b) Loans and Advances	NIL
(b) Provisions			
Provision for tax	1,239		
Proposed dividend	800		
CDT	<u>332.2</u>		
	<u>8,500</u>		<u>8,500</u>

Notes to Accounts:**1. Segmental Disclosures (Business Segments)**

(Figures in Rs. 000's)

	<i>Engineering Division</i>	<i>Chemical Division</i>	<i>Ceramics division</i>	<i>Total</i>
Sales	<u>6,000</u>	<u>8,000</u>	<u>1,500</u>	<u>15,500</u>
Cost of Sales	2,600	4,300	900	7,800
Administration Cost (5:3:2)	1,000	600	400	2,000
Distribution Cost (3:1:1)	900	300	300	1,500

Corporate Financial Reporting

Profit/Loss	<u>1,500</u>	<u>2,800</u>	<u>(100)</u>	<u>4,200</u>
	<u>6,000</u>	<u>8,000</u>	<u>1,500</u>	<u>15,500</u>
Original cost of Assets (Equal Capital Base)	3,000	3,000	3,000	9,000
Depreciation @ 10% p.a.				
For the year ended 31.3.2009	300	300	NIL	600
For the year ended 31.3.2010	300	300	300	900

Note: Ceramics division is a reportable segment as per assets criteria.

2. Tax computation

	<i>(Rs. in 000's)</i>
Profit before tax for the year ended 31.3.2010	4,200
Add: Depreciation provided in the books (300 + 300 + 300)	<u>900</u>
	5,100
Less: Depreciation as per Income Tax Act (480 + 480 + 600)	<u>1,560</u>
Taxable Income	<u>3,540</u>
Tax at 35%	<u>1,239</u>

3. Deferred Tax liability (as per AS 22 on Accounting for Taxes on Income)

	<i>Rs.'000</i>
Opening Timing Difference on 1.4.2009	
WDV of fixed assets as per books	5,400
WDV of fixed assets as per Income Tax Act	<u>4,800</u>
Difference	<u>600</u>
Deferred Tax Liability @ 35% on 600	210
This has been adjusted against opening balance of retained profits.	
Current year (ended 31st March, 2010)	<i>Rs.'000</i>
Depreciation as per	900
Depreciation as per Income Tax Act (480 + 480 + 600)	<u>1,560</u>
Difference	<u>660</u>
Deferred Tax Liability @ 35% on 660 (to be carried forward)	231

Financial Reporting

4. **Contingent Liabilities not provided:** Company is contesting claim for damages for Rs. 7,50,000 and as such the same is not acknowledged as debts.
5. **Related Party Disclosure:** Para 3 of AS 18 lists out related party relationships. It includes individuals owning, directly or indirectly, an interest in voting power of reporting enterprise which gives them control or significant influence over the enterprises, and relatives of any such individual. In the instant case, Mr. Gamma as a managing director controls operating and financial actions of Beta Enterprise Ltd. He is also owning 100% share Capital of Alpha Ltd. thereby exercising control over it. Hence, Alpha Ltd. is a related party as per para 3 of AS 18.

Disclosure to be made:

Name of the related party

and nature of relationship

Nature of the transaction

Volume of the transaction

Alpha Ltd.

common director

Sale of goods at normal commercial terms

Sales to Alpha Ltd. worth Rs. 25 lakhs.

EXERCISES**Question 1**

In order to enhance the level of disclosure by the listed companies, SEBI has amended clause 32 of the listing agreement. After amendment what disclosures are required?

Question 2

Marks Limited manufactures a special type of Computer. The company has a software division for developing programs with respect to specialized areas such as Medical Imaging, Process Control and Information System.

Following is the draft of Profit and Loss Account prepared by the Chief Accountant for the year ended 31st March, 2010

	Figures in lakhs	
	Rs.	Rs.
Sales: Hardware division	1,200	
Software division	<u>800</u>	2,000
Opening stock of finished goods	90	
Raw materials consumed	400	
Direct labour — Hardware division	250	
— Software division	150	
Variable production overheads — Hardware division	150	
— Software division	50	
Fixed Production Overheads [including interest and depreciation]		
— Hardware division	290	
— Software division	100	
Closing stock of finished goods	<u>(180)</u>	<u>1,300</u>
Gross Profit		700
Administration Expenses	50	
Selling and distribution expenses	<u>150</u>	<u>200</u>
Profit before tax		500
Tax at 40%		<u>200</u>
Profit after tax		300
Add: Balance of profit b/f		<u>200</u>
Profit carried forward		<u>500</u>

Financial Reporting

The following further informations are given:

- (a) 10 employees, who were working in a software division were made redundant on account of abandoning a particular software program and each of them were paid a compensation of Rs. 5 lakhs on the average. This cost is included in direct labour.
- (b) The fixed production overheads of Hardware division included interest of Rs. 50 lakhs and depreciation of Rs. 50 lakhs. Further this sum of Rs. 50 lakhs included an additional depreciation of Rs. 10 lakhs on a special machinery used in the manufacturer of computer parts for better display purposes.
- (c) During the year, the Software division supplied a special program for a foreign firm on a consideration of Rs. 100 lakhs. It was found on June 1st, 2010 that the foreign firm has become bankrupt. The company had received an advance of Rs. 50 lakhs in the year ended 31st March, 2010 from the foreign firm.
- (d) The Software division was involved in a special program on hospital information system. The company so far incurred a sum of Rs. 20 lakhs as salaries and Rs. 10 lakhs as overheads, which were included in direct labour and fixed production overheads respectively. Management feels that a further Rs. 50 lakhs will be required to complete the program, so that it can be effectively marketed.
- (e) Included in Fixed production overheads of Hardware division is a sum of Rs. 50 lakhs being the cost of prototype computers manufactured by the company. These are not to be sold, but to be kept back for demonstrating the medical imaging software program.
- (f) The company manufactured 550 computers during the year. It has a policy of valuing finished stock of goods at a standard cost of Rs. 1.8 lakhs per computer.

You are required to :

- (i) Redraft the Profit and Loss Account for the year ended 31st March, 2010 with reference to relevant Accounting Standards issued by the institute.
- (ii) Compute the value of Closing Stock of finished goods.

[Answer: Profit after tax Rs. 312 Lakhs; Surplus carried to balance sheet Rs. 512 lakhs; For the purpose of tax computation, Rs. 520 lakhs have been taken as taxable profits.]

As per AS-2 (Revised) on Valuation of Inventories, finished stock of goods should be valued on the basis of absorption costing. In this case finished stock has been valued at a standard cost of Rs. 1.8 lakhs per computer which incidentally synchronizes with the value computed on the basis of absorption costing (Cost per computer $990/550 = \text{Rs. 1.8 lakhs.}$)]

ACCOUNTING FOR CORPORATE RESTRUCTURING

BASIC CONCEPTS

Corporate restructuring (CR) is a broad term to denote significant reorientation or realignment of the investment (assets) and/or financing (liabilities) structure of a company through conscious management action with a view to drastically alter the quality and quantum of its future cash flow streams. This broad definition includes such corporate actions as mergers, acquisitions/ amalgamations/ absorption, divestitures, demergers (spin-offs) and debt-equity changes.

The different methods of restructuring and their implications are discussed below:

- (1) External Restructuring
 - (a) Asset-based (portfolio) restructuring
 - (b) Financial or capital restructuring
- (2) Internal Restructuring
 - (a) Portfolio restructuring (Cost reduction through closure of units, redundancy programmes etc.)
 - (b) Organisational restructuring (Management or organisational restructuring involving decentralisation, delayering, product-market based divisionalisation, matrix structure etc.)
- (3) Amalgamation, absorption or external reconstruction.

Asset-based Restructuring

(i) Mergers and Acquisitions (M & A)

In the Indian context the term merger is used to denote consolidation of separate legal entities, not necessarily of similar sizes, into one through a statutory process of amalgamation. the motives of merger or acquisition are the same and both involve transfer of ownership and control of assets and the right to manage corporate cash flows.

For Example-Reliance Natural and Reliance Power Merger

(ii) Divestitures and Asset Swaps

Divestiture refers to disposal (in favour of third party) of business units, subsidiary

Financial Reporting

companies or significant holdings in associates, often for cash. Asset swap, on other hand, entails simultaneous divesting and acquisition of each others' business by two companies, settling the difference in valuation, if any in cash.

(iii) Demergers or Spin-offs

Demerger involves spinning off (profitable or robust) parts of a diversified company into a new company and undertaking free distribution of the shares of the new (spun-off) company to the shareholders of the original company. For Example-RIL gets split among several companies between two brothers-Mukesh and Anil Ambani.

Unlike in a divestiture, the "parent" company or group does not receive any proceeds from a demerger as the demerged company's shares are directly distributed to the "parent" company's shareholders.

Capital and Financial Restructuring

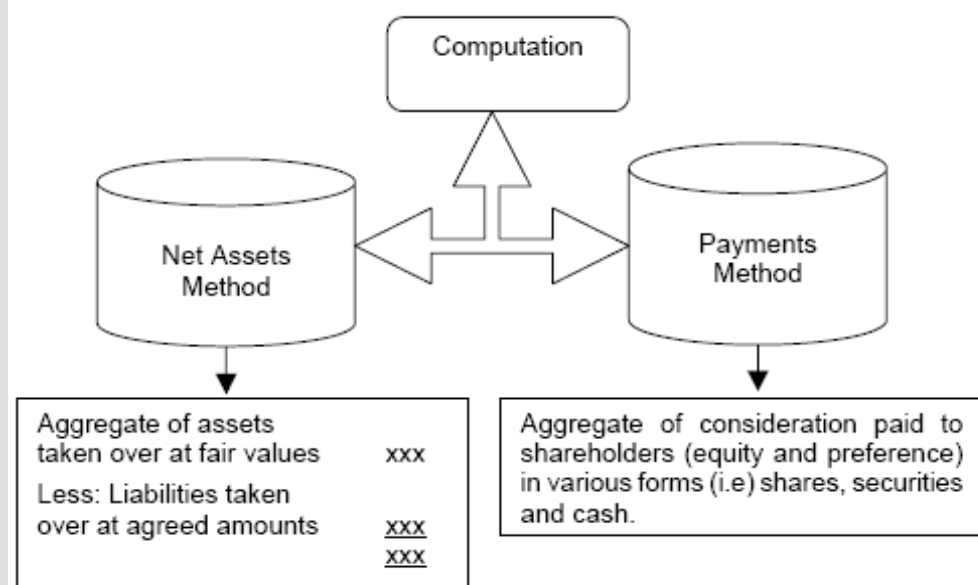
This type of restructuring includes buy back of shares, debt to equity conversions etc.

Purchase Consideration

In the problem information for PC will be available in two ways. Firstly, list of the various consideration paid is given, one should take care to add only those items paid to the members of the company and not to any outsider.

Secondly, assets and liabilities taken over are given in the problem. Purchase consideration in this case will be the net assets taken over by the amalgamated company.

Computation of Purchase consideration



Discharge of Purchase Consideration

The purchase consideration in the case of amalgamation is payable to the shareholders, both preference and equity, of the transferor company. This may be discharged by issuing preference and/or equity shares of the transferee company and partly by cash. Often the transferee company discharges claims of the preference shareholders of the transferor company at a premium or at a discount by issuing preference shares. Similarly, claims of the equity shareholders of the transferor company may also be discharged by issuing equity shares of the transferee company either at par or at premium or at discount. Debentures paid to shareholders of the transferor company will be considered as the part of purchase consideration but debentures paid to the debenture holders or to the sundry creditors of the transferor company will not form part of purchase consideration.

Methods of Accounting for Amalgamation

There are two main methods of accounting for amalgamations:

- (a) The Pooling of Interests Methods (for amalgamation in the nature of merger), and
- (b) The Purchase Method (for amalgamation in the nature of purchase).

The first method is applied in case of amalgamation in the nature of merger and the second method in case of amalgamation in the nature of purchase.

- **The Pooling of Interests Method:** Under this method the assets, liabilities and all reserves of the transferor company are recorded by transferee company at their existing carrying amounts unless the carrying amounts are to be adjusted to follow a uniform set of accounting policies. The balance of the profit and loss account of the transferor company should be aggregated with the corresponding balance of the transferee company or transferred to general reserve, if any.

The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of transferor company should be adjusted in reserves.

Therefore, no 'goodwill' arises in case of amalgamations in the nature of merger.

- **The Purchase Method :** Here the assets and liabilities of the transferor company should be incorporated in the transferee company's financial statements in either of the following two ways:
 - (i) at their existing carrying amounts; or
 - (ii) the purchase consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation.

<i>Particulars</i>	<i>Pooling of Interest</i>	<i>Purchase</i>
Discharge of purchase consideration	Mainly shares; cash for settling dues of fractional shares	Shares, or other securities, or cash
Assets and Liabilities	Recorded at book values	Recorded at Fair values
Reserves	Are brought into and recorded in the books	Only statutory reserves are recorded by debit to Amalgamation adjustment account (reversed when statutory conditions are met)
Difference between consideration and net value of assets	Not recorded – difference is adjusted against reserves	Recorded as goodwill or capital reserve

- The 'Amalgamation Adjustment A/c' should be disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet of the transferee company.
- When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the adjustment account should be reversed.

Question 1

The Balance Sheet of Z Ltd. as at 31st March, 2010 is given below. In it, the respective shares of the company's two divisions namely S Division and W Division in the various assets and liabilities have also been shown.

	(All amounts in crores of Rupees)		
	S Division	W Division	Total
<i>Fixed Assets:</i>			
Cost	875	249	
Less: Depreciation	<u>360</u>	<u>81</u>	
Written-down value	<u>515</u>	<u>168</u>	683
Investments			97
<i>Net Current assets:</i>			
Current Assets	445	585	
Less: Current Liabilities	<u>270</u>	<u>93</u>	
	<u>175</u>	<u>492</u>	<u>667</u>
			<u>1,447</u>
<i>Financed by:</i>			
Loan funds		15	417
<i>Own funds:</i>			
Equity share capital: shares of Rs. 10 each			345
Reserves and surplus			<u>685</u>
			<u>1,447</u>

Loan funds included, inter alia, Bank Loans of Rs. 15 crore specifically taken for W Division and Debentures of the paid up value of Rs. 125 crore redeemable at any time between 1st October, 2009 and 30th September, 2010.

On 1st April, 2010 the company sold all of its investments for Rs. 102 crore and redeemed all the debentures at par, the cash transactions being recorded in the Bank Account pertaining to S Division.

Then a new company named Y Ltd. was incorporated with an authorized capital of Rs. 900 crore divided into shares of Rs. 10 each. All the assets and liabilities pertaining to W Division were transferred to the newly formed company; Y Ltd. allotting to Z Ltd.'s shareholders its two fully paid equity shares of Rs. 10 each at par for every fully paid equity share of Rs. 10 each held in Z Ltd. as discharge of consideration for the division taken over.

Y Ltd. recorded in its books the fixed assets at Rs. 218 crore and all other assets and liabilities at the same values at which they appeared in the books of Z Ltd.

Financial Reporting

You are required to:

- (i) Show the journal entries in the books of Z Ltd.
- (ii) Prepare Z Ltd.'s Balance Sheet immediately after the demerger and the initial Balance Sheet of Y Ltd. (Schedules in both cases need not be prepared).
- (iii) Calculate the intrinsic value of one share of Z Ltd. immediately before the demerger and immediately after the demerger; and
- (iv) Calculate the gain, if any, per share to the shareholders of Z Ltd. arising out of the demerger.

Answer

(i) Journal Entries in Z Ltd.'s Books

	(Rs. in crores)	
	Dr. Amount Rs.	Cr. Amount Rs.
Bank Account (Current Assets)	Dr. 102	
To Investments		97
To Profit and Loss Account (Reserves and Surplus)		5
(Sale of investments at a profit of Rs. 5 crore)		
Debentures (Loan Funds)	Dr. 125	
To Bank Account (Current Assets)		125
(Redemption of debentures at par)		
Current Liabilities	Dr. 93	
Bank Loan (Loan Funds)	Dr. 15	
Provision for Depreciation	Dr. 81	
Reserves and Surplus (Loss on Demerger)	Dr. 645	
To Fixed Assets		249
To Current Assets		585
(Assets and liabilities pertaining to W Division taken out of the books on transfer of the division to Y Ltd.)		

(ii) (a) Z Ltd.'s Balance Sheet after demerger

	<i>Rs. in crores</i>	<i>Rs. in crores</i>
Fixed Assets		
Gross Block	875	
Less: Depreciation	<u>360</u>	515
Net Current Assets		
Current Assets	422	
Less: Current Liabilities	<u>270</u>	<u>152</u>
		<u>667</u>
Financed by		
Shareholders' Funds		
Equity Share Capital	345	
Reserves and Surplus	<u>45</u>	390
Loan Funds		<u>277</u>
		<u>667</u>

Working Notes:

		<i>Rs. in crores</i>
1. Reserves and Surplus		
Balance as on 31st March, 2010		685
Add: Profit on sale of investments		<u>5</u>
		690
Less: Loss on demerger		<u>645</u>
Balance shown in balance sheet after demerger		<u>45</u>
2. Loan Funds		
Balance as on 31st March, 2010		417
Less: Bank Loan transferred to Y Ltd.	15	
Debentures redeemed	<u>125</u>	<u>140</u>
Balance shown in balance sheet after demerger		<u>277</u>
3. Current Assets		
Balance as on 31st March, 2010		445
Add: Cash received from sale of investments		<u>102</u>
		547
Less: Cash paid to redeem debentures		<u>125</u>
Balance in balance sheet after demerger		<u>422</u>

Financial Reporting

(b) Initial Balance Sheet of Y Ltd.

	<i>Rs. in crores</i>	<i>Rs. in crores</i>
Fixed Assets		218
Net Current Assets		
Current Assets	585	
Less: Current Liabilities	<u>93</u>	<u>492</u>
		<u>710</u>
Financed by		
Shareholders' funds:		
Capital (Issued for acquisition of business)		690
Capital Reserve*		5
Loan Funds		<u>15</u>
		<u>710</u>

(iii) Calculation of intrinsic value of one share of Z Ltd.

	<i>Rs. in crores</i>
<i>Before demerger</i>	
Fixed Assets	683
Net current assets Rs.(667 + 102 – 125)	<u>644</u>
	1,327
Less: Loan funds Rs.(417 – 125)	<u>292</u>
	<u>1,035</u>
Intrinsic Value per share = Rs. $\frac{1,035 \text{ crores}}{34.5 \text{ crores}}$ = Rs.30 per share	
<i>After demerger</i>	
Fixed Assets	515
Net Current Assets Rs.(175 + 102 – 125)	<u>152</u>
	667
Less: Loan funds	<u>277</u>
	<u>390</u>
Intrinsic Value of one share = Rs. $\frac{390 \text{ crores}}{34.5 \text{ crores}}$ = Rs. 11.30 per share	

* Capital Reserve has been calculated as

	<i>Rs. in crores</i>
Purchase consideration	690
Less: Assets transferred	710
Loan funds transferred	<u>(-15)</u>
Capital reserve	<u>695</u>
	<u>5</u>

(iv) Gain per share to Shareholders:

After demerger, for every share in Z Ltd. the shareholder holds 2 shares in Y Ltd.

	Rs.
Value of one share in Z Ltd.	11.30
Value of two shares in Y Ltd. (Rs. 10 × 2)	<u>20.00</u>
	31.30
Less: Value of one share before demerger	<u>30.00</u>
Gain per share	<u>1.30</u>

The gain per share amounting Rs. 1.30 is due to appreciation in the value of fixed assets by Y Ltd.

Question 2

Ksha Ltd. and Yaa Ltd. are two companies. On 31st March, 2009 their Balance Sheets were as under:

	(Rs. in crores)			
	Ksha Ltd.		Yaa Ltd.	
	Rs.	Rs.	Rs.	Rs.
<i>Sources of funds:</i>				
<i>Share Capital:</i>				
Authorised:		<u>500</u>		<u>500</u>
Issued: Equity shares of Rs. 10 each fully paid up		300		200
<i>Reserves and surplus:</i>				
Capital reserves	40		20	
Revenue reserves	700		425	
Surplus	<u>10</u>	<u>750</u>	<u>5</u>	<u>450</u>
Owners' funds		1,050		650
Loan funds		<u>250</u>		<u>350</u>
		<u>1,300</u>		<u>1,000</u>
<i>Fund employed in:</i>				
<i>Fixed assets:</i>				
Cost	1,000		700	
Less: Depreciation	<u>400</u>	600	<u>300</u>	400
<i>Net current assets:</i>				
Current assets	2,000		1,500	
Less: Current liabilities	<u>1,300</u>	<u>700</u>	<u>900</u>	<u>600</u>
		<u>1,300</u>		<u>1,000</u>

Financial Reporting

Ksha Ltd. has 2 divisions very profitable division A and loss making division B. Yaa Ltd. similarly has 2 divisions very profitable division B and loss making division A.

The two companies decided to reorganize. Necessary approvals from creditors and members and sanction by High Court have been obtained to the following scheme:

1. Division B of Ksha Ltd. which has fixed assets costing Rs. 400 crores (written down value Rs. 160 crores), Current assets Rs. 900 crores, Current liabilities Rs. 750 crores and loan funds of Rs. 200 crores is to be transferred at Rs. 125 crores to Yaa Ltd.
2. Division A of Yaa Ltd. which has fixed assets costing Rs. 500 crores (depreciation Rs. 200 crores), Current assets Rs. 800 crores, Current liabilities Rs. 700 crores, and loan funds Rs. 250 crores is to be transferred at Rs. 140 crores to Ksha Ltd.
3. The difference in the two considerations is to be treated as loan carrying interest at 15% per annum.
4. The directors of each of the companies revalued the fixed assets taken over as follows:
 - (i) Division of A of Yaa Ltd. taken over: Rs. 325 crores.
 - (ii) Division B of Ksha Ltd. taken over: Rs. 200 crores.

All the other assets and liabilities are recorded at the balance sheet values.

- (a) The directors of both the companies ask you to prepare the balance sheets after reconstruction (showing the corresponding figures before reconstruction).
- (b) Master Richie Rich, who owns 50,000 equity shares of Ksha Ltd. and 30,000 equity shares of Yaa Ltd. wants to know whether he has gained or lost in terms of net asset value of equity shares on the above reorganizations.

Answer

(a)

Ksha Ltd.

Balance Sheet as at 31st March, 2009

(Rs. in crores)

	Schedule	After reconstruction	Before reconstruction
I SOURCES OF FUNDS			
(1) Shareholders' funds:			
(a) Capital	A	300	300
(b) Reserves and surplus	B	<u>800</u> 1,100	<u>750</u> 1,050
(2) Loan funds	C	<u>315</u>	<u>250</u>

Accounting For Corporate Restructuring

TOTAL	<u>1,415</u>	<u>1,300</u>
II APPLICATION OF FUNDS		
(1) Fixed assets:		
(a) Gross block	925	1,000
(b) Less: Depreciation	<u>160</u>	<u>400</u>
(c) Net block	765	600
(2) Investments	—	—
(3) Current assets	1,900	2,000
Less: Current liabilities	<u>1,250</u>	<u>1,300</u>
Net current assets	<u>650</u>	<u>700</u>
TOTAL	<u>1,415</u>	<u>1,300</u>

Schedules to Balance Sheet

(Rs. in crores)

	<i>After reconstruction</i>	<i>Before reconstruction</i>
A. Share Capital		
Authorised:		
50 crores equity shares of Rs. 10 each	<u>500</u>	<u>500</u>
Issued and subscribed:		
30 crores equity shares of Rs. 10 each fully paid up	<u>300</u>	<u>300</u>
B. Reserves and surplus		
Capital reserves	40	40
Add: Capital profit on reconstruction	<u>50</u>	—
	90	40
Revenue reserves	700	700
Surplus	<u>10</u>	<u>10</u>
	<u>800</u>	<u>750</u>

Financial Reporting

C. Loan funds

Yaa Ltd. (Interest @ 15% p.a.)	15	—
Others	<u>300</u>	<u>250</u>
	<u>315</u>	<u>250</u>

Yaa Ltd.

Balance Sheet as at 31st March, 2009

				(Rs. in crores)	
	Schedule	After reconstruction		Before reconstruction	
I SOURCES OF FUNDS					
(1) Shareholders' funds:					
(a) Capital	A	200		200	
(b) Reserves and surplus	B	<u>465</u>	665	<u>450</u>	650
(2) Loan funds (others)		<u>300</u>			<u>350</u>
TOTAL		<u>965</u>			<u>1,000</u>
II APPLICATION OF FUNDS					
(1) Fixed assets:					
(a) Gross block		400		700	
(b) Less: Depreciation		<u>100</u>		<u>300</u>	
(c) Net block			300		400
(2) Investments			—		—
(3) Current assets, loans and advances					
(a) Current assets		1,600		1,500	
(b) Loan to Ksha Ltd.		<u>15</u>		—	
		1,615		1,500	
Less: Current liabilities		<u>950</u>		<u>900</u>	
Net current assets			<u>665</u>		<u>600</u>
TOTAL		<u>965</u>			<u>1,000</u>

Schedules to Balance Sheet

(Rs. in crores)

	<i>After reconstruction</i>	<i>Before reconstruction</i>
A. Share Capital		
Authorised:		
50 crores equity shares of Rs. 10 each	<u>500</u>	<u>500</u>
Issued and subscribed:		
20 crores equity shares of Rs. 10 each fully paid up	<u>200</u>	<u>200</u>
B. Reserves and surplus		
Capital reserves	20	20
Add: Capital profit on reconstruction	<u>15</u>	<u>—</u>
	35	20
Revenue reserves	425	425
Surplus	<u>5</u>	<u>5</u>
	<u>465</u>	<u>450</u>

(b) Net asset value of Master Riche Rich's holdings

	<i>Pre- reorganisation Rs.</i>	<i>Post- reorganisation Rs.</i>	<i>Change (Gain) Rs.</i>
Net asset value of one equity share:			
(Refer to working notes)			
Ksha Ltd.	35.00	36.67	1.67
Yaa Ltd.	32.50	33.25	0.75
Net asset value of equity shares owned by Master Riche Rich			
Ksha Ltd. (50,000 shares)	17,50,000	18,33,500	83,500
Yaa Ltd. (30,000 shares)	<u>9,75,000</u>	<u>9,97,500</u>	<u>22,500</u>
	<u>27,25,000</u>	<u>28,31,000</u>	<u>1,06,000</u>

Master Riche Rich has gained in terms of net asset value of his holdings as indicated in the last column.

Financial Reporting

Working Notes:

(1) Ksha Ltd.

(i)

Amounts (Rs. in crores)

	<i>Pre-re- organisatio n figures</i>	<i>Sale of divisio n B</i>	<i>Purchas e of division A of Yaa Ltd.</i>	<i>Post-re- organisation figures</i>
	(a)	(b)	(c)	(d) = (a) – (b) + (c)
Fixed assets:				
Cost	1,000	400	325	925
Depreciation	<u>(400)</u>	<u>(240)</u>	—	<u>(160)</u>
Written down value (I)	<u>600</u>	<u>160</u>	<u>325</u>	<u>765</u>
Current assets	2,000	900	800	1,900
Current liabilities	<u>(1,300)</u>	<u>(750)</u>	<u>(700)</u>	<u>(1,250)</u>
Net current assets (II)	<u>700</u>	<u>150</u>	<u>100</u>	<u>650</u>
Funds employed [(I) + (II)]	1,300	310	425	1,415
Loan funds:				
Others (III)	(250)	(200)	(250)	(300)
Yaa Ltd. (balance payable on transfers of divisions i.e. 140 – 125) (IV)	—	—	—	<u>(15)</u>
Net worth (I + II – III – IV)	<u>1,050</u>	<u>110</u>	<u>175</u>	<u>1,100</u>

(ii) Sale of division B	(Rs. in crores)
Transfer price	125
Cost of the division (160 + 150 – 200)	<u>110</u>
Capital Profit	<u>15</u>
(iii) Purchase of division A of Yaa Ltd.	(Rs. in crores)
Agreed value of assets less liabilities taken over (325 + 100 – 250)	175
Less: Transfer price	<u>140</u>
Capital Profit	<u>35</u>

Accounting For Corporate Restructuring

(iv)				(Rs. in crores)	
	Pre-reorganisation net worth			1,050	
	Add: Capital profit on				
	Sale	15			
	Acquisition	<u>35</u>		<u>50</u>	
	Post-reorganisation net worth			<u>1,100</u>	
	No. of equity shares		30 crores		
	Net asset value of equity share:		Rs.		
	Pre-reorganisation	1,050/30 = 35.00			
	Post-reorganisation	1,100/30 = 36.67 (rounded off)			
(2)	Yaa Ltd.				
(i)				Amounts (Rs. in crores)	
		<i>Pre-re- organisation figures</i>	<i>Sale of division A</i>	<i>Purchase of division B of Ksha Ltd.</i>	<i>Post-re- organisation figures</i>
		(a)	(b)	(c)	(d) = (a) – (b) + (c)
	Fixed assets:				
	Cost	700	500	200	400
	Depreciation	<u>(300)</u>	<u>(200)</u>	—	<u>(100)</u>
	Written down value (I)	<u>400</u>	<u>300</u>	<u>200</u>	<u>300</u>
	Current assets	1,500	800	900	1,600
	Current liabilities	<u>(900)</u>	<u>(700)</u>	<u>(750)</u>	<u>(950)</u>
	Net current assets (II)	<u>600</u>	<u>100</u>	<u>150</u>	<u>650</u>
	Funds employed [(I) + (II)]	1,000	400	350	950
	Loan funds—others (III)	<u>(350)</u>	<u>(250)</u>	<u>(200)</u>	<u>(300)</u>
		650	150	150	650
	Ksha Ltd. (balance on account of transfers of divisions) (IV)	—	—	—	<u>15</u>
	Net worth (I + II – III + IV)	<u>650</u>	<u>150</u>	<u>150</u>	<u>665</u>

Financial Reporting

(ii)	Purchase of division B of Ksha Ltd.	Sale of division A
Value of assets less liabilities	150	150
(Value to Yaa Ltd.) (200 + 900 – 750 – 200)		(300 + 800 – 700 – 250)
Less: Transfer Price	<u>125</u>	<u>140</u>
Capital Profit	<u>25</u>	<u>(10)</u>
(iii) Pre-reorganisation net worth		650
Add: Capital profit on acquisition	25	
Sale	<u>(10)</u>	<u>15</u>
Post-reorganisation net worth		<u>665</u>
No. of equity shares	20 crores	
Net asset value of equity share:	Rs.	
Pre-reorganisation	650/20 = 32.50	
Post-reorganisation	665/20 = 33.25	

Question 3

The Balance Sheet of Gunshot Ltd. as on 31.3.2010 is given:

Liabilities	Amount	Assets	Amount
Share Capital :		Fixed Assets	2,700
Equity shares of Rs. 10 each	800	Non-trade Investments	300
Securities Premium	100	Stock	600
General Reserve	780	Sundry Debtors	360
Profit and Loss Account	120	Cash and Bank	160
10% Debenture	2,000		
Creditors	<u>320</u>		
	<u>4,120</u>		<u>4,120</u>

Gunshot Ltd. buy back 16,000 shares of Rs. 20 per share. For this purpose, the Company sold its all non-trade investments for Rs. 3,20,000. Give Journal Entries with full narrations effecting the buy back.

Answer**Journal Entries for Buy-back of shares of Gun Shot Ltd.**

			Rs.	Rs.
(i)	Bank A/c	Dr.	3,20,000	
	To Non-trade Investments			3,00,000
	To Profit & Loss A/c			20,000
	(Being the entry for sale of Non-trade Investments)			
(ii)	Shares Buy back A/c (16,000 x Rs. 20)	Dr.	3,20,000	
	To Bank A/c			3,20,000
	(Being purchase of 16,000 shares @ Rs.20 per share)			
(iii)	Equity Share Capital A/c (16,000 x Rs.10)	Dr.	1,60,000	
	Buy-back Premium (16,000 x Rs.10)	Dr.	1,60,000	
	To Shares Buy-back A/c			3,20,000
	(Being cancellation of shares bought back)			
(iv)	Securities Premium A/c	Dr.	1,00,000	
	General Reserve	Dr.	60,000	
	To Buy-back Premium			1,60,000
	(Being adjustment of buy-back premium)			
(v)	General Reserve	Dr.	1,60,000	
	To Capital Redemption Reserve			1,60,000
	(Being the entry for transfer of General Reserve to Capital Redemption Reserve to the extent of face value of equity shares bought back)			

Question 4

A Ltd. and B Ltd. were amalgamated on and from 1st April, 2010. A new company C Ltd. was formed to take over the business of the existing companies. The Balance Sheets of A Ltd. and B Ltd. as on 31st March, 2010 are given below:

				(Rs. in lakhs)	
Liabilities	A Ltd.	B Ltd.	Assets	A Ltd.	B Ltd.
Share Capital			Fixed Assets		
Equity Shares of Rs. 100 each	800	750	Land and Building	550	400

Financial Reporting

12% Preference shares of Rs.100 each	300	200	Plant and Machinery	350	250
Reserves and Surplus			Investments	150	50
Revaluation Reserve	150	100	Current Assets, Loans and Advances		
General Reserve	170	150			
Investment Allowance Reserve	50	50	Stock	350	250
Profit and Loss Account	50	30	Sundry Debtors	250	300
Secured Loans			Bills Receivable	50	50
10% Debentures (Rs. 100 each)	60	30	Cash and Bank	300	200
Current Liabilities and provisions					
Sundry Creditors	270	120			
Bills Payable	<u>150</u>	<u>70</u>			
	<u>2.000</u>	<u>1.500</u>		<u>2.000</u>	<u>1.500</u>

Additional Information:

- (1) 10% Debentureholders of A Ltd. and B Ltd. are discharged by C Ltd. issuing such number of its 15% Debentures of Rs. 100 each so as to maintain the same amount of interest.
- (2) Preference shareholders of the two companies are issued equivalent number of 15% preference shares of C Ltd. at a price of Rs. 150 per share (face value of Rs. 100).
- (3) C Ltd. will issue 5 equity shares for each equity share of A Ltd. and 4 equity shares for each equity share of B Ltd. The shares are to be issued @ Rs. 30 each, having a face value of Rs. 10 per share.
- (4) Investment allowance reserve is to be maintained for 4 more years.

Prepare the Balance Sheet of C Ltd. as on 1st April, 2010 after the amalgamation has been carried out on the basis of Amalgamation in the nature of purchase.

Answer

Balance Sheet of C Ltd.
as at 1st April, 2010

Liabilities	Amount	Assets	(Rs. in lakhs) Amount
SHARE CAPITAL		FIXED ASSETS	
70,00,000 Equity shares of Rs.10 each	700	Goodwill	20
		Land and Building	950

Accounting For Corporate Restructuring

5,00,000 Preference shares of Rs. 100 each (all the above shares are allotted as fully paid-up pursuant to contracts without payment being received in cash)		500 Plant and Machinery	600
		INVESTMENTS	200
RESERVES AND SURPLUS		CURRENT ASSETS, LOANS AND ADVANCES	
Securities Premium Account	1,650	A Current Assets	
Investment Allowance Reserve	100	Stock	600
SECURED LOANS		Sundry debtors	550
15% Debentures	60	Cash and Bank	500
UNSECURED LOANS	—	B Loans and Advances	
CURRENT LIABILITIES AND PROVISIONS		Bills Receivable	100
A Current Liabilities		MISCELLANEOUS EXPENDITURE (to the extent not written off or adjusted)	
Acceptances	220	Amalgamation Adjustment Account	100
Sundry Creditors	390		
B Provisions	—		
	<u>3,620</u>		<u>3,620</u>

Working Notes:

(Rs. in lakhs)

A Ltd.

B Ltd.

(1) Computation of Purchase consideration

(a) Preference shareholders:

$$\left(\frac{3,00,00,000}{100} \right) \text{ i.e. } 3,00,000 \text{ shares} \times \text{Rs. } 150 \text{ each} \quad 450$$

$$\left(\frac{2,00,00,000}{100} \right) \text{ i.e. } 2,00,000 \text{ shares} \times \text{Rs. } 150 \text{ each} \quad 300$$

(b) Equity shareholders:

$$\left(\frac{8,00,00,000 \times 5}{100} \right) \text{ i.e. } 40,00,000 \text{ shares} \times \text{Rs. } 30 \text{ each} \quad 1,200$$

Financial Reporting

	$\left(\frac{7,50,00,000 \times 4}{100} \right)$ i.e. 30,00,000 shares × Rs. 30 each	<u>900</u>
	Amount of Purchase Consideration	<u>1,650</u>
(2)	Net Assets Taken Over	<u>1,200</u>
	Assets taken over:	
	Land and Building	550
	Plant and Machinery	350
	Investments	150
	Stock	350
	Sundry Debtors	250
	Bills receivable	50
	Cash and bank	<u>300</u>
		2,000
	Less: Liabilities taken over:	
	Debentures	40
	Sundry Creditors	270
	Bills payable	<u>150</u>
		<u>460</u>
	Net assets taken over	1,540
	Purchase consideration	<u>1,650</u>
	Goodwill	<u>110</u>
	Capital reserve	<u>90</u>

Question 5

The following are the Balance Sheets of Big Ltd. and Small Ltd. for the year ending on 31st March, 2010. (Figures in crores of rupees):

	Big Ltd.	Small Ltd.
Equity share capital – in equity shares of Rs. 10 each	50	40
Preference share capital – in 10% preference shares of Rs. 100 each	–	60
Reserves and Surplus	<u>200</u>	<u>150</u>
	250	250

Accounting For Corporate Restructuring

Loans – Secured	<u>100</u>	<u>100</u>
Total funds	<u>350</u>	<u>350</u>
Applied for: Fixed assets at cost less depreciation	150	150
Current assets less current liabilities	<u>200</u>	<u>200</u>
	<u>350</u>	<u>350</u>

The present worth of fixed assets of Big Ltd. is Rs. 200 crores and that of Small Ltd. is Rs. 429 crores. Goodwill of Big Ltd. is Rs. 40 crores and of Small Ltd. is 75 crores.

Small Ltd. absorbs Big Ltd. by issuing equity shares at par in such a way that intrinsic net worth is maintained.

Goodwill account is not to appear in the books. Fixed assets are to appear at old figures.

- (a) Show the Balance Sheet after absorption.
- (b) Draft a statement of valuation of shares on intrinsic value basis and prove the accuracy of your workings.

Answer**(a) Small Ltd.****Balance Sheet as at 1st April, 2010**

	Schedule No.	(Rs. in crores)
I SOURCES OF FUNDS		
(1) Shareholders' funds:		
(a) Capital	A	125
(b) Reserves and surplus	B	<u>375</u>
		500
(2) Loan funds:		
Secured loans	C	<u>200</u>
TOTAL		<u>700</u>
II APPLICATION OF FUNDS		
(1) Fixed assets:		
Net block	D	300
(2) Investments		—
(3) Net current assets	E	<u>400</u>
TOTAL		<u>700</u>

Financial Reporting*(Rs. in Crores)*

Schedules to Accounts:

A Share Capital:

6.5 crores equity shares of Rs. 10 each (of the above shares, 2.5 crores equity shares are allotted as fully paid-up for consideration other than cash)	65
60 lakhs 10% Preference shares of Rs. 100 each	<u>60</u>
	<u>125</u>

B Reserves and Surplus:

As per last Balance Sheet	150
Capital Reserve	<u>225</u>
	<u>375</u>

C Secured Loans:

As per last Balance Sheet	100
Taken over on absorption of Big Ltd.	<u>100</u>
	<u>200</u>

D Fixed Assets:

As per last Balance Sheet	150
Taken over on absorption of Big Ltd.	<u>150</u>
	<u>300</u>

E Net Current Assets:

As per last Balance Sheet	200
Taken over on absorption of Big Ltd.	<u>200</u>
	<u>400</u>

(b) Valuation of shares on intrinsic value basis

(i)	<i>Big Ltd.</i>	<i>Small Ltd.</i> <i>(Rs. in crores)</i>
Equity share capital	50	40
Reserves and Surplus	<u>200</u>	<u>150</u>
	250	190
Goodwill agreed upon	40	75
Increase in the value of fixed assets (Present worth less book value)	<u>50</u>	<u>279</u>
	<u>340</u>	<u>544</u>

Accounting For Corporate Restructuring

(ii)	<i>Big Ltd.</i>	<i>Small Ltd.</i>
Number of Equity shares	5 crores	4 crores
Intrinsic value per equity share	Rs. 68	Rs. 136
(iii) Ratio of intrinsic value of shares in the two companies	1 : 2	
Since the shares are to be issued at par, the number of equity shares of Rs. 10 each to be issued to maintain the intrinsic net worth = 5 crores / 2 = 2.5 crores		
(iv) Statement to prove the accuracy of workings		
	<i>(Rs. in crores)</i>	
(1) Equity share capital (after absorption)		65
Reserves and Surplus (after absorption)		<u>375</u>
		440
Add: Unrecorded value of goodwill (40 + 75)		115
Add: Unrecorded incremental value of fixed assets (50+279)		<u>329</u>
		<u>884</u>
(2) Number of equity shares	6.5 crores	
(3) Intrinsic value of an equity share (884/6.5)	Rs. 136	

Working Note:**Calculation of Capital Reserve on Absorption**

	<i>(Rs. in crores)</i>
Fixed Assets taken over	150
Net current assets taken over	<u>200</u>
	350
Less: Secured loans taken over	<u>100</u>
Net Assets taken over	250
Less: Purchase consideration	<u>25</u>
	<u>225</u>

Financial Reporting

Question 6

Given below is the Balance Sheet of H Ltd. as on 31.3.2009:

(Figures in Rs. lakhs)

Equity share capital (in equity shares of Rs. 10 each)	4.00	Block assets less depreciation to date	6.00
10% preference share capital	3.00	Stock and debtors	5.30
General reserve	1.00	Cash and bank	0.70
Profit and loss account	1.00		
Creditors	<u>3.00</u>		
	<u>12.00</u>		<u>12.00</u>

M Ltd. another existing company holds 25% of equity share capital of H Ltd. purchased at Rs. 10 per share.

It was agreed that M Ltd. should take over the entire undertaking of H Ltd. on 30.9.2009 on which date the position of current assets (except cash and bank balances) and creditors was as follows:

Stock and debtors	4 lakhs
Creditors	2 lakhs

Profits earned for half year ended 30.09.2009 by H Ltd. was Rs. 70,500 after charging depreciation of Rs. 32,500 on block assets. H Ltd. declared 10% dividend for 2008-09 on 30.08.2009 and the same was paid within a week.

Goodwill of H Ltd. was valued at Rs. 80,000 and block assets were valued at 10% over their book value as on 31.3.2009 for purposes of take over. Preference shareholders of H Ltd. will be allotted 10% preference shares of Rs. 10 each by M Ltd. Equity shareholders of H Ltd. will receive requisite number of equity shares of Rs. 10 each from M Ltd. valued at Rs. 10 per share.

- Compute the purchase consideration.
- Explain, how the capital reserve or goodwill, if any, will appear in the Balance Sheet of M Ltd. after absorption.

Answer

(a) Calculation of Purchase Consideration (for net assets of H Ltd. taken over)

Assets taken over:	Rs.
Goodwill as agreed	80,000
Block Assets at 10% over their book value as on 31.3.2009	6,60,000

(agreed value for purposes of take over)	
Stock and Debtors	4,00,000
Cash and Bank (See Working Note)	<u>1,33,000</u>
	12,73,000
Less: Liabilities taken over:	
Creditors	<u>2,00,000</u>
	<u>10,73,000</u>

<i>Calculation of Shares Allotted:</i>	Rs.
Net Assets taken over	10,73,000
Less: Allotment of 10% preference shares to preference shareholders of H Ltd.	<u>3,00,000</u>
	7,73,000
Less: Belonging to M Ltd. ($\frac{1}{4} \times 7,73,000$)	<u>1,93,250</u>
Payable to other equity shareholders	<u>5,79,750</u>
Number of equity shares of Rs. 10 each to be issued (valued at Rs. 10 each) = 57,975	

<i>Calculation of Capital Reserve:</i>	Rs.
Net Assets taken over	10,73,000
Less: Preference shares to be allotted	3,00,000
Equity shares to be allotted	5,79,750
Cost of investments	<u>1,00,000</u>
Capital Reserve	<u>93,250</u>

Alternatively, Capital Reserve may be computed as follows:

Value of investments in H Ltd.	1,93,250
Less: Cost of investments	<u>1,00,000</u>
	<u>93,250</u>

(b) Balance Sheet of M Ltd. as at 30th September, 2009 (Extract)

		Rs.
Capital Reserve	93,250	
Less: Goodwill	<u>80,000</u>	13,250

Financial Reporting

Working Note:**Ascertainment of Cash and Bank Balances as on 30th September, 2009****Balance Sheet as at 30th September, 2009**

	Rs.		Rs.
Equity Share Capital	4,00,000	Block Assets	6,00,000
10% Preference Share Capital	3,00,000	Less: Depreciation	<u>32,500</u>
General Reserve	1,00,000	Stock and Debtors	4,00,000
Profit and Loss Account:		Cash and Bank	1,33,000
Balance brought forward	1,00,000	(Balancing figure)	
Add: Profit for the first half	<u>70,500</u>		
	1,70,500		
Less: Dividend on preference			
share capital paid	30,000		
Dividend on			
equity share			
capital paid	<u>40,000</u>		
	<u>70,000</u>		
	1,00,500		
Creditors	<u>2,00,000</u>		
	<u>11,00,500</u>		<u>11,00,500</u>

Question 7

AB Ltd. and MB Ltd. decide to amalgamate and to form a new company AM Ltd. The following are their balance sheets as at 31.3.2010:

Liabilities	AB Ltd.	MB Ltd.	Assets	AB Ltd.	MB Ltd.
Share Capital			Fixed Assets	7,50,000	2,00,000
(Rs. 100) each	10,00,000	6,00,000	Investments:		
General Reserve	1,00,000	50,000	1,500 Shares in MB	3,50,000	—
Investment Allowance			4,000 Shares in AB	—	5,00,000
Reserve	40,000	30,000			
12% Debentures			Current Assets	4,00,000	1,00,000
(Rs. 100 each)	3,00,000	1,00,000			
Sundry Creditors	<u>60,000</u>	<u>20,000</u>			
	<u>15,00,000</u>	<u>8,00,000</u>		<u>15,00,000</u>	<u>8,00,000</u>

Calculate the amount of purchase consideration for AB Ltd. and MB Ltd. and draw up the balance sheet of AM Ltd. after considering the following:

- Assume amalgamation is in the nature of purchase.
- Fixed assets of AB Ltd. are to be reduced by Rs. 50,000 and that of MB Ltd. are to be taken at Rs. 3,00,000.
- 12% debentureholders of AB Ltd. and MB Ltd. are discharged by AM Ltd. by issuing such number of its 15% debentures of Rs. 100 each so as to maintain the same amount of interest.
- Shares of AM Ltd. are of Rs. 100 each.

Also show, how the investment allowance reserve will be treated in the Financial Statement assuming the Reserve will be maintained for 3 years.

Answer

Calculation of Purchase consideration

- Value of Net Assets of AB Ltd. and MB Ltd. as on 31st March, 2010

		AB Ltd. Rs.		MB Ltd. Rs.
Assets taken over:				
Fixed Assets	7,00,000		3,00,000	
Current Assets	<u>4,00,000</u>	11,00,000	<u>1,00,000</u>	4,00,000
Less: Liabilities taken over:				
Debentures	2,40,000*		80,000**	
Sundry Creditors	<u>60,000</u>	<u>3,00,000</u>	<u>20,000</u>	<u>1,00,000</u>
		<u>8,00,000</u>		<u>3,00,000</u>

$$* 3,00,000 \times \frac{12}{100} \times \frac{100}{15} = \text{Rs. } 2,40,000$$

$$** 1,00,000 \times \frac{12}{100} \times \frac{100}{15} = \text{Rs. } 80,000$$

- Value of Shares of AB Ltd. and MB Ltd.

The value of shares of AB Ltd. is Rs. 8,00,000 plus 1/4 of the value of the shares of MB Ltd.

Similarly, the value of shares of MB Ltd. is Rs. 3,00,000 plus 2/5 of the value of shares of AB Ltd.

Let 'a' denote the value of shares of AB Ltd. and 'm' denote the value of shares of MB Ltd. then

Financial Reporting

$$a = 8,00,000 + 1/4 m ; \text{ and}$$

$$m = 3,00,000 + 2/5 a.$$

Substituting the value of m,

$$a = 8,00,000 + 1/4 (3,00,000 + 2/5 a)$$

$$a = 8,00,000 + 75,000 + 1/10 a$$

$$9/10 a = 8,75,000$$

$$a = 9,72,222$$

$$m = 3,00,000 + 2/5 (9,72,222)$$

$$m = 6,88,889$$

(iii) Amount of Purchase Consideration

	<i>AB Ltd.</i>	<i>MB Ltd.</i>
	<i>Rs.</i>	<i>Rs.</i>
Total value of shares (as determined above)	9,72,222	6,88,889
Less: Internal investments:		
2/5 for shares held by MB Ltd.	3,88,889	
1/4 for shares held by AB Ltd.	<u> </u>	<u>1,72,222</u>
Amount due to outsiders	<u>5,83,333</u>	<u>5,16,667</u>

Purchase Consideration will be satisfied by AM Ltd. as follows:

	<i>AB Ltd.</i>	<i>MB Ltd.</i>
	<i>Rs.</i>	<i>Rs.</i>
In shares (of Rs. 100 each)	5,83,300	5,16,600
In cash	33	67
(iv) Net Amount of Goodwill/Capital Reserve		
	<i>Rs.</i>	<i>Rs.</i>
Total Purchase Consideration		
AB Ltd.	5,83,333	
MB Ltd.	<u>5,16,667</u>	11,00,000
Less: Net Assets taken over		
AB Ltd.	8,00,000	
MB Ltd.	<u>3,00,000</u>	<u>11,00,000</u>
		<u>Nil</u>

(Alternatively, the calculations may be made separately for both the companies)

Balance Sheet of AM Ltd.
as at 31st March, 2010

<i>Liabilities</i>	<i>Amount</i>	<i>Assets</i>	<i>Amount</i>
	<i>Rs.</i>		<i>Rs.</i>
Share Capital 10,999 shares of Rs. 100 each	10,99,900	Goodwill	—
(All the above shares are allotted as fully paid-up for consideration other than cash)		Fixed Assets Investments	10,00,000
Investment Allowance Reserve	70,000		—
15% Debentures	3,20,000	Current Assets	4,99,900
Sundry Creditors	80,000	(5,00,000 – 33 – 67)	
		Miscellaneous Expenditure	
		(to the extent not written off or adjusted):	
		Amalgamation Adjustment Account	70,000
	<u>15,69,900</u>		<u>15,69,900</u>

Treatment of Investment Allowance Reserve

According to para 39 (read with para 18) of AS 14 on Accounting for Amalgamations, where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are to be complied with, the statutory reserves of the transferor company should be recorded in the financial statements of the transferee company. The corresponding debit should be given to a suitable account head (e.g., 'Amalgamation Adjustment Account') which should be disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account should be reversed.

Question 8

The summarised Balance Sheets of R Ltd. and P Ltd. for the year ending on 31.3.2010 are as under:

	<i>R Ltd.</i>	<i>P Ltd.</i>		<i>R Ltd.</i>	<i>P Ltd.</i>
	<i>Rs.</i>	<i>Rs.</i>		<i>Rs.</i>	<i>Rs.</i>
Equity share Capital (in shares of Rs. 10 each)	24,00,000	12,00,000	Fixed Assets	55,00,000	27,00,000
			Current Assets	25,00,000	23,00,000

Financial Reporting

8% Preference Share Capital (in shares of Rs. 10 each)	8,00,000	–		
10% Preference Share Capital (in shares of Rs. 10 each)	–	4,00,000		
Reserves	30,00,000	24,00,000		
Current Liabilities	<u>18,00,000</u>	<u>10,00,000</u>		
	<u>80,00,000</u>	<u>50,00,000</u>	<u>80,00,000</u>	<u>50,00,000</u>

The following information is provided:

		R Ltd. Rs.	P Ltd. Rs.
(1)	(a) Profit before tax	10,64,000	4,80,000
	(b) Taxation	4,00,000	2,00,000
	(c) Preference dividend	64,000	40,000
	(d) Equity dividend	2,88,000	1,92,000
(2)	The equity shares of both the companies are quoted in the market. Both the companies are carrying on similar manufacturing operations.		
(3)	R Ltd. proposes to absorb P Ltd. as on 31.3.2010. The terms of absorption are as under:		
	(a)	Preference shareholders of P Ltd. will receive 8% preference shares of R Ltd. sufficient to increase the income of preference shareholders of P Ltd. by 10%.	
	(b)	The equity shareholders of P Ltd. will receive equity shares of R Ltd. on the following basis:	
	(i)	The equity shares of P Ltd. will be valued by applying to the earnings per share of P Ltd. 75% of price earnings ratio of R Ltd. based on the results of 2009-2010 of both the companies.	
	(ii)	The market price of equity shares of R Ltd. is Rs. 40 per share.	
	(iii)	The number of shares to be issued to the equity shareholders of P Ltd. will be based on the above market value.	
	(iv)	In addition to equity shares, 8% preference shares of R Ltd. will be issued to the equity shareholders of P Ltd. to make up for the loss in income arising from the above exchange of shares based on the dividends for the year 2009-2010.	

- (4) The assets and liabilities of P Ltd. as on 31.3.2010 are revalued by professional valuer as under:

	Increased by Rs.	Decreased by Rs.
Fixed Assets	1,00,000	—
Current Assets	—	2,00,000
Current Liabilities	—	40,000

- (5) For the next two years, no increase in the rate of equity dividend is expected.

You are required to:

- Set out in detail the purchase consideration.
- Give the Balance Sheet as on 31.3.2010 after absorption.

Note: Journal entries are not required.

Answer

(i) Computation of Purchase Consideration

	Rs.
(a) Preference Shareholders	
Current income of preference shareholders of P Ltd.	40,000
Add: 10% increase thereof	<u>4,000</u>
	<u>44,000</u>
Preference shares to be issued	
$= 44,000 \times \frac{100}{8} =$	5,50,000
(b) Equity Shareholders	
(1) Issue of Equity Shares	
P/E ratio in R Ltd.	
	Rs.
Profit before tax	10,64,000
Less: Tax	<u>4,00,000</u>
	6,64,000
Less: Preference dividend	<u>64,000</u>
Profit available for equity shareholders	<u>6,00,000</u>

Financial Reporting

$$\text{Earnings per share (EPS)} = \frac{6,00,000}{2,40,000} = \text{Rs. } 2.50$$

$$\text{Price earnings ratio (P/E)} = \frac{40}{2.50} = \text{Rs. } 16$$

EPS of P Ltd:

	Rs.
Profit before tax	4,80,000
Less: Tax	<u>2,00,000</u>
Profit after tax	2,80,000
Less: Preference dividend	<u>40,000</u>
Profit available for equity shareholders	<u>2,40,000</u>
EPS = $\frac{2,40,000}{1,20,000}$	= Rs. 2

Valuation of equity shares of P Ltd:

$$= 1,20,000 \text{ shares} \times (\text{Rs. } 2 \times 16 \times 0.75 \text{ i.e. Rs. } 24)$$

$$= \text{Rs. } 28,80,000$$

Number of equity shares to be issued:

$$= \frac{28,80,000}{40} = 72,000$$

	Rs.
Equity Share Capital	7,20,000
Securities Premium	<u>21,60,000</u>
	<u>28,80,000</u>

(2) *Issue of Preference Shares*

	Rs.
Current equity dividend	1,92,000
Less: Expected equity dividend from R Ltd. (Rs. 7,20,000 × 2,88,000/24,00,000)	<u>86,400</u>
Loss in income	<u>1,05,600</u>

$$8\% \text{ Preference Shares to be issued} = \frac{1,05,600}{0.08} = \text{Rs. } 13,20,000$$

Accounting For Corporate Restructuring

Total Purchase Consideration:		Rs.
Preference shares to be issued	5,50,000	
	<u>13,20,000</u>	18,70,000
Equity shares to be issued (at premium)		<u>28,80,000</u>
		<u>47,50,000</u>

(ii)

R Ltd.

Balance Sheet as at 31st March, 2010

(after absorption)

Schedule No.

Rs.

SOURCES OF FUNDS

(1) Shareholders' funds:

(a) Capital	A	57,90,000	
(b) Reserves and Surplus	B	<u>51,60,000</u>	1,09,50,000

(2) Loan funds

--

Total

1,09,50,000

APPLICATION OF FUNDS

(1) Fixed assets:

Net block	C	91,10,000
-----------	---	-----------

(2) Investments

—

(3) Net Current assets

18,40,000

Total

1,09,50,000

Schedules to Balance Sheet

Rs.

A. Share Capital:

3,12,000 Equity Shares of Rs. 10 each (of the above shares, 72,000 equity shares are allotted as fully paid up for consideration other than cash) 31,20,000

2,67,000 8% Preference Shares of Rs. 10 each (of the above, 1,87,000 are allotted as fully paid up for consideration other than cash) 26,70,000

57,90,000

B. Reserves and Surplus:

As per last Balance Sheet 30,00,000

Financial Reporting

Securities Premium	<u>21,60,000</u>
	<u>51,60,000</u>
C. Fixed Assets:	
As per last Balance Sheet	55,00,000
Taken over on absorption of P Ltd.	<u>28,00,000</u>
	83,00,000
Goodwill	<u>8,10,000</u>
	<u>91,10,000</u>
D. Net Current Assets:	
As per last Balance Sheet	7,00,000
Taken over on absorption of P Ltd.	<u>11,40,000</u>
	<u>18,40,000</u>

Working Note:**Calculation of Goodwill on Absorption**

	Rs.
Purchase consideration	47,50,000
Fixed assets taken over	28,00,000
Current assets taken over	<u>21,00,000</u>
	49,00,000
Less: Current liabilities	<u>9,60,000</u>
Net assets taken over	<u>39,40,000</u>
Goodwill	<u>8,10,000</u>

Question 9

The Balance Sheets of O Ltd. and P Ltd. as on 31st March, 2010 are as under:

				(Rs. in lakhs)	
Liabilities	O	P	Assets	O	P
Equity Shares of Rs.10 each	25.00	50.00	Fixed Assets	110.00	50.00
Reserves	131.00	29.25	Investments	16.25	25.00
12% Debentures	11.00	5.50	Current Assets	40.25	3.25
Creditors	8.00	2.75	Miscellaneous Expenditure	8.50	9.25
	<u>175.00</u>	<u>87.50</u>		<u>175.00</u>	<u>87.50</u>

Investments of O Ltd. represent 1,25,000 shares of P Ltd. Investments of P Ltd. are considered worth Rs. 30 lakhs.

P Ltd. is taken over by O Ltd. on the basis of the intrinsic value of shares in their respective books of account.

Prepare a statement showing the number of shares to be allotted by O Ltd. to P Ltd. and the Balance Sheet of O Ltd. after absorption of P Ltd.

Answer

Balance sheet of O Ltd. (after absorption)

		(Rs. in lakhs)	
Liabilities	Amount	Assets	(Amount)
SHARE CAPITAL		FIXED ASSETS	
3,43,750 Equity Shares of Rs. 10 each	34.375	Fixed Assets	110.000
(Of the above shares, 93,750 equity shares are allotted as fully paid-up for consideration other than cash)		Add: Taken over INVESTMENT	<u>50.000</u> 160.000 30.000
RESERVES AND SURPLUS			
As per last Balance Sheet	131.00	CURRENT ASSETS, LOANS AND ADVANCES	
Capital Reserve	2.500		
Securities Premium	<u>46.875</u>	Current Assets	40.250
	180.375	Add: Taken over	<u>3.250</u> 43.500
SECURED LOANS		MISCELLANEOUS EXPENDITURE	8.500
12% Debentures	11.000		
Add: Taken over	<u>5.500</u>		
	16.500		
CURRENT LIABILITIES AND PROVISIONS			
Creditors	8.000		
Add: Taken over	<u>2.750</u>		
	<u>10.750</u>		
	<u>242.000</u>		<u>242.000</u>

Financial Reporting

Working Notes:

(a)	(i)	Calculation of Net Assets	(Rs. in lakhs)	
			<i>O Ltd.</i>	<i>P Ltd.</i>
		Fixed Assets	110.00	50.00
		Investments	18.75*	30.00
		Current Assets	<u>40.25</u>	<u>3.25</u>
			<u>169.00</u>	<u>83.25</u>
		12% Debentures	11.00	5.50
		Creditors	<u>8.00</u>	<u>2.75</u>
			<u>19.00</u>	<u>8.25</u>
		Net Assets	<u>150.00</u>	<u>75.00</u>
			<i>O Ltd.</i>	<i>P Ltd.</i>
	(ii)	Number of equity shares	2.50 lakhs	5.00 lakhs
		Intrinsic Value	Rs. 60.00	Rs. 15.00
		* 1.25 lakhs shares × Rs. 15		
(b)	Calculation of Shares Allotted		(Rs. in lakhs)	
		Net assets taken over		75.00
		Less: Belonging to O Ltd.	$\left(\frac{1,25,000}{5,00,000} \times 75 \text{ lakhs} \right)$	
				<u>18.75</u>
		Payable to other equity shareholders		<u>56.25</u>
		Number of equity shares of Rs. 10 each to be issued =	$\frac{\text{Rs. } 56,25,000}{\text{Rs. } 60}$	
		= 93,750 shares (valued at Rs. 60 each)		
		Credit to share capital		Rs. 9,37,500
		Credit to securities premium		Rs. 46,87,500

Question 10

A Ltd. agreed to take over B Ltd. as on 1st October, 2009. No Balance Sheet of B was prepared on that date:

Balance Sheets of A and B as at 31st March, 2009 were as follows:

	A Rs.	B Rs.		A Rs.	B Rs.
Share Capital:			Fixed Assets	12,50,000	8,75,000
Equity shares of Rs. 10 each fully paid up	15,00,000	10,00,000	Current Assets:		
Reserves and Surplus:			Stock	2,37,500	1,87,500
Reserve	4,15,000	2,56,000	Debtors	3,90,000	2,56,000
Profit and Loss	1,87,500	1,50,000	Bank	2,93,750	1,50,000
Creditors	93,750	75,000	Miscellaneous		
			Expenditure:		
			Preliminary Expenses	<u>25,000</u>	<u>12,500</u>
	<u>21,96,250</u>	<u>14,81,000</u>		<u>21,96,250</u>	<u>14,81,000</u>

Additional information available:

- For the six months period from 1st April, 2009, A made a profit of Rs. 4,20,000 after writing off depreciation at 10% per annum on its fixed assets.
- For the same period, B made a net profit of Rs. 2,04,000 after writing off depreciation at 10% p.a. on its fixed assets.
- Both the companies paid on 1st August, 2009, equity dividends of 15%. Tax at 10% on such payments was also paid by each of them.
- Goodwill of B was valued at Rs. 1,20,000 on the date of take-over; stock of B, subject to an abnormal item of Rs. 7,500 to be fully written off, would be appreciated by 25% for purpose of take-over:
- A to issue to B's shareholders fully paid equity shares of Rs. 10 each, on the basis of the comparative intrinsic values of the shares on the take-over date.

Draft the Balance Sheet of A after absorption of B. All workings are to form part of your answer.

Financial Reporting

Answer

Balance Sheet of A Ltd. (after absorption of B Ltd.)

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>	<i>Rs.</i>
<i>Share Capital</i>		<i>Fixed Assets</i>		
2,56,000 Equity Shares of Rs. 10 each fully paid (1,06,000 shares allotted as fully paid without payment being received in cash)	25,60,000	Goodwill		1,20,000
		Other Fixed Assets	21,25,000	
		(12,50,000 + 8,75,000)		
		Less: Depreciation	<u>1,06,250</u>	20,18,750
<i>Reserves and Surplus</i>		<i>Current Assets, Loans and Advances</i>		
Securities Premium	5,30,000	Stock		
Reserves	4,15,000	(2,37,500 + 2,25,000)		4,62,500
Profit and Loss Account	3,60,000	Debtors		
<i>Current Liabilities</i>		(3,90,000 + 2,56,000)		6,46,000
Creditors	1,68,750	Bank Balance		
		(5,28,750 + 2,32,750)		7,61,500
		<i>Miscellaneous Expenditure</i>		
		Preliminary Expenses		<u>25,000</u>
	<u>40,33,750</u>			<u>40,33,750</u>

Working Notes:

(1) Bank Balance on 1.10.2009

	<i>A Ltd.</i>	<i>B Ltd.</i>
	<i>Rs.</i>	<i>Rs.</i>
Bank Balance as on 31.3.2009	2,93,750	1,50,000
Add: Net Profit	4,20,000	2,04,000
Depreciation	<u>62,500</u>	<u>43,750</u>
	7,76,250	3,97,750
Less: Dividend	<u>2,25,000</u>	<u>1,50,000</u>
	5,51,250	2,47,750
Less: Dividend Tax	<u>22,500</u>	<u>15,000</u>
Bank Balance as on 1.10.2009	<u>5,28,750</u>	<u>2,32,750</u>

Accounting For Corporate Restructuring

(2) Profit and Loss Account as on 1.10.2009

	<i>A Ltd.</i>	<i>B Ltd.</i>
	<i>Rs.</i>	<i>Rs.</i>
Balance as on 31.3.2009	1,87,500	1,50,000
Add: 6 months' profit	<u>4,20,000</u>	<u>2,04,000</u>
	6,07,500	3,54,000
Less: Dividend	2,25,000	1,50,000
Dividend tax	<u>22,500</u>	<u>15,000</u>
	<u>3,60,000</u>	<u>1,89,000</u>

(3) Balance Sheets of A Ltd. and B Ltd.

as on 1st October, 2009 (before absorption)

	<i>A Ltd.</i>	<i>B Ltd.</i>		<i>A Ltd.</i>	<i>B Ltd.</i>
	<i>Rs.</i>	<i>Rs.</i>		<i>Rs.</i>	<i>Rs.</i>
Share Capital	15,00,000	10,00,000	Fixed Assets	12,50,000	8,75,000
Reserves	4,15,000	2,56,000	Less: Depreciation	<u>(62,500)</u>	<u>(43,750)</u>
Profit and Loss	3,60,000	1,89,000	Net Fixed Assets	11,87,500	8,31,250
Creditors*	93,750	75,000	Current Assets		
			Stock*	2,37,500	1,87,500
			Debtors*	3,90,000	2,56,000
			Bank	5,28,750	2,32,750
			Miscellaneous		
			Expenditure		
			Preliminary		
			Expenses	<u>25,000</u>	<u>12,500</u>
	<u>23,68,750</u>	<u>15,20,000</u>		<u>23,68,750</u>	<u>15,20,000</u>

*It is assumed that these amounts as on 1st October, 2009 are same in the absence of any other information.

(4) Purchase consideration

	<i>A Ltd.</i>	<i>B Ltd.</i>
	<i>Rs.</i>	<i>Rs.</i>
Goodwill	—	1,20,000
Fixed Assets	11,87,500	8,31,250
Stock	2,37,500	2,25,000
Debtors	3,90,000	2,56,000

Financial Reporting

Bank Balance	<u>5,28,750</u>	<u>2,32,750</u>
	23,43,750	16,65,000
Less: Creditors	<u>93,750</u>	<u>75,000</u>
Net Assets	<u>22,50,000</u>	<u>15,90,000</u>
Number of Shares	1,50,000	1,00,000
Intrinsic value	15.00	15.90

Purchase consideration Rs. 15,90,000 in the form of Share capital Rs. 10,60,000 and securities premium Rs. 5,30,000.

Question 11

The following are the Balance Sheets of A Ltd. and B Ltd. as on 31st December, 2009:

Liabilities	A Ltd. Rs.	B Ltd. Rs.	Assets	A Ltd. Rs.	B Ltd. Rs.
Share Capital			Fixed Assets	7,00,000	2,50,000
Equity Shares of Rs. 10 each	6,00,000	3,00,000	Investment:		
10% Pref. Shares of Rs. 100 each	2,00,000		6,000 Shares of B Ltd.	80,000	—
			5,000 Shares of A Ltd.	—	80,000
Reserves and Surplus	3,00,000	1,00,000			
		2,00,000			
Secured Loans:			Current Assets:		
12% Debentures	2,00,000	1,50,000	Stock	2,40,000	3,20,000
Current Liabilities:			Debtors	3,60,000	1,90,000
Sundry Creditors	2,20,000	1,25,000	Bills Receivable	60,000	20,000
Bills Payable	<u>30,000</u>	<u>25,000</u>	Cash at Bank	<u>1,10,000</u>	<u>40,000</u>
	<u>15,50,000</u>	<u>9,00,000</u>		<u>15,50,000</u>	<u>9,00,000</u>

Fixed Assets of both the companies are to be revalued at 15% above book value. Stock in Trade and Debtors are taken over at 5% lesser than their book value. Both the companies are to pay 10% Equity dividend, Preference dividend having been already paid.

After the above transactions are given effect to, A Ltd. will absorb B Ltd. on the following terms:

- (i) 8 Equity Shares of Rs. 10 each will be issued by A Ltd. at par against 6 shares of B Ltd.

- (ii) 10% Preference Shareholders of B Ltd. will be paid at 10% discount by issue of 10% Preference Shares of Rs. 100 each at par in A Ltd.
- (iii) 12% Debentureholders of B Ltd. are to be paid at 8% premium by 12% Debentures in A Ltd. issued at a discount of 10%.
- (iv) Rs. 30,000 is to be paid by A Ltd. to B Ltd. for Liquidation expenses. Sundry Creditors of B Ltd. include Rs. 10,000 due to A Ltd.

Prepare:

- (a) Absorption entries in the books of A Ltd.
- (b) Statement of consideration payable by A Ltd.

Answer

(a) Absorption Entries in the Books of A Ltd.

		Dr. Rs.	Cr. Rs.
Fixed Assets	Dr.	1,05,000	
To Revaluation Reserve			1,05,000
(Revaluation of fixed assets at 15% above book value)			
Bank Account	Dr.	6,000	
To Reserves and Surplus			6,000
(Dividend received from B Ltd. on 6,000 shares)			
Reserve and Surplus	Dr.	60,000	
To Equity Dividend			60,000
(Declaration of equity dividend @ 10%)			
Equity Dividend	Dr.	60,000	
To Bank Account			60,000
(Payment of equity dividend)			
Business Purchase Account	Dr.	3,60,000	
To Liquidator of B Ltd.			3,60,000
(Consideration payable for the business taken over from B Ltd.)			
Fixed Assets (115% Rs. 2,50,000)	Dr.	2,87,500	
Stock (90% Rs. 3,20,000)	Dr.	3,04,000	
Debtors	Dr.	1,90,000	

Financial Reporting

Bills Receivable	Dr.	20,000	
Cash at Bank	Dr.	15,000	
(Rs. 40,000 – Rs. 30,000 dividend paid + Rs. 5,000 dividend received)			
To Provision for Bad Debts (5% of Rs.1,90,000)			9,500
To Sundry Creditors			1,25,000
To 12% Debentures in B Ltd.			1,62,000
To Bills Payable			25,000
To Business Purchase Account			3,90,000
To Investments in B Ltd.			80,000
To Capital Reserve (Balancing figure)			25,000
(Incorporation of various assets and liabilities taken over from B Ltd. at agreed values and cancellation of investment in B Ltd. account, profit being credited to capital reserve)			
Liquidator of B Ltd.	Dr.	3,60,000	
To Equity Share Capital			2,70,000
To 10% Preference Share Capital			90,000
Discharge of consideration for B Ltd.'s business)			
Capital Reserve	Dr.	30,000	
To Bank Account			30,000
(Payment of liquidation expenses)			
12% Debentures in B Ltd. (Rs. 1,50,000 × 108%)	Dr.	1,62,000	
Discount on Issue of Debentures		18,000	
To 12% Debentures			1,80,000
(Allotment of 12% Debentures to debenture holders at a discount of 10% to discharge the liability on B Ltd. debentures)			
Sundry Creditors	Dr.	10,000	
To Sundry Debtors			10,000
(Cancellation of mutual owing)			

(b) Statement of Consideration payable by A Ltd.

For equity shares held by outsiders

Shares held by them 30,000 – 6,000 = 24,000

$$\text{Shares to be allotted} \quad \frac{24,000}{6} \times 8 = 32,000$$

as 5,000 shares are already with B Ltd; i.e. A Ltd. will now issue only 27,000 shares of Rs. 10 each i.e. Rs. 2,70,000 (i).

For 10% preference shares, to be paid at 10% discount

$$\text{Rs. } \frac{1,00,000 \times 90}{100} \quad \text{Rs. } 90,000 \quad (\text{ii})$$

$$\text{Consideration amount [(i) + (ii)]} \quad \text{Rs. } 3,60,000$$

Note: It has been assumed that dividend on equity shares have been paid by both the companies.

Question 12

The following are the Balance Sheets of RS Ltd. and XY Ltd. as on 31.3.2010:

Rs. in '000s					
Liabilities	RS Ltd.	XY Ltd.	Assets	RS Ltd.	XY Ltd.
	Rs.	Rs.		Rs.	Rs.
Share Capital:			Fixed Assets net of		
Equity Shares of Rs. 100 each fully paid up	2,000	1,000	depreciation	2,700	850
			Investments	700	—
Reserves and Surplus	800	—	Sundry Debtors	400	150
10% Debentures	500	—	Cash and Bank	250	—
Loan from Financial Institutions	250	400	Profit and Loss Account	—	800
Bank Overdraft	—	100			
Sundry Creditors	300	300			
Proposed Dividend	<u>200</u>	<u>—</u>			
Total	<u>4,050</u>	<u>1,800</u>	Total	<u>4,050</u>	<u>1,800</u>

It was decided that XY Ltd. will acquire the business of RS Ltd. for enjoying the benefit of carry forward of business loss. After acquisition, XY Ltd. will be renamed as XYZ Ltd. The following scheme has been approved for the merger:

- (i) XY Ltd. will reduce its shares to Rs. 10 and then consolidate 10 such shares into one share of Rs. 100 each (New Share).

Financial Reporting

- (ii) Financial institutions agreed to waive 15% of the loan of XY Ltd.
- (iii) Shareholders of RS Ltd. will be given one new share of XY Ltd. in exchange of every share held in RS Ltd.
- (iv) RS Ltd. will cancel 20% holding of XY Ltd. Investments were held at Rs. 250 thousands.
- (v) After merger the proposed dividend of RS Ltd. will be paid to the shareholders of RS Ltd.
- (vi) Authorised Capital of XY Ltd. will be raised accordingly to carry out the scheme.
- (vii) Sundry creditors of XY Ltd. includes payable to RS Ltd. Rs. 1,00,000.

Pass the necessary entries to implement the scheme in the books of RS Ltd. and XY Ltd. and prepare a Balance Sheet of XYZ Ltd.

Answer**Journal Entries in the books of RS Ltd.**

		(Rs. '000)
	Dr.	Cr.
	Rs.	Rs.
10% Debentures Account	Dr. 500	
Loan from Financial Institutions Account	Dr. 250	
Sundry Creditors Account	Dr. 300	
Proposed Dividend Account	Dr. 200	
Realisation Account	Dr. 2,800	
To Fixed Assets Account		2,700
To Investments Account		700
To Sundry Debtors Account		400
To Cash and Bank Account		250
(Transfer of assets and liabilities to realisation account)		
Share Capital Account	Dr. 2,000	
Reserve and Surplus Account	Dr. 800	
To Equity Shareholders Account		2,800
(Transfer of share capital, reserve and surplus to shareholders account)		
Equity Shareholders Account	Dr. 250	
To Realisation Account		250
(Cancellation of 20% holding of XY Ltd. held as investments)		

Accounting For Corporate Restructuring

Shares in XYZ Ltd.	Dr.	2,000	
To Realisation Account			2,000
(Issue of shares by XYZ Ltd. in the ratio of 1 : 1)			
Equity Shareholders Account	Dr.	550	
To Realisation Account			550
(Transfer of loss on realisation)			
Equity Shareholders Account	Dr.	2,000	
To Shares in XYZ Ltd.			2,000
(Distribution of Shares of XYZ Ltd. among the shareholders)			

Journal Entries in the books of XY Ltd.

		(Rs. '000)	
		Dr.	Cr.
		Rs.	Rs.
Equity Share Capital (Face value – Rs. 100) Account	Dr.	1,000	
To Equity Share Capital (Face value – Rs. 10) Account			100
To Reconstruction Account			900
(Face value of equity shares of Rs. 100 each reduced to Rs. 10 each)			
Equity Share Capital (Face value – Rs. 10 each) A/c	Dr.	100	
To Equity Share Capital Account			100
(Face value – Rs. 100 each)			
(Consolidation of 10,000 equity shares of Rs. 10 each to 1,000 equity shares of Rs. 100 each)			
Loan from Financial Institutions Account	Dr.	60	
To Reconstruction Account			60
(Waiver of 15% of loan by financial institutions)			
Reconstruction Account (900 + 60)	Dr.	960	
To Profit and Loss Account			800
To Capital Reserve			160
(Utilisation of Reconstruction account balance to write off the Profit and Loss Account)			

Financial Reporting

Proposed Dividend Account	Dr.	200	
To Bank Account			200
(Payment of Proposed dividend to shareholders of RS Ltd.)			
Fixed Assets Account	Dr.	2,700	
Other Investments Account	Dr.	450	
Sundry Debtors Account	Dr.	400	
Cash and Bank Account	Dr.	250	
To Reserves Account			570
To 10% Debentures Account			500
To Loan from Financial Institutions Account			250
To Sundry Creditors Account			300
To Proposed Dividend Account			200
To Business Purchase Account			1,980
(Incorporation of various assets and liabilities acquired from RS Ltd. after cancellation of investment held by RS Ltd. in XY Ltd., profit on acquisition credited to Reserves Account)			
Business Purchase Account	Dr.	1,980	
To Liquidator of RS Ltd.			1,980
(Consideration Payable on business acquired from RS Ltd.)			
Liquidator of RS Ltd.	Dr.	1,980	
To Equity Share Capital of XYZ Ltd.			1,980
(Discharge of purchase consideration in the form of equity shares of XYZ Ltd.)			
Sundry Creditors Account	Dr.	100	
To Sundry Debtors Account			100
(Cancellation of intercompany owings)			

Balance Sheet of XYZ Ltd.**as on 31st March, 2010 (immediately after acquisition)***(Rs. in 000's)*

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Share Capital:		Fixed Assets net of depreciation	3,550
20,800 Equity Shares @ Rs. 100		Investments	450

Accounting For Corporate Restructuring

each (1,980 + 20 + 80)	2,080	Sundry Debtors	450
Capital Reserve	160		
General Reserve	570		
10% Debentures	500		
Loan from financial institutions	590		
Bank Overdraft (100 – 250 + 200)	50		
Sundry Creditors	<u>500</u>		<u> </u>
	<u>4,450</u>		<u>4,450</u>

Working Notes:

- Rs.
- Original Share Capital of XY Ltd.
10,000 Equity Shares of Rs. 100 each 10,00,000
Share Capital of XY Ltd. after Reduction
10,000 Equity Shares of Rs. 10 each 1,00,000
 - Share Capital of XY Ltd. after Reconsolidation
1,000 Equity Shares of Rs. 100 each 1,00,000
 - Reduced value of holdings of RS Ltd. in XY Ltd.
RS Ltd. was holding 20% of XY Ltd., that is,
2,000 Equity Shares of Rs. 100 each 2,00,000
which has now reduced to 200 Equity Shares of Rs. 100 each 20,000
 - Calculation of Purchase Consideration
Equity Share Capital of RS Ltd. 20,000 Equity Shares of Rs. 100 each 20,00,000
Exchange Ratio = 1 : 1
No. of Equity Shares to be given 20,000
Less: No. of Equity Shares already held by RS Ltd. 200
19,800
Purchase consideration
19,800 Equity Shares of Rs. 100 each 19,80,000
-

Financial Reporting

5. Aggregate Reserves in the new company on acquisition
- | | |
|---|-----------------|
| Reserves of RS Ltd. acquired | 8,00,000 |
| Less: Loss on investments held by RS Ltd. | |
| Value of investments cancelled | 2,50,000 |
| Less: Reduced value of shares of XY Ltd. | <u>20,000</u> |
| | <u>2,30,000</u> |
| Amount of Reserves to be carried to Balance Sheet | <u>5,70,000</u> |
6. Share Capital in Combined Balance Sheet of XYZ Ltd.
- | | |
|--|------------------|
| Holding of RS Ltd. (200 Equity Shares @ Rs. 100 each) | 20,000 |
| Other Existing Shares (800 Equity Shares of Rs. 100 each) | 80,000 |
| Given as Purchase Consideration (19,800 equity shares @ Rs.100 each) | <u>19,80,000</u> |
| | <u>20,80,000</u> |
7. It has been assumed that the bank overdraft and cash balance can be netted of.

Alternative Solution:

The candidates may pass a journal entry in the books of XY Ltd. for cancellation of shares held by RS Ltd.

In that case the first three entries in books of XY Ltd. will remain the same, further:-

		(Rs. '000)
	<i>Dr.</i>	<i>Cr.</i>
	<i>Rs.</i>	<i>Rs.</i>
Equity Share Capital Account	Dr. 20	
To Reconstruction Account		20
Equity Share Capital (Rs.10) Account	Dr. 80	
To Equity Share Capital Account (Rs.100)		80
Reconstruction Account	Dr. 980	
To Profit and Loss Account		800
To Capital Reserve		180
Fixed Assets Account	Dr. 2,700	
Other Investments Account	Dr. 450	
Sundry Debtors Account	Dr. 400	

Accounting For Corporate Restructuring

Cash and Bank Account	Dr.	250	
To Reserves Account			550
To 10% Debentures Account			500
To Loan from Financial Institutions Account			250
To Sundry Creditors Account			300
To Proposed Dividend Account			200
To Business Purchase Account			2,000
Business Purchase Account	Dr.	2,000	
To Liquidator of RS Ltd.			2,000
Liquidator of RS Ltd.	Dr.	2,000	
To Equity Shares (Rs.10 each)			2,000

Note: In the Balance Sheet, capital reserve will go up by Rs.20,000 and general reserve will come down by Rs. 20,000.

Question 13

The following are the Balance Sheets of C Ltd. and D Ltd. on 31st March, 2009:

Balance Sheets

Liabilities	C Ltd. Rs.	D Ltd. Rs.	Assets	C Ltd. Rs.	D Ltd. Rs.
Equity Shares of Rs. 100 each fully paid	45,00,000	15,00,000	Fixed Assets	30,00,000	1,50,000
General Reserve	4,00,000	3,00,000	Investments		
Profit and Loss A/c	7,34,000	30,000	3,000 shares in D Ltd.	4,50,000	—
14% Debentures	—	9,00,000	9,000 Shares in C Ltd.	—	15,00,000
Current Liabilities	6,00,000	2,70,000	Debtors	8,70,000	4,50,000
			Stock	14,40,000	6,30,000
			Bank Balance	<u>4,74,000</u>	<u>2,70,000</u>
	<u>62,34,000</u>	<u>30,00,000</u>		<u>62,34,000</u>	<u>30,00,000</u>

Stock of C Ltd. includes goods worth Rs. 3,00,000 purchased from D Ltd., which made a profit of 20% on selling price. As on 31.3.2009, C Ltd. owes to D Ltd. Rs. 1,20,000. C Ltd. absorbs D Ltd. on the basis of the intrinsic value of the shares of both companies as on 31st March, 2009. Before absorption C Ltd. has declared a dividend of 12%. Dividend tax is 10%.

Show the Balance Sheet of C Ltd. after the absorption of D Ltd. and the working for the number of shares issued.

Financial Reporting

Answer

(a) (i) Computation of Net Assets excluding Inter-Company Investments.

	<i>C Ltd</i> Rs.	<i>D Ltd</i> Rs.
A. Total Assets		
Tangible Assets	57,84,000	15,00,000
Dividend Receivable	-	<u>1,08,000</u>
	<u>57,84,000</u>	<u>16,08,000</u>
B. External Liabilities		
Current Liabilities	6,00,000	2,70,000
Proposed Dividend	5,40,000	-
Dividend Tax	54,000	-
14% Debentures	-	<u>9,00,000</u>
	<u>11,94,000</u>	<u>11,70,000</u>
C. Net Assets (A – B)	<u>45,90,000</u>	<u>4,38,000</u>

(ii) Intrinsic value of equity shares.

Assume 'a' is the intrinsic value (net assets including inter company investments) of equity shares of C Ltd and 'b' is the intrinsic value of equity shares of D Ltd.

$$a = \text{Rs.} 45,90,000 + \frac{1}{5} \times b \quad (1)$$

$$b = \text{Rs.} 4,38,000 + \frac{1}{5} \times a \quad (2)$$

$$\text{or } b = \text{Rs.} 4,38,000 + \frac{1}{5} \left(45,90,000 + \frac{1}{5} \times b \right)$$

$$\text{or } b = \text{Rs.} 4,38,000 + 9,18,000 + \frac{b}{25}$$

$$\text{or } \frac{24}{25} \times b = \text{Rs.} 13,56,000$$

$$\text{or } b = \frac{\text{Rs.} 13,56,000}{24} \times 25 = \text{Rs.} 14,12,500$$

Putting the value of b in equation (1) we get,

$$a = \text{Rs.} 45,90,000 + \frac{1}{5} \times 14,12,500 = \text{Rs.} 48,72,500$$

$$\text{Intrinsic value of share of C Ltd.} = \frac{\text{Rs } 48,72,500}{45,000} = \text{Rs. } 108.278 \text{ approximately}$$

$$\text{Intrinsic value of share of D Ltd} = \frac{\text{Rs } 14,12,500}{15,000} = \text{Rs. } 94.167 \text{ approximately.}$$

(iii) Calculation of Purchase consideration

$$\begin{aligned} \text{Value of shares held by outside shareholders in D Ltd: } & \frac{\text{Rs. } 14,12,500 \times 12,000}{15,000} \\ & = \text{Rs } 11,30,000 \end{aligned}$$

Shares to be issued by C Ltd on the basis of intrinsic value of shares = Rs.11,30,000 x (45,000 / 48,72,500)	10,436.12
Less: Shares held by D Ltd	<u>9,000.00</u>
Number of shares to be issued	<u>1,436.12</u>
Total purchase price for outside shareholders	Rs.
Additional shares in C Ltd. (1,436 x Rs.108.278)	1,55,487*
Cash for fractional shares (0.12 x Rs. 108.278)	13*
Value of 3000 shares held by C Ltd	<u>2,82,500</u>
	<u>4,38,000</u>

(iv) General Reserve (C Ltd)

	Rs.
As per Balance sheet	4,00,000
Less: Reduction in value of shares held in D Ltd (Rs. 4,50,000 - 2,82,500)	<u>1,67,500</u>
	<u>2,32,500</u>

(v) Bank Balance

	C Ltd.	D Ltd.
	Rs.	Rs.
As per Balance Sheet	4,74,000	2,70,000
Add: Dividend received	<u> </u>	<u>1,08,000</u>
	4,74,000	3,78,000
Less: Dividend	5,40,000	
Dividend tax	54,000	
Cash for fractional shares <u>13</u>	<u>5,94,013</u>	<u> </u>
	<u>(1,20,013)</u>	<u>3,78,000</u>
		= Rs. 2,57,987.

Financial Reporting

Balance Sheet of C Ltd (after absorption of D Ltd)

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Share Capital :		Goodwill	60,000
Issued and Subscribed		Other Fixed Assets	31,50,000
46,436 shares of Rs.100 each fully paid (1,436 shares allotted to vendors for consideration other than cash)	46,43,600	Current Assets, Loans and Advances:	
Reserves and Surplus:		Stock	20,70,000
General Reserve	2,32,500	Less: Unrealised Profit (Goodwill)	<u>60,000**</u>
Profit and Loss Account		Bank Balance	2,57,987
(Rs.7,34,000 – Rs.5,40,000 – Rs.54,000)	1,40,000	Debtors	13,20,000
Securities Premium		Less: Inter Co. dues	<u>1,20,000</u>
(Rs.1,55,487 – Rs.1,43,600)	11,887		12,00,000
Secured Loans:			
14% Debentures	9,00,000		
Current Liabilities and Provisions:			
Current Liabilities	Rs. 8,70,000		
Less: Inter-Co. dues	Rs. <u>1,20,000</u>		
	<u>7,50,000</u>		
	<u>66,77,987</u>		<u>66,77,987</u>

* Appropriate figures have been considered

**Alternatively this sum can also be adjusted against the balance in the Profit and Loss Account.

Question 14

The summarized Balance sheets of X Ltd. and its subsidiary Y Ltd. as at 31.3.2010 were as follows:

<i>Liabilities</i>	<i>X Ltd.</i>	<i>Y Ltd.</i>	<i>Assets</i>	<i>X Ltd.</i>	<i>Y Ltd.</i>
	<i>Rs.</i>	<i>Rs.</i>		<i>Rs.</i>	<i>Rs.</i>
Share capital	50,00,000	10,00,000	Fixed assets	60,00,000	18,00,000
(Share of Rs.10 each)			Investment in Y Ltd. (60,000 shares)	6,00,000	---
General reserves	50,00,000	20,00,000	Sundry debtors	35,00,000	5,00,000
Profit and Loss			Inventories	30,00,000	25,00,000

Accounting For Corporate Restructuring

account	20,00,000	15,00,000			
Secured loan	20,00,000	2,50,000	Cash and bank	39,00,000	2,00,000
Current liabilities	<u>30,00,000</u>	<u>2,50,000</u>			
	<u>1,70,00,000</u>	<u>50,00,000</u>		<u>1,70,00,000</u>	<u>50,00,000</u>

X Ltd. holds 60% of the paid-up capital of Y Ltd. and the balance is held by a foreign company.

A memorandum of understanding has been entered into with the foreign company by X Ltd. to the following effect:

- (i) The shares held by the foreign company will be sold to X Ltd. at a price per share to be calculated by capitalizing the yield at 15%. Yield, for this purpose, would mean 50% of the average of pre-tax profits for the last 3 years, which were Rs.12 lakhs, 18 lakhs and 24 lakhs respectively. (Average tax rate was 40%).
- (ii) The actual cost of shares to the foreign company was Rs.4,40,000 only. Gains accruing to the foreign company are taxable at 20%. The tax payable will be deducted from the sale proceeds and paid to government by X. 50% of the consideration (after payment of tax) will be remitted to the foreign company by X Ltd. and also any cash for fractional shares allotted.
- (iii) For the balance of consideration, X Ltd. would issue its shares at their intrinsic value.

It was also decided that X Ltd. would absorb Y Ltd. Simultaneously by writing down the Fixed assets of Y Ltd. by 10%. The Balance Sheet figures included a sum of Rs.1,00,000 due by Y Ltd. to X Ltd. and stock of X Ltd. included stock of Rs.1,50,000 purchased from Y Ltd., who sold them at cost plus 20%.

The entire arrangement was approved and put through by all concern effective from 1.4.2010.

You are required to indicate how the above arrangements will be recorded in the books of X Ltd. and also prepare a Balance Sheet after absorption of Y Ltd. Workings should form part of your answer.

Answer**X Ltd.****Balance Sheet as at 1st April, 2010**

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Share Capital:			
Shares	5,00,000	Fixed Assets	78,00,000

Financial Reporting

Shares issued in lieu of purchase consideration			Less :Revaluation loss	<u>1,80,000</u>	76,20,000
	<u>33,466</u>				
(Shares of Rs.10 each)	5,33,466	53,34,660	Sundry Debtors (35,00,000+5,00,000)	40,00,000	
General Reserve		50,00,000	Less: Mutual Debts	<u>1,00,000</u>	39,00,000
Capital Reserve		13,20,000			
Profit and Loss Account	20,00,000		Inventories (30,00,000+25,00,000)	55,00,000	
Less: unrealized profit on stock	<u>25,000</u>	19,75,000	Less: Unrealised profit on stock	<u>25,000</u>	54,75,000
Securities Premium (33,466×20)		6,69,320			
Secured Loans (20,00,000 + 2,50,000)		22,50,000	Cash at Bank		27,03,980
Current Liabilities (30,00,000 + 2,50,000)	32,50,000				
Less: Mutual Debts	<u>1,00,000</u>	<u>31,50,000</u>			
		<u>1,96,98,980</u>			<u>1,96,98,980</u>

Working Notes:

(1) Yield of Y Ltd.

$$\text{Average of Pre Tax Profit} = \frac{12 + 18 + 24}{3} = \text{Rs.18 lakhs}^*$$

$$\text{Yield} = 18 \times \frac{50}{100} = \text{Rs.9 lakhs}$$

(2) Price per share of Y Ltd:-

$$\text{Capitaised value of yield of Y Ltd.} = \frac{9 \text{ lakhs}}{15} \times 100 = 60 \text{ lakhs.}$$

* By setting the trend, weighted average profit can also be calculated.

No. of shares = 1,00,000

Price per share = $\frac{60 \text{ lakhs}}{1 \text{ lakh}} = \text{Rs.60 per share}$

(3) Purchase consideration for 40% of share capital of Y Ltd.

$$= 1,00,000 \times 60 \times \frac{40}{100} = \text{Rs.24,00,000}$$

(4) Calculation of intrinsic value of shares of X Ltd.

	Rs.
Total Assets excluding Investments in Y Ltd.	1,64,00,000
Value of Investment $60,000 \times 60$	<u>36,00,000</u>
	2,00,00,000
Less: Outside Liabilities:	
Secured Loan	20,00,000
Current Liabilities	<u>30,00,000</u>
	<u>50,00,000</u>
Net Assets	<u>1,50,00,000</u>
Intrinsic value per share = $\frac{\text{Net Assets}}{\text{No. of Shares}} = \frac{\text{Rs.1,50,00,000}}{5,00,000} = \text{Rs.30 per share}$	

(5) Discharge of purchase consideration by X Ltd.

	<i>Equity share capital</i>	<i>Cash</i>	<i>Total</i>
	Rs.	Rs.	Rs.
(i) Payment of Tax $(24 - 4.40) \times \frac{20}{100} =$	---	3,92,000	3,92,000
(ii) Issue of shares to foreign company [50% of $(24 - 3.92) = 10.04$ lakhs No. of shares issued by X Ltd. $\frac{10,04,000}{30}$ = 33,466.6666 shares Value of shares capital = $33,466 \times 30 =$	10,03,980	---	10,03,980

Financial Reporting

(iii)	Cash Payment [50% of (24 – 3.92) = 10.04 lakhs]	---	10,04,000	10,04,000
(iv)	Cash for fractional shares = 0.6666×30	---	20	20
	Total		<u>10,03,980</u>	<u>13,96,020</u>
				<u>24,00,000</u>

(6) Calculation for Goodwill/Capital Reserve to X Ltd.

		Rs.
Total of Assets as per Balance Sheet of Y Ltd.		50,00,000
Less: 10% Reduction in the value of Fixed Assets		
	$\left(\frac{10}{100} \times 18,00,000 \right)$	<u>1,80,0000</u>
		48,20,000
Less: Secured Loan	2,50,000	
Current Liabilities	<u>2,50,000</u>	<u>5,00,000</u>
Net Assets		43,20,000
Less: Purchase consideration (outside shareholders)		<u>24,00,000</u>
		19,20,000
Less: Investment in Y Ltd. as per Balance Sheet of X Ltd.		<u>6,00,000</u>
Capital Reserve		<u>13,20,000</u>

(7) Cash and Bank Balance of X Ltd. after acquisition of shares

		Rs.
Opening Balance (X Ltd.)		39,00,000
Cash and Bank Balance of Y Ltd.		<u>2,00,000</u>
		41,00,000
Less: Remittance to the foreign company		<u>10,04,020</u>
		30,95,980
Less: T.D.S. paid to Government		<u>3,92,000</u>
		<u>27,03,980</u>

(8) Unrealized profit included in stock of X Ltd. = $1,50,000 \times \frac{20}{120} = \text{Rs.} 25,000$

Question 15

The following are the Balance sheets (as at 31.3.2010) of A Ltd. and B Ltd.:

Liabilities	A Ltd. Rs.	B. Ltd. Rs.	Assets	A Ltd. Rs.	B. Ltd. Rs.
Share Capital:			Fixed Assets	50,00,000	30,00,000
Equity Shares of Rs.10 each	36,00,000	18,00,000	Investments	5,00,000	5,00,000
10% Preference shares of Rs.100 each	12,00,000	-	Current Assets		
12% Preference shares of Rs.100 each	-	6,00,000	Stock	18,00,000	12,00,000
			Debtors	15,00,000	12,00,000
			Bills receivable	50,000	10,000
			Cash at Bank	1,50,000	90,000
Reserve and Surplus:					
Statutory Reserve	1,00,000	1,00,000			
General Reserve	25,00,000	17,00,000			
Secured Loan					
15% Debentures	5,00,000	-			
12% Debentures	-	5,00,000			
Current Liabilities					
Sundry creditors	10,80,000	12,80,000			
Bills payable	<u>20,000</u>	<u>20,000</u>			
	<u>90,00,000</u>	<u>60,00,000</u>		<u>90,00,000</u>	<u>60,00,000</u>

Contingent liabilities for bills receivable discounted Rs.20,000.

(A) The following additional information is provided to you:

	A Ltd. Rs.	B Ltd. Rs.
Profit before Interest and Tax	14,75,000	7,80,000
Rate of Income-tax	40%	40%
Preference dividend	1,20,000	72,000
Equity dividend	3,60,000	2,70,000
Balance profit transferred to Reserve account.		

Financial Reporting

- (B) *The equity shares of both the companies are quoted on the Mumbai Stock Exchange. Both the companies are carrying on similar manufacturing operations.*
- (C) *A Ltd proposes to absorb business of B Ltd. as on 31.3.2010. The agreed terms for absorption are:*
- (i) 12% Preference shareholders of B Ltd. will receive 10% Preference shares of A Ltd. sufficient to increase their present income by 20%.*
 - (ii) The Equity shareholders of B Ltd. will receive equity shares of A Ltd. on the following terms:*
 - (a) The Equity shares of B Ltd. will be valued by applying to the earnings per share of B Ltd. 60 per cent of price earnings ratio of A Ltd. based on the results of 2009-10 of both the Companies.*
 - (b) The market price of Equity shares of A Ltd. is Rs.40 per share.*
 - (c) The number of shares to be issued to Equity shareholders of B Ltd. will be based on the 80% of market price.*
 - (d) In addition to Equity shares, 10% Preference shares of A Ltd. will be issued to the equity shareholders of B Ltd. to make up for the loss in income arising from the above exchange of shares based on the dividends for the year 2009-2010.*
 - (iii) 12% Debentureholders of B Ltd. are to be paid at 8% premium by 15% debentures in A Ltd. issued at a discount of 10%.*
 - (iv) Rs.16,000 is to be paid by A Ltd. to B Ltd. for liquidation expenses. Sundry Creditors of B Ltd. include Rs.20,000 due to A Ltd. Bills receivable discounted by A Ltd. were all accepted by B Ltd.*
 - (v) Fixed assets of both the companies are to be revalued at 20% above book value. Stock in trade is taken over at 10%; less than their book value.*
 - (vi) Statutory reserve has to be maintained for two more years.*
 - (vii) For the next two years no increase in the rate of equity dividend is anticipated.*
 - (viii) Liquidation expense is to be considered as part of purchase consideration.*

You are required to:

- (i) Find out the purchase consideration.*
- (ii) Give journal entries in the books of A Ltd.*
- (iii) Give the Balance Sheet as at 31.3.2010 after absorption.*

Answer

(i) Computation of Purchase Consideration	Rs.
<i>For Preference Shareholders</i>	
Present Income of Preference Shareholders of B Ltd.	72,000
Add : Required 20% increase	<u>14,400</u>
	<u>86,400</u>
10% Preference Shares to be issued of Rs. 8,64,000 (86,400/10x 100)	
<i>For Equity Shareholders</i>	
Valuation of Equity Shares of B Ltd. =	
Number of shares x Value of one share (i.e. EPS of B Ltd. x P/E ratio of A Ltd. x 60/100)	
$= 1,80,000 \times \left(\text{Rs.} 2 \times 20 \times \frac{60}{100} \right) = 1,80,000 \times 24 = \text{Rs.} 43,20,000$	
<i>Issue of Equity Shares</i>	
No. of Equity Shares to be issued at 80% of Market Price i.e.	
80% of Rs.40 = Rs.32	
$\frac{43,20,000}{32} = 1,35,000$ shares	
Equity Share Capital = 1,35,000 x Rs.10 = Rs.13,50,000	
Securities Premium = 1,35,000 x Rs. 22 = <u>Rs.29,70,000</u>	
	<u>Rs.43,20,000</u>
<i>Issue of Preference Shares</i>	Rs.
Present Equity Dividend	2,70,000
Less: Expected Equity Dividend from A Ltd.	
$\left(13,50,000 \times \frac{10}{100} \right)$	<u>1,35,000</u>
Loss in income	<u>1,35,000</u>
10% Preference Shares to be issued of Rs. 13,50,000 (1,35,000/10x 100)	
Purchase Consideration	
Preference Shares Capital [Rs.8,64,000 + Rs.13,50,000]	22,14,000
Equity Share Capital (1,35,000 shares of Rs.10 each at Rs.32 per share)	43,20,000
Liquidation Expenses (in cash)	<u>16,000</u>
	<u>65,50,000</u>

Financial Reporting**(ii) Journal Entries in the Books of A Ltd.**

	<i>Particulars</i>		<i>Dr. (Rs.)</i>	<i>Cr. (Rs.)</i>
1.	Fixed Assets A/c	Dr.	10,00,000	
	To Revaluation Reserve			10,00,000
	(Being Revaluation of Fixed assets at 20% above book value)			
2.	Business Purchase A/c	Dr.	65,50,000	
	To Liquidator of B Ltd.			65,50,000
	(Being purchase consideration payable for the business taken over from B Ltd.)			
3.	Fixed Assets A/c	Dr.	36,00,000	
	Investment A/c	Dr.	5,00,000	
	Stock A/c	Dr.	10,80,000	
	Debtors A/c	Dr.	12,00,000	
	Bills Receivable A/c	Dr.	10,000	
	Cash at Bank A/c	Dr.	90,000	
	Goodwill A/c (Balancing figure)	Dr.	19,10,000	
	To 12% Debentures in B Ltd.			5,40,000
	To Creditors			12,80,000
	To Bills Payable			20,000
	To Business Purchase A/c			65,50,000
	(Being incorporation of different assets and liabilities of B Ltd. taken over at agreed values and balance debited to goodwill account)			
4.	Liquidator of B Ltd.	Dr.	65,50,000	
	To Equity Share Capital A/c			13,50,000
	To Securities Premium A/c			29,70,000
	To Preference Share Capital A/c			22,14,000
	To Bank A/c			16,000
	(Being discharge of consideration for B Ltd's business)			

Accounting For Corporate Restructuring

5.	12% Debentures in B Ltd.	Dr.	5,40,000	
	Discount on issue of Debentures	Dr.	60,000	
	To 15% Debentures			6,00,000
	(Being allotment of 15% Debentures to debenture holders at a discount of 10% to discharge liability of B Ltd. debentures)			
6.	Sundry Creditors A/c	Dr.	20,000	
	To Sundry Debtors A/c			20,000
	(Being cancellation of Mutual owing)			
7.	Amalgamation Adjustment A/c	Dr.	1,00,000	
	To Statutory Reserve A/c			1,00,000
	(Being statutory reserve account is maintained under statutory requirements)			
8.	Securities Premium A/c	Dr.	60,000	
	To Discount on issue of Debentures A/c			60,000
	(Being discount on issue of Debentures written off out of securities premium)			

(iii) **Balance Sheet of A Ltd (after absorption of B Ltd.)****as on 31.3.2010**

<i>Liabilities</i>	<i>Amount</i>	<i>Assets</i>	<i>Amount</i>
	<i>Rs.</i>		<i>Rs.</i>
<i>Share Capital:</i>		<i>Fixed Assets:</i>	
4,95,000 Equity Shares of	49,50,000	Goodwill	19,10,000
Rs. 10 each fully paid (1,35,000 shares have been allotted as fully paid up for consideration other than cash)		Other Fixed Assets (60,00,000+36,00,000)	96,00,000
10% Preference Shares of Rs.100 each fully paid	34,14,000	<i>Investment</i> (5,00,000+5,00,000)	10,00,000
<i>Reserve & Surplus:</i>		<i>Current Assets:</i>	
Statutory Reserve	2,00,000	Stock (18,00,000+10,80,000)	28,80,000
Revaluation Reserve	10,00,000	Debtors (15,00,000+12,00,000-20,000)	26,80,000
General Reserve	25,00,000		

Financial Reporting

Securities Premium	29,10,000	Bills Receivable	60,000
<i>Secured Loan:</i>		(50,000+10,000)	
15% Debentures	11,00,000	Cash at Bank	2,24,000
(5,00,000 + 6,00,000)		(1,50,000 + 90,000-16,000)	
<i>Current Liabilities and</i>			
<i>Provisions:</i>		Amalgamation Adjustment	1,00,000
Creditors		A/c	
(10,80,000+12,80,000-20,000)	23,40,000		
Bills Payable (20,000 + 20,000)	<u>40,000</u>		
	<u>1,84,54,000</u>		<u>1,84,54,000</u>

Note: No footnote will appear for contingent liability as it has been converted into actual liability after absorption of B Ltd.

Working Notes:**1. Calculation of EPS & P/E ratio**

	<i>A Ltd.</i>	<i>B Ltd.</i>
	<i>Rs.</i>	<i>Rs.</i>
Profit before Interest and Tax	14,75,000	7,80,000
<i>Less: Interest on debentures</i>	<u>75,000</u>	<u>60,000</u>
Profit before tax	14,00,000	7,20,000
<i>Less: Tax @ 40%</i>	<u>5,60,000</u>	<u>2,88,000</u>
	8,40,000	4,32,000
<i>Less: Preference Dividend</i>	<u>1,20,000</u>	<u>72,000</u>
Earnings available for equity shareholders	<u>7,20,000</u>	<u>3,60,000</u>
Number of shares	3,60,000 shares	1,80,000 shares
EPS (Earnings/ No. of shares)	2	2
Market Price	Rs.40	Not given
P/E ratio	40/2 = 20	N.A.

2. Computation of Goodwill/Capital Reserve on absorption:

		<i>Rs.</i>
Purchase Consideration		65,50,000
Fixed Assets taken over	30,00,000	
<i>Add: Increase by 20%</i>	<u>6,00,000</u>	36,00,000
Investments		5,00,000

Accounting For Corporate Restructuring

Current Assets:

Stock	12,00,000	
Less: Reduction in value by 10%	<u>1,20,000</u>	
	10,80,000	
Debtors	12,00,000	
B/R	10,000	
Cash at Bank	<u>90,000</u>	<u>23,80,000</u>
		64,80,000

Less: Outside Liabilities:

12% Debentures at premium	5,40,000		
Sundry Creditors	12,80,000		
Bills Payable	<u>20,000</u>	<u>18,40,000</u>	<u>46,40,000</u>
Goodwill			<u>19,10,000</u>

Question 16

The Balance Sheets of Strong Ltd. and Weak Ltd. as on 31.03.2009 is as below:

Balance Sheet as on 31.03.2009

Liabilities	Strong Ltd. Rs.	Weak Ltd. Rs.	Assets	Strong Ltd. Rs.	Weak Ltd. Rs.
Equity Share Capital (Rs.100 each)	50,00,000	30,00,000	Fixed Assets other than Goodwill	30,00,000	20,00,000
Reserve	4,00,000	2,00,000	Stock	8,00,000	6,00,000
P/L A/c	6,00,000	4,00,000	Debtors	14,00,000	9,00,000
Creditors	5,00,000	3,00,000	Cash & Bank	12,00,000	3,50,000
			Preliminary Expenses	<u>1,00,000</u>	<u>50,000</u>
	<u>65,00,000</u>	<u>39,00,000</u>		<u>65,00,000</u>	<u>39,00,000</u>

Strong Ltd. takes over Weak Ltd. on 01.07.09. No Balance Sheet of Weak Ltd. is available as on that date. It is however estimated that Weak Ltd. earns estimated profit of Rs.2,00,000 after charging proportionate depreciation @ 10% p.a. on fixed assets, during April-June, 2009.

Financial Reporting

Estimated profit of Strong Ltd. during these 3 months is Rs.4,00,000 after charging proportionate depreciation @ 10% p.a. on fixed assets.

Both the companies have declared and paid 10% dividend within this 3 months' period. Goodwill of Weak Ltd. is valued at Rs.2,00,000 and Fixed Assets are valued at Rs.1,00,000 above the estimated book value. Purchase consideration is to be satisfied by Strong Ltd. by shares at par. Ignore Income-tax.

You are required to calculate the following:

- (i) No. of shares to be issued by Strong Ltd. to Weak Ltd. against purchase consideration;
- (ii) Net Current Assets of Strong Ltd. and Weak Ltd. as on 01.07.2009;
- (iii) P/L A/c balance of the Strong Ltd. as on 01.07.2009;
- (iv) Fixed Assets as on 01.07.2009;
- (v) Balance Sheet of Strong Ltd. as on 01.07.2009 after take over of Weak Ltd.

Answer

- (i) **Number of shares to be issued by Strong Ltd. to Weak Ltd. against purchase consideration**

Weak Ltd.	Rs.	Rs.
Goodwill		2,00,000
Fixed Assets	20,00,000	
Less: Depreciation	<u>50,000</u>	
	19,50,000	
Add: Appreciation	<u>1,00,000</u>	20,50,000
Stock		6,00,000
Debtors		9,00,000
Cash and Bank balances	3,50,000	
Add: Profit after depreciation	2,00,000	
Add: Depreciation (non-cash)	<u>50,000</u>	2,50,000
Less: Dividend	<u>(3,00,000)</u>	<u>3,00,000</u>
		40,50,000
Less: Creditors		<u>3,00,000</u>
Purchase Consideration		<u>37,50,000</u>

- (ii) **Calculation of Net Current Assets as on 01.07.2009**

	Strong Ltd.	Weak Ltd.
	Rs.	Rs.
Current assets:		
Stock	8,00,000	6,00,000

Accounting For Corporate Restructuring

Debtors		14,00,000		9,00,000
Cash and Bank	12,00,000		3,50,000	
Less: Dividend	(5,00,000)		(3,00,000)	
Add: Profit before depreciation	<u>4,75,000</u>	<u>11,75,000</u>	<u>2,50,000</u>	<u>3,00,000</u>
		33,75,000		18,00,000
Less: Creditors		<u>5,00,000</u>		<u>3,00,000</u>
		<u>28,75,000</u>		<u>15,00,000</u>

(iii) Profit and Loss Account balance of Strong Ltd. as on 1.07.2009

	Rs.
P & L A/c balance as on 31.03.2009	6,00,000
Less: Dividend paid	<u>5,00,000</u>
	1,00,000
Add: Estimated profit for 3 months after charging depreciation	<u>4,00,000</u>
	<u>5,00,000</u>

(iv) Fixed Assets as on 01.07.2009

Fixed Assets of Strong Ltd. as on 31.03.2009		30,00,000
Less: Depreciation for 3 months		<u>75,000</u>
		29,25,000
Fixed assets taken over of Weak Ltd. as on 31.03.2009	20,00,000	
Less: Proportionate depreciation for 3 months on fixed assets	<u>50,000</u>	
	19,50,000	
Add: Appreciation above the estimated book value	<u>1,00,000</u>	<u>20,50,000</u>
		<u>49,75,000</u>

(v) Balance Sheet of Strong Ltd. as on 01.07.2009 (after Take Over)

Liabilities	Rs.	Assets	Rs.
Equity Share capital:		Goodwill	2,00,000
87500 (50,000+ 37,500)		Fixed assets	49,75,000
shares of Rs.100 each	87,50,000	[as computed in (iv)]	
Reserves	4,00,000	Stock	14,00,000
Profit and Loss Account	5,00,000	(8,00,000 + 6,00,000)	
[as computed in (iii)]		Debtors	23,00,000

Financial Reporting

Creditors (5,00,000 + 3,00,000)	8,00,000 (14,00,000 + 9,00,000)		
		Cash and Bank (11,75,000+ 3,00,000)	14,75,000
		Preliminary expenses	<u>1,00,000</u>
	<u>1,04,50,000</u>		<u>1,04,50,000</u>

Question 17

T. Ltd. and V. Ltd. propose to amalgamate. Their balance sheets as at 31st March, 2008 were as follows:

Liabilities	T. Ltd. Rs.	V. Ltd. Rs.	Assets	T. Ltd. Rs.	V. Ltd. Rs.
Share capital:			Fixed assets		
Equity shares of Rs.10 each	15,00,000	6,00,000	Less: Depreciation	12,00,000	3,00,000
General reserve	6,00,000	60,000	Investments (face value of Rs.3 lakhs, 6% tax free G.P. notes)	3,00,000	-
Profit & Loss A/c	3,00,000	90,000	Stock	6,00,000	3,90,000
Creditors	3,00,000	1,50,000	Debtors	5,10,000	1,80,000
			Cash and bank balances	<u>90,000</u>	<u>30,000</u>
	<u>27,00,000</u>	<u>9,00,000</u>		<u>27,00,000</u>	<u>9,00,000</u>

Their net profits (after taxation) were as follows:

Year	T. Ltd.	V. Ltd.
2005-06	3,90,000	1,35,000
2006-07	3,75,000	1,20,000
2007-08	4,50,000	1,68,000

Normal trading profit may be considered as 15% on closing capital invested. Goodwill may be taken as 4 years' purchase of average super profits. The stock of T. Ltd. and V. Ltd. are to be taken at Rs.6,12,000 and Rs.4,26,000 respectively for the purpose of amalgamation. W. Ltd. is formed for the purpose of amalgamation of two companies.

- Suggest a scheme of capitalization of W. Ltd. and ratio of exchange of shares; and*
- Draft the opening balance sheet of W. Ltd. £*

£ The question involves the application of calculation of goodwill. Therefore, students are advised to go through this problem after preparing Chapter 9.

Financial Reporting

Current Liabilities:		Investments in 6% Tax free G.P. Notes	3,00,000
Creditors	4,50,000	Current Assets:	
		Stock (6,12,000 + 4,26,000)	10,38,000
		Debtors (5,10,000 + 1,80,000)	6,90,000
		Cash and bank balance (90,000 + 30,000)	<u>1,20,000</u>
	<u>40,88,400</u>		<u>40,88,400</u>

Working Notes:

1. Calculation of closing trading capital employed on the basis of net assets

	<i>T. Ltd.</i>	<i>V. Ltd.</i>
	<i>Rs.</i>	<i>Rs.</i>
Fixed Assets	12,00,000	3,00,000
Stock	6,12,000	4,26,000
Debtors	5,10,000	1,80,000
Cash and Bank Balances	<u>90,000</u>	<u>30,000</u>
	24,12,000	9,36,000
Less: Creditors	<u>3,00,000</u>	<u>1,50,000</u>
Net Assets	<u>21,12,000</u>	<u>7,86,000</u>

2. Calculation of value of goodwill

(i) Average Trading Profit	<i>T. Ltd.</i>	<i>V. Ltd.</i>
	<i>Rs.</i>	<i>Rs.</i>
2005-06	3,90,000	1,35,000
2006-07	3,75,000	1,20,000
2007-08	<u>4,50,000</u>	<u>1,68,000</u>
Profit after tax	<u>12,15,000</u>	<u>4,23,000</u>

Accounting For Corporate Restructuring

Profit before tax (40%)*	20,25,000	7,05,000
Add : Under valuation of closing stock	<u>12,000</u>	<u>36,000</u>
	<u>20,37,000</u>	<u>7,41,000</u>
Average of 3 years' profit before tax	6,79,000	2,47,000
Less: Income from non-trade investments (3,00,000 x 6%)	<u>18,000</u>	<u>-</u>
Average profit before tax	6,61,000	2,47,000
Less: 40% tax	<u>2,64,400</u>	<u>98,800</u>
Average profit after tax	<u>3,96,600</u>	<u>1,48,200</u>
(ii) Super Profits		
Average trading profit	3,96,600	1,48,200
Less: Normal Profit		
T. Ltd. Rs. 21,12,000 x 15%	3,16,800	
V. Ltd Rs. 7,86,000 x 15%	<u>-</u>	<u>1,17,900</u>
	<u>79,800</u>	<u>30,300</u>
(iii) Value of goodwill at 4 years' purchase of super profits	<u>3,19,200</u>	<u>1,21,200</u>

Question 18

The following are the Balance Sheets of Andrew Ltd. and Barry Ltd., as at 31.12.2009:

Andrew Ltd.

(in Rs.'000s)

Liabilities	Assets
Share capital	Fixed assets
3,00,000 Equity shares of Rs.10 each	3,000 Stock (pledged with secured loan creditors)
10,000 Preference shares of Rs.100 each	1,000 Other Current assets
General reserve	Profit and Loss account
Secured loans (secured against pledge of stocks)	
	400
	16,000

* Tax rate of 40% has been assumed. The candidates may assume some other tax rate and give the solution accordingly.

Financial Reporting

Unsecured loans	8,600	
Current liabilities	13,000	
	<u>42,000</u>	<u>42,000</u>

Barry Ltd.

(in Rs.'000s)

Liabilities	Assets	
Share capital	Fixed assets	6,800
1,00,000 Equity shares of Rs.10 each	1,000 Current assets	9,600
General reserve	2,800	
Secured loans	8,000	
Current liabilities	<u>4,600</u>	
	<u>16,400</u>	<u>16,400</u>

Both the companies go into liquidation and Charlie Ltd., is formed to take over their businesses. The following information is given:

- (a) All Current assets of two companies, except pledged stock are taken over by Charlie Ltd. The realisable value of all Current assets are 80% of book values in case of Andrew Ltd. and 70% for Barry Ltd. Fixed assets are taken over at book value.
- (b) The break up of Current liabilities is as follows:

	Andrew Ltd.	Barry Ltd.
	Rs.	Rs.

Statutory liabilities (including Rs.22 lakh in case of Andrew Ltd. in case of a claim not having been admitted shown as contingent liability)	72,00,000	10,00,000
---	-----------	-----------

Liability to employees	30,00,000	18,00,000
------------------------	-----------	-----------

The balance of Current liability is miscellaneous creditors.

- (c) Secured loans include Rs.16,00,000 accrued interest in case of Barry Ltd.
- (d) 2,00,000 equity shares of Rs.10 each are allotted by Charlie Ltd. at par against cash payment of entire face value to the shareholders of Andrew Ltd. and Barry Ltd. in the ratio of shares held by them in Andrew Ltd. and Barry Ltd.
- (e) Preference shareholders are issued Equity shares worth Rs. 2,00,000 in lieu of present holdings.

Accounting For Corporate Restructuring

- (f) Secured loan creditors agree to continue the balance amount of their loans to Charlie Ltd. after adjusting value of pledged security in case of Andrew Ltd. and after waiving 50% of interest due in the case of Barry Ltd.
- (g) Unsecured loans are taken over by Charlie Ltd. at 25% of Loan amounts.
- (h) Employees are issued fully paid Equity shares in Charlie Ltd. in full settlement of their dues.
- (i) Statutory liabilities are taken over by Charlie Ltd. at full values and miscellaneous creditors are taken over at 80% of the book value.

Show the opening Balance Sheet of Charlie Ltd. Workings should be part of the answer.

Answer**Balance sheet of Charlie Ltd. as at 31st December, 2009**

(in Rs. '000s)

Liabilities		Assets	
Share Capital		Goodwill (W.N.4)	9,470
Issued, subscribed & Paid up:		Other Fixed Assets (3,400 + 6,800)	10,200
7,00,000 equity shares of Rs.10 each, fully paid up (W.N. 5)	7,000	Current Assets(2,880 + 6,720)	9,600
(of the above 5,00,000 shares have been issued for consideration other than cash)		Cash at Bank	2,000
Secured loans (1,280 + 7,200)	8,480		
Unsecured Loans (25% of 8,600)	2,150		
Current Liabilities			
(7,200 + 1,000 + 4,000 +1,440)	13,640		
	<u>31,270</u>		<u>31,270</u>

Working Notes:**1. Value of miscellaneous creditors taken over by Charlie Ltd.**

(in Rs. '000s)

	Andrew Ltd. Rs.	Barry Ltd. Rs.
Given in balance sheet	13,000	4,600
Less: Statutory liabilities	5,000	1,000
Liability to employees	<u>3,000</u>	<u>1,800</u>
Miscellaneous creditors	<u>5,000</u>	<u>1,800</u>
80% thereof	<u>4,000</u>	<u>1,440</u>

Financial Reporting

2. Value of total liabilities taken over by Charlie Ltd.

	Andrew Ltd.		Barry Ltd.	
	Rs.	Rs.	Rs.	Rs.
<i>Current liabilities</i>				
Statutory liabilities	7,200		1,000	
Liability to employees	3,000		1,800	
Miscellaneous creditors (W.N.1)	<u>4,000</u>	14,200	<u>1,440</u>	4,240
<i>Secured loans</i>				
Given in Balance sheet	16,000		8,000	
Interest waived	-		<u>800</u>	7,200
Value of Stock (80% of Rs.184 lakhs)	<u>14,720</u>	1,280		
<i>Unsecured Loans</i> (25% of Rs. 86 lakhs)		<u>2,150</u>		-
		<u>17,630</u>		<u>11,440</u>

3. Assets taken over by Charlie Ltd.

	Andrew Ltd.	Barry Ltd.
	Rs.	Rs.
Fixed Assets (Assumed on book value basis)	3,400	6,800
Current Assets 80% and 70% respectively of book value	<u>2,880</u>	<u>6,720</u>
	<u>6,280</u>	<u>13,520</u>

4. Goodwill / Capital Reserve on amalgamation

Liabilities taken over (W.N. 2)	17,630	11,440
Equity shares to be issued to Preference Shareholders	<u>200</u>	-
	A 17,830	11,440
Less: total assets taken over (W.N. 3)	B <u>6,280</u>	<u>13,520</u>
	A-B 11,550	(2,080)
	Goodwill	Capital Reserve
Net Goodwill	9,470	

5. Equity shares issued by Charlie Ltd.

	Number
(i) For Cash	2,00,000
For consideration other than cash	
(ii) In Discharge of Liabilities to Employees	4,80,000

(iii) To Preference shareholders	<u>20,000</u>	<u>5,00,000</u>
		<u>7,00,000</u>
Value of shares (Rs.10x 7,00,000)	Rs. 70 Lakhs	

Question 19

Agni Ltd. and Bayu Ltd. both engaged in similar merchanting activities since 2006, decide to amalgamate their businesses. A holding company, Chandrama Ltd. would be formed on 1st January, 2008 to acquire the entire shares in both the companies.

From the information given below you are required to prepare:

- (a) *A statement of purchase consideration, supported by requisite working notes.*
- (b) *Balance Sheet of Chandrama Ltd. after the transactions have been completed.*
 - (i) *The terms of the offer were:*
 - *Rs.100, 15 per cent debentures for every Rs.100 of net assets owned by each company on 31st December, 2007.*
 - *Rs.100 equity shares based on two years purchase of profit before taxation. The profit is to be determined by taking weighted average profits of 2006 and 2007, weights being 1 and 2 respectively.*
 - (ii) *It was agreed that the accounts of Bayu Ltd. for the two years ended 31st December, 2007 be adjusted, where necessary, to conform to the accounting policies followed by Agni Ltd.*
 - (iii) *The Pre-tax profits, including investment income, of the two companies were as follows:*

	2006	2007
	Rs.	Rs.
Agni Ltd.	16,38,000	16,36,000
Bayu Ltd.	17,88,300	25,74,000

- (iv) *Agni Ltd. values its stock on FIFO basis while Bayu Ltd. used a different basis. To bring Bayu Ltd.'s values in line with those of Agni Ltd, value of its stock will require to be reduced by Rs.36,000 at the end of 2006 and Rs.1,02,000 at the end of 2007.*
- (v) *Both the companies use straight line method of depreciation.*
- (vi) *Bayu Ltd. deducts 1 per cent from trade debtors as a general provision against doubtful debts.*
- (vii) *Prepaid expenses in Bayu Ltd. include advertisement expenditure carried forward of Rs.1,80,000 in 2006 and Rs.90,000 in 2007, being part of initial advertising in 2006,*

Financial Reporting

which is being written off over three years. Similar expenditure in Agni Ltd. has been fully written off in 2006.

(viii) To bring Director's remuneration on to a comparative basis, the profits of Bayu Ltd. are to be reduced by Rs.1,20,000 in 2006 and Rs.1,80,000 in 2007 and the net assets are also to be adjusted accordingly.

Balance Sheets as at 31st December, 2006 and 2007 were as follows:

Agni Ltd.

Liabilities	2006 Rs.	2007 Rs.	Assets	2006 Rs.	2007 Rs.
Share capital issued and subscribed: 12,000 shares of Rs.100 each, fully paid	12,00,000	12,00,000	Fixed assets: Furniture and Fixtures: at cost	6,90,000	6,90,000
Reserves and Surplus			Less: depreciation	(69,000)	(1,38,000)
Capital reserve	-	2,10,000	Investments: Quoted investments at market value	-	7,80,000
Revenue reserve	7,98,300	16,74,000	Current assets:		
Current Liabilities and provisions:			Stock at cost	18,30,000	21,75,000
Sundry creditors	15,02,700	18,21,000	Sundry debtors	18,00,000	22,20,000
Provision for taxation	8,40,000	9,60,000	Prepaid expenses	30,000	42,000
			Cash at bank	60,000	96,000
	<u>43,41,000</u>	<u>58,65,000</u>		<u>43,41,000</u>	<u>58,65,000</u>

Bayu Ltd.

Liabilities	2006 Rs.	2007 Rs.	Assets	2006 Rs.	2007 Rs.
Share capital: Issued and subscribed 15,000 equity shares of Rs.100 each, fully paid	15,00,000	15,00,000	Fixed assets: Furniture and fixture at cost	9,60,000	9,60,000
Reserves and surplus:			Less: depreciation	(1,44,000)	(2,88,000)
Revenue reserve	8,58,000	21,42,000	Investments:		

Accounting For Corporate Restructuring

Current liabilities and provisions:			Quoted investments (Market value Rs. 14,70,000)		
Sundry creditors	14,70,000	14,82,000		-	12,00,000
Bank overdraft	-	5,10,000	Current assets:		
Provision for taxation	9,30,000	12,90,000	Stock at cost	17,91,000	22,26,000
			Sundry debtors		
			Less: provision	17,82,000	26,73,000
			Prepaid expenses	2,16,000	1,44,000
			Cash at bank	1,53,000	9,000
	<u>47,58,000</u>	<u>69,24,000</u>		<u>47,58,000</u>	<u>69,24,000</u>

Answer

(a) Statement of Purchase Consideration

Agni Ltd. Bayu Ltd. (Refer W.N. 1)

Year	PBT (Rs.)	Weight	Rs.	PBT (Rs.)	Weight	Rs.
2006	16,38,000	1	16,38,000	15,18,300	1	15,18,300
2007	18,36,000	2	36,72,000	27,63,000	2	55,26,000
Total Profit			<u>53,10,000</u>			<u>70,44,300</u>
Weighted average profit (Divided by 3)			17,70,000			23,48,100
(i) Two years' purchase of average profits			35,40,000			46,96,200
(ii) Net assets (Refer working notes 2 and 3)			<u>30,84,000</u>			<u>35,43,000</u>
			<u>66,24,000</u>			<u>82,39,200</u>
(iii) Discharge of purchase consideration						
82,362 Shares will be issued for goodwill amounting Rs. 82,36,200 (Rs. 35,40,000 + Rs. 46,96,200)						
66,270 15% Debentures will be issued for net assets amounting Rs. 66,27,000 (30,84,000 + 35,43,000)						
Total purchase consideration will amount to Rs. 1,48,63,200.						

Financial Reporting

(b) Balance Sheet of Chandrama Ltd. as on 1st January, 2008

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
<i>Share Capital- issued and subscribed</i>		<i>Investments</i>	
82,362 shares of Rs.100 each, fully paid up	82,36,200	Shares in Agni Ltd.	66,24,000
(Issued for consideration other than cash)		Shares in Bayu Ltd.	82,39,200
<i>Secured Loans</i>			
66,270 15% debentures of Rs.100 each, fully paid	66,27,000		
	<u>1,48,63,200</u>		<u>1,48,63,200</u>

Working Notes:

1. Statement of adjusted Net Profits of Bayu Ltd.

	<i>Year 2006</i>		<i>Year 2007</i>	
	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>
Net Profit as given		17,88,300	-	25,74,000
Add: Provision for Bad Debts-Note (a)	18,000		27,000	
Advertising	-		90,000	
Depreciation- Note(b)	48,000		48,000	
Appreciation in Investment	-		2,70,000	
Value of Opening Stock	-	66,000	<u>36,000</u>	<u>4,71,000</u>
		18,54,300		30,45,000
Less: Value of Closing Stock	36,000		1,02,000	
Advertising	1,80,000		-	
Directors' Remuneration	1,20,000	3,36,000	1,80,000	2,82,000
		<u>15,18,300</u>		<u>27,63,000</u>

Note:

	<i>Rs.</i>	<i>Rs.</i>
	<i>Year 2006</i>	<i>Year 2007</i>
(a) Sundry Debtors as per Balance sheet	17,82,000	26,73,000
Provision created		
1% of (Rs. 17,82,000 / .99)	18,000	
1% of (Rs. 26,73,000 / .99)		27,000

- (b) Rate of depreciation under straight line method for Agni Ltd. is $(\text{Rs.}69,000/6,90,000) \times 100 = 10\%$. Rate of depreciation under straight line method for Bayu Ltd. is $(\text{Rs.}1,44,000/9,60,000) \times 100 = 15\%$
Difference of 5% in depreciation amount i.e. (5% of Rs.9,60,000 = Rs. 48,000) has been added back to ensure uniform accounting policies.

2. Statement of Net Assets of Agni Ltd.

	Rs.	Rs.
Total Assets		58,65,000
Less: Sundry Creditors	18,21,000	
Provision for Taxation	<u>9,60,000</u>	27,81,000
		<u>30,84,000</u>

3. Statement of Adjusted Net Assets of Bayu Ltd.

	Rs.	Rs.
Furniture and Fixtures	9,60,000	
Less: Depreciation at 10% p.a. for two years	<u>1,92,000</u>	7,68,000
Quoted investments at market value		14,70,000
Stock (Rs.22,26,000 – Rs.1,02,000)		21,24,000
Sundry Debtors after Reversal of Provision (Rs.26,73,000 + Rs.27,000)		27,00,000
Prepaid Expenses (Rs.1,44,000 – 90,000)		54,000
Cash at Bank		<u>9,000</u>
		71,25,000
Less: Sundry Creditors	14,82,000	
Bank Overdraft	5,10,000	
Liability for Directors' Remuneration	3,00,000	
Provision for Taxation	<u>12,90,000</u>	35,82,000
		<u>35,43,000</u>

Question 20

Small Ltd. and Little Ltd., two Companies in the field of speciality chemicals, decided to go in for a follow on Public Offer after completion of an amalgamation of their businesses. As per agreed terms initially a new company Big Ltd. will be incorporated on 1st January, 2010 with an authorized capital of Rs.2 crore comprised of 20 lakh equity shares of Rs.10 each. The holding company would acquire the entire shareholding of Small Ltd. & Little Ltd. and in turn would issue its shares to the outside holders of these shares. It is also agreed that the

Financial Reporting

consideration would be a multiple of the average P/E ratio for the period 1st January, 2009 to 31st March, 2009 times the rectified profits of each company, subject to necessary adjustments for complying with the terms of the share issue.

The following information is supplied to you:

	Small Ltd.	Little Ltd.
Ordinary Shares of Rs.10 each (Nos.)	40 lakhs	20 lakhs
10% Preference shares of Rs.100 each (Nos.)	2 lakh	Nil
10% Preference shares of Rs.10 each (Nos.)	Nil	2 lakh
5% debentures of Rs.10 each (Nos.)	4 lakh	4 lakh
Investments Held		
(a) 4 lakh ordinary shares in Small Ltd.	-	Rs.40 lakhs
(b) 2 lakh ordinary shares in Little Ltd.	Rs.20 lakhs	-
Profit before Interest & Tax (PBIT) after considering impact of Inter-company Transactions and Holdings.	Rs.50 lakhs	Rs.25 lakhs
Average P/E ratio January, 2009 to March, 2009	10	8

The following additional information is also furnished to you in respect of adjustments required to the profit figure as given above:

1. The profits of the respective companies would be adjusted for half the value of contingent liabilities as on 31st March, 2009.
2. Debtors of Small Ltd. include an irrecoverable amount of Rs.2 lakh against which Rs.1 lakh was recovered but kept in Advance account.
3. Little Ltd. had omitted to provide for increased FOREX liability of US\$10,000 on loan availed in financial year 2005-06 for purchase of Machinery. The machinery was acquired on 1st January, 2006 and put to use in Financial year 2006-07. The additional liability arose due to change in exchange rates and is arrived at in conformity with prevailing provisions of AS 11. The exchange rate is US \$ 1 = INR 50.
4. Small Ltd. has omitted to invoice a sale that took place on 31st March, 2009 of goods costing Rs.2,50,000 at a mark up of 15 per cent instead the goods were considered as part of closing inventory.
5. Closing Inventory of Rs.45 lakhs of Little Ltd. as on 31st March, 2009 stands undervalued by 10 per cent.
6. Contingent liabilities of Small Ltd. and Little Ltd. as on 31st March, 2009 stands at Rs.5 lakhs and Rs.10 lakhs respectively.

The terms of the share issue are as under:

- (i) Shares in Big Ltd. will be issued at a premium of Rs.13 per share for all external shareholders of Small Ltd. The Premium will be Rs.15 per share for shares in Big Ltd. issued to all external shareholders of Little Ltd.
- (ii) No shares in Big Ltd. will be issued in lieu of the investments (intercompany holdings) of both companies. Instead the shares so held shall be transferred to Big Ltd. at the close of the financial year ended 31st March, 2010 at Par Value consideration payable on date of transfer.
- (iii) Big Ltd. would in addition to the issue of shares to outside shareholders of Small Ltd. and Little Ltd. make a preferential allotment on 31st March, 2010 of 2 lakhs ordinary shares at a premium of Rs.28 per share to Virgin Capital Ltd. (VCL). These shares will not be eligible for any dividends declared or paid till that date.
- (iv) Big Ltd. will go in for a 18 per cent unsecured Bank overdraft facility to meet incorporation costs of Rs.16 lakhs and towards management expenses till 31st March, 2010 estimated at Rs.14 lakhs. The overdraft is expected to be availed on 1st February, 2010 and closed on 31st March, 2010 out of the proceeds of the preferential allotment.
- (v) It is agreed that interim dividends will be paid on 31.03.2010 for the period January, 2010 to March, 2010 by Big Ltd. at 2 per cent; Small Ltd. at 3 per cent and Little Ltd. at 2.5 per cent. Ignore Dividend Distribution tax.
- (vi) The prevailing Income Tax Rate is 25 per cent.

You are required to compute the number of shares to be issued to the shareholders of each of the companies and prepare the projected Profit and Loss Account for the period from 1st January, 2010 to 31.03.2010 of Big Ltd. and its Balance Sheet as on 31st March, 2010.

Answer

Computation of number of shares issued

Calculation of Rectified Profits and Purchase consideration

	Rs.	Rs.
Small Ltd.		
Given profits		50,00,000
Less: Irrecoverable Debtors	1,00,000	
50% Contingent Liability	<u>2,50,000</u>	<u>3,50,000</u>
		46,50,000
Add: Profit on omitted sale (15% of Rs.2,50,000)		<u>37,500</u>

Financial Reporting

	46,87,500
Less: Debenture interest	<u>2,00,000</u>
	44,87,500
Less: Income Tax @ 25%	<u>11,21,875</u>
Profits after Tax (PAT)	33,65,625
Less: Preference Dividend (10% of Rs.2,00,00,000)	<u>20,00,000</u>
Rectified Profits	<u>13,65,625</u>
Average PE ratio = 10	
Total consideration for all equity shareholders (Average PE ratio × Profit)	136,56,250
Less: 10% thereof for shareholders of Little Ltd.	<u>13,65,625</u>
Balance available for other shareholders of Small Ltd.	<u>122,90,625</u>

Little Ltd.

Given profits		25,00,000
Less: Increase in FOREX liability (US\$10,000 × 50)	5,00,000	
50% Contingent Liability	<u>5,00,000</u>	<u>10,00,000</u>
		15,00,000
Add: Undervaluation of inventory (45,00,000 × 10/90)		<u>5,00,000</u>
		20,00,000
Less: Debenture interest		<u>2,00,000</u>
		18,00,000
Less: Income Tax @ 25%		<u>4,50,000</u>
Profits after Tax (PAT)		13,50,000
Less: Preference Dividend (10% of Rs.20,00,000)		<u>2,00,000</u>
Rectified Profits		<u>11,50,000</u>
Average PE ratio = 8		
Total consideration for all equity shareholders (Average PE ratio × Profit)		92,00,000
Less: 10% thereof for shareholders of Small Ltd.		<u>9,20,000</u>
Balance available for other shareholders of Little Ltd.		<u>82,80,000</u>

Accounting For Corporate Restructuring

Statement showing Disposal of Purchase Consideration

	Small Ltd. Rs.	Little Ltd. Rs.	Total Rs.
Number of shares [Purchase consideration/(Face Value + Securities Premium)]	<u>5,34,375</u>	<u>3,31,200</u>	<u>8,65,575</u>
Share Capital	53,43,750	33,12,000	86,55,750
Securities Premium	<u>69,46,875</u>	<u>49,68,000</u>	<u>1,19,14,875</u>
Purchase Consideration	<u>122,90,625</u>	<u>82,80,000</u>	<u>2,05,70,625</u>

Projected Profit and Loss Account of Big Ltd.
for the period 1st January, 2010 to 31st March, 2010

	Rs.
Dividends received from Subsidiaries (12,00,000 + 5,00,000)	17,00,000
Less: Management expenses	14,00,000
Interest on Bank O/D	<u>90,000</u>
Net profit for the period	2,10,000
Less: Proposed Dividend (2% of Rs.86,55,750)	<u>1,73,115</u>
Balance of Profit and Loss Account carried forward	<u>36,885</u>

Projected Balance Sheet of Big Ltd.
as on 31st March, 2010

Liabilities	Rs.	Assets	Rs.
<i>Equity Share Capital</i>		<i>Investments</i>	
<i>Authorised</i>		Shares in Subsidiaries (W.N. 4)	2,65,70,625
20 lakhs shares of Rs.10 each	<u>2,00,00,000</u>	<i>Current Assets</i>	
Issued & Paid up		Cash at Bank (W.N. 3)	36,885
10,65,575 shares of Rs.10 each (out of the above 8,65,575 shares have been issued for consideration other than cash)	1,06,55,750	<i>Miscellaneous Expenditure</i>	
		Preliminary expenses	16,00,000
<i>Reserves & Surplus</i>			
Securities Premium	1,75,14,875		
(1,19,14,875 + 56,00,000)			
Profit and loss Account	<u>36,885</u>		
	<u>2,82,07,510</u>		<u>2,82,07,510</u>

Financial Reporting

Working Notes:

1. Shares issued by Big Ltd. to Virgin capital Ltd. (VCL)

Number of shares issued	2,00,000
	Rs.
Face Value of Share Capital @ Rs.10 each	20,00,000
Securities Premium @ Rs.28 each	<u>56,00,000</u>
Total cash received from VCL	<u>76,00,000</u>

2. Overdraft of Big Ltd. as on 31.3.2010

	Rs.
Towards Incorporation expenses i.e. preliminary expenses	16,00,000
Towards Management expenses	<u>14,00,000</u>
Total Bank Overdraft availed	<u>30,00,000</u>
Interest @ 18% p.a. for 2 months	<u>90,000</u>

3. Bank balance of Big Ltd. as on 31.3.2010

Bank Account of Big Ltd.

			Rs.				Rs.
01.02.2010	To	Overdraft	30,00,000	01.02.2010	By	Incorporation expenses	16,00,000
31.03.2010	To	VCL	76,00,000	31.03.2010	By	Management expenses	14,00,000
31.03.2010	To	Dividend		31.03.2010	By	Interest on Overdraft	90,000
		Small	12,00,000 ¹	31.03.2010	By	Overdraft	30,00,000
		Little	5,00,000 ²	31.03.2010	By	Dividend paid	1,73,115 ³
				31.03.2010	By	Shares in Small Ltd. bought from Little Ltd.	40,00,000
				31.03.2010	By	Shares in Little Ltd. bought from Small Ltd.	20,00,000
					By	Balance c/d (Balancing figure)	<u>36,885</u>
			<u>123,00,000</u>				<u>123,00,000</u>

¹ (40,00,000 x 10) x 3% = 12,00,000.

² (20,00,000 x 10) x 2.5% = 5,00,000.

³ [(5,34,375 + 3,31,200) x 10] x 2% = 1,73,115.

4. Investments of Big Ltd. in Projected Balance Sheet

Rs.

Purchase consideration paid for acquiring shares of outside holders of-

Small Ltd	122,90,625
-----------	------------

Little Ltd.	82,80,000
-------------	-----------

Consideration paid in cash for acquiring cross holdings

From Small Ltd. (shares of Little Ltd.)	20,00,000
---	-----------

From Little Ltd. (shares of Small Ltd.)	<u>40,00,000</u>
---	------------------

	<u>2,65,70,625</u>
--	--------------------

Question 21

Dawn Ltd. was incorporated to take over Arun Ltd., Brown Ltd. and Crown Ltd. Balance Sheets of all the three companies as on 31.03.2008 are as follows:

Particulars	Arun Ltd.	Brown Ltd.	Crown Ltd.
<i>Liabilities :</i>			
Equity Share Capital (Share of Rs. 10 each)	1,800	2,100	900
Reserve	300	150	300
10 % Debentures	600	---	300
Other Liabilities	<u>600</u>	<u>450</u>	<u>300</u>
Total	<u>3,300</u>	<u>2,700</u>	<u>1,800</u>

Particulars	Arun Ltd.	Brown Ltd.	Crown Ltd.
<i>Assets :</i>			
Net Tangible Block	2,400	1,800	1,500
Goodwill	-	150	-
Other Assets	<u>900</u>	<u>750</u>	<u>300</u>
Total	<u>3,300</u>	<u>2,700</u>	<u>1,800</u>

From the following information you are to:

- (a) Work out the number of Equity shares and Debentures to be issued to the shareholders of each company.

Financial Reporting

(b) Prepare the Balance Sheet of Dawn Ltd. as on 31.03.2008.

Information:

(i) Assets are to be revalued and the revalued amount of Tangible Block and other Assets are as follows:

	<i>Tangible Block</i>	<i>Other Assets</i>
<i>Arun Ltd.</i>	<i>Rs. 30,00,000</i>	<i>Rs. 10,50,000</i>
<i>Brown Ltd.</i>	<i>Rs. 15,00,000</i>	<i>Rs. 4,20,000</i>
<i>Crown Ltd.</i>	<i>Rs. 18,00,000</i>	<i>Rs. 2,40,000</i>

(ii) Normal profit on capital employed is to be taken at 10%

(iii) Average amount of profit for three years before charging interest on Debentures are:

<i>Arun Ltd.</i>	<i>Rs. 5,40,000</i>
<i>Brown Ltd.</i>	<i>Rs. 4,32,000</i>
<i>Crown Ltd.</i>	<i>Rs. 3,12,000</i>

(iv) Goodwill is to be calculated at three years' purchase of average super profits for three years, such average is to be calculated after adjustment of 10% depreciation on Increase/ Decrease on revaluation of Fixed Assets (Tangible Block) .

(v) Capital employed being considered on the basis of net revaluation of Tangible Assets.

(vi) Equity Shares of Rs. 10 each fully paid up in Dawn Ltd. are to be distributed in the ratio of average profit after adjustment of depreciation on revaluation of Tangible Block.

(vii) 10% Debentures of Rs. 100 each fully paid up are to be issued by Dawn Ltd. for the balance due.

(viii) The ratio of issue of Equity shares and debentures of Dawn Ltd. are to be maintained at 3:1, towards the take over companies.

(ix) The amount required for preliminary expenses of Rs. 1,50,000 and for payment to existing Debenture holders, were provided by issuing Equity shares of Rs. 10 each in Dawn Ltd.

Answer**(a) Number of Equity shares and Debentures to be issued to the shareholders of each company**

	<i>Arun Ltd.</i>	<i>Brown Ltd.</i>	<i>Crown Ltd.</i>	<i>Total paid by Dawn Ltd. in 3:1 Rs.</i>
	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>	
Equity shares of Rs.10/- each in the ratio of adjusted profits (420:462:252)	20,65,000	22,71,500	12,39,000	55,75,500
10% Debentures [Balance of purchase consideration] –Refer W.N. 2	<u>11,90,000</u>	<u>1,43,500</u>	<u>5,25,000</u>	<u>18,58,500</u>
	<u>32,55,000</u>	<u>24,15,000</u>	<u>17,64,000</u>	<u>74,34,000</u>
No. of shares of Rs.10 each	2,06,500	2,27,150	1,23,900	5,57,550
10% Debentures of Rs.100 each in numbers	11,900	1,435	5,250	18,585

(b) Balance Sheet of Dawn Ltd.as at 31.3.2008

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Share capital		Goodwill	16,74,000
6,62,550 shares of Rs.10- each, fully paid up (Including 5,57,550 shares of Rs.10 each issued for consideration other than cash)	66,25,500	Tangible Assets Block	63,00,000
		Current Assets	17,10,000
18,585, 10% Debentures of Rs.100 each	18,58,500	Preliminary Expenses	1,50,000
Current Liabilities	<u>13,50,000</u>		
	<u>98,34,000</u>		<u>98,34,000</u>

Working Notes:**1. Computation of Goodwill**

	<i>Arun Ltd.</i>	<i>Brown Ltd.</i>	<i>Crown Ltd.</i>	<i>Total</i>
	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>
Profit	5,40,000	4,32,000	3,12,000	12,84,000
Debenture Interest	<u>(60,000)</u>	<u>-</u>	<u>(30,000)</u>	<u>(90,000)</u>
Profit after Debenture Interest	4,80,000	4,32,000	2,82,000	11,94,000

Financial Reporting

Adjustment for increase/decrease in depreciation due to revaluation	<u>(60,000)</u>	<u>30,000</u>	<u>(30,000)</u>	<u>(60,000)</u>
	4,20,000	4,62,000	2,52,000	11,34,000
Less: Normal Profit @ 10% on Capital employed as per Working Note 2	<u>2,85,000</u>	<u>1,47,000</u>	<u>1,44,000</u>	<u>5,76,000</u>
Super Profits	<u>1,35,000</u>	<u>3,15,000</u>	<u>1,08,000</u>	<u>5,58,000</u>
Goodwill on 3 years of super profits	<u>4,05,000</u>	<u>9,45,000</u>	<u>3,24,000</u>	<u>16,74,000</u>

2. Statement showing calculation of Capital Employed and Purchase Consideration

	<i>Arun Ltd.</i>	<i>Brown Ltd.</i>	<i>Crown Ltd.</i>	<i>Total</i>
	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>
Fixed Assets	30,00,000	15,00,000	18,00,000	63,00,000
Current Assets	<u>10,50,000</u>	<u>4,20,000</u>	<u>2,40,000</u>	<u>17,10,000</u>
	40,50,000	19,20,000	20,40,000	80,10,000
Less: Debentures	6,00,000	---	3,00,000	9,00,000
Current Liabilities	<u>6,00,000</u>	<u>4,50,000</u>	<u>3,00,000</u>	<u>13,50,000</u>
Capital Employed	28,50,000	14,70,000	14,40,000	57,60,000
Goodwill as per (i)	<u>4,05,000</u>	<u>9,45,000</u>	<u>3,24,000</u>	<u>16,74,000</u>
Purchase consideration	<u>32,55,000</u>	<u>24,15,000</u>	<u>17,64,000</u>	<u>74,34,000</u>

3. Total number of equity shares issued

	<i>Equity Shares</i>
For purchase consideration	5,57,500
preliminary expenses (Rs. 1,50,000/ Rs. 10)	15,000
payment of existing debenture holders (Rs. 6,00,000 + Rs. 3,00,000) /Rs. 10	<u>90,000</u>
	<u>6,62,550</u>

Question 22

The following are the Balance Sheets of H Ltd. and S Ltd. as at 31.03.09:

			Rs. in lakhs	
	H Ltd. Rs.	S Ltd. Rs.	H Ltd. Rs.	S Ltd. Rs.
Share capital			60	18
Share of Rs.10 each	50	10	6	-
General reserve	50	20	35	5
Profit and Loss	20	15	30	25
Secured loan	20	3	39	2
Current liabilities	<u>30</u>	<u>2</u>		
	<u>170</u>	<u>50</u>	<u>170</u>	<u>50</u>
			Fixed assets	
			Investment in S Ltd. (60,000 shares)	
			Debtors	
			Inventories	
			Cash at Bank	

H Ltd. holds 60% of the paid up capital of S Ltd. and balance is held by a foreign company. The foreign company agreed with H Ltd. as under:

- (i) The shares held by the foreign company will be sold to H Ltd. at Rs. 50 above than nominal value of per share.
- (ii) The actual cost per share to the Foreign Company was Rs. 11, gain accruing to Foreign Company is taxable @ 20 % . The tax payable will be deducted from the sale proceeds and paid to Government by H Ltd. 50% of the consideration (after payment of tax) will be remitted to Foreign Company by H Ltd. and also any cash for fractional shares allotted.
- (iii) For the Balance of consideration H Ltd. would issue its shares at their intrinsic value.

It was also decided that H Ltd. would also absorb S Ltd. simultaneously by writing down the fixed assets of S Ltd. by 10 %. The Balance Sheet figure included a sum of Rs. 1 lakh due by S Ltd. to H Ltd, included stock of Rs. 1.5 lakhs purchased from S Ltd. who sold them at cost plus 20 %.

Pass Journal entries in the books of H Ltd. to record the above arrangement on 31.03.09 and prepare the Balance Sheet of H Ltd. after absorption of S Ltd. Workings should form part of your answer.

Answer**Journal Entries in the books of H Ltd.**

		Rs.	Rs.
1.	Business Purchase A/c	Dr.	24,00,000
	To Foreign Company		24,00,000
	(Being business purchased)		
2.	Fixed Assets A/c	Dr.	16,20,000
	Debtors A/c	Dr.	5,00,000

Financial Reporting

Inventories A/c	Dr.	25,00,000	
Cash at Bank A/c	Dr.	2,00,000	
To Current Liabilities A/c			2,00,000
To Secured Loan A/c			3,00,000
To Investment in S Ltd. A/c			6,00,000
To Business Purchase A/c			24,00,000
To Capital Reserve A/c (B.F.)			13,20,000
(Being various assets and liabilities taken over)			
3. Profit and Loss A/c	Dr.	25,000	
To Inventories A/c			25,000
(Being elimination of unrealized profit)			
4. Current Liabilities A/c	Dr.	1,00,000	
To Debtors A/c			1,00,000
(Being elimination of mutual owing)			
5. Foreign Company	Dr.	24,00,000	
To Tax Payable A/c			3,92,000
To Bank A/c(Rs.10,04,000 + Rs.20)			10,04,020*
To Equity Share Capital A/c			3,34,660
To Securities Premium A/c			6,69,320
(Being payment made to foreign company)			
6. Tax Payable A/c	Dr.	3,92,000	
To Bank A/c			3,92,000
(Being tax paid to Government)			

Balance Sheet of H Ltd. (After Absorption)

Liabilities	Rs.	Assets	Rs.
5,34,466 Shares of Rs.10 each	53,34,660	Fixed Assets	76,20,000
(out of above, 33,466 shares issued for consideration other than cash)		(60,00,000+16,20,000)	
General Reserve	50,00,000	Sundry Debtors	39,00,000
Profit & Loss (20,00,000– 25,000)	19,75,000	(35,00,000 – 1,00,000	
Capital Reserve	13,20,000	+5,00,000)	
Securities Premium	6,69,320		

* It is assumed that payment of fractional shares has also been routed through Bank A/c along with 50% payment remitted to Foreign Company.

Accounting For Corporate Restructuring

Secured Loan (20,00,000+3,00,000)	23,00,000	Inventories (30,00,000-25,000+25,00,000)	54,75,000
Current Liabilities (30,00,000+2,00,000-1,00,000)	31,00,000	Cash at Bank (39,00,000+2,00,000- 10,04,020-3,92,000)	27,03,980
	<u>196,98,980</u>		<u>196,98,980</u>

Working Notes:**1. Amount payable to foreign company**

Price per share of S Ltd. = Rs.50 + Rs.10 (Nominal value) = Rs.60

Value of 40% shares held by foreign company = $10,00,000 \times 40\% \times \frac{60}{10} = \text{Rs. } 24,00,000$

Capital gain = $\text{Rs. } 24,00,000 - \left(4,00,000 \times \frac{11}{10} \right) = \text{Rs. } 19,60,000$

Tax on capital gain = $\text{Rs. } 19,60,000 \times 20\% = \text{Rs. } 3,92,000$

Amount payable to Foreign Company after tax = $\text{Rs. } 24,00,000 - \text{Rs. } 3,92,000 = \text{Rs. } 20,08,000$

50% of Rs.20,08,000 = Rs.10,04,000 to be remitted to foreign company.

2. Intrinsic value of shares of H Ltd. and balance payment to foreign company

	Rs.	Rs.
Total assets (Excluding Investment in S Ltd.)		1,64,00,000
Add: Investment in S Ltd. (60,000 shares × Rs.60)		<u>36,00,000</u>
		2,00,00,000
Less: Liabilities:		
Secured Loan	20,00,000	
Current Liability	<u>30,00,000</u>	<u>50,00,000</u>
		<u>1,50,00,000</u>
No. of equity shares		5,00,000
Intrinsic value per share		Rs.30
Number of shares to be issued for payment of 50% balance amount		
$\frac{\text{Rs. } 10,04,000}{30} = 33,466 \text{ shares}$		
Cash for fractional shares = $\text{Rs. } 10,04,000 - (33,466 \times \text{Rs. } 30) = \text{Rs. } 20$		

Financial Reporting**EXERCISES****Question 1**

The summarized Balance Sheets of A Ltd. and its subsidiary B Ltd. as on 31.3.2010 are as follows:

	A Ltd. Rs.	B Ltd. Rs.
Shares of Rs. 10 each	1,00,00,000	20,00,000
Reserves and Surplus	1,40,00,000	60,00,000
Secured Loans	40,00,000	—
Current Liabilities	<u>60,00,000</u>	<u>20,00,000</u>
	<u>3,40,00,000</u>	<u>1,00,00,000</u>
Fixed Assets	1,20,00,000	35,00,000
Investment in B Ltd.	7,40,000	—
Sundry Debtors	70,00,000	10,00,000
Inventories	60,00,000	50,00,000
Cash and Bank	<u>82,60,000</u>	<u>5,00,000</u>
	<u>3,40,00,000</u>	<u>1,00,00,000</u>

A Ltd. holds 76% of the paid up capital of B Ltd. The balance shares in B Ltd. are held by a Foreign Collaborating company. A memorandum of understanding has been entered into with the foreign company providing for the following:

- The shares held by the foreign company will be sold to A Ltd. The price per share will be calculated by capitalizing the yield at 16%. Yield, for this purpose, would mean 40% of the average of pre-tax profits for the last 3 years, which were Rs. 35 lakhs, Rs. 44 lakhs and Rs. 65 lakhs.
- The actual cost of shares to the foreign company was Rs. 2,40,000 only. The profit that would accrue to them would be taxable at an average rate of 30%. The tax payable be deducted from the proceeds and A Ltd. will pay it to the Government.
- Out of the net consideration, 50% would be remitted to the foreign company immediately and the balance will be an unsecured loan repayable after one year. It was also decided that A Ltd. would absorb B Ltd. simultaneously by writing down the Fixed Assets of B Ltd. by 5%. The Balance Sheet figures included a sum of Rs. 1,50,000 due by B Ltd. to A Ltd.

The entire arrangement was approved by all concerned for giving effect to on 1.4.2010.

You are required to show the Balance Sheet of A Ltd. as it would appear after the arrangement is put through on 1.4.2010.

[Answer: Total of the balance sheet of A Ltd. Rs. 410.99 Lakhs; Yield of B Ltd.: Rs. 19.2 lakhs; Price per share of B Ltd. = Rs. 60; Purchase consideration for 24% of share capital of B Ltd. = Rs. 28.80 lakhs; Capital Reserve to A Ltd. Rs. 42.05 lakhs; Cash and bank balance of A Ltd. after acquisition of shares Rs. 69.24 lakhs.]

Discharge of Purchase Consideration:

(i) as Tax :Rs. 7.92 lakhs

(ii) 50% of (28.80 – 7.92 i.e. Rs. 20.88 lakhs) = Rs. 10.44 lakhs (to be remitted immediately)

(iii) Balance 50% = Rs. 10.44 lakhs (to be retained as unsecured loan)]

Question 2

Travels & Tours Ltd. has two divisions – 'Inland' and 'International'. The Balance Sheet as at 31st December, 2009 was as under:

	Inland (Rs. crores)	International (Rs. crores)	Total (Rs. crores)
Fixed Assets:			
Cost	600	600	1,200
Depreciation	<u>500</u>	<u>200</u>	<u>700</u>
W.D.V. (written down value) (A)	100	400	500
Net Current Assets:			
Current assets	400	300	700
Less: Current liabilities	<u>200</u>	<u>200</u>	<u>400</u>
(B)	<u>200</u>	<u>100</u>	<u>300</u>
Total (A + B)	<u>300</u>	<u>500</u>	<u>800</u>
Financed by:			
Loan funds:			
(Secured by a charge on fixed assets)	—	100	100
Own Funds:			
Equity capital (fully paid up Rs. 10 shares)			50
Reserves and surplus	<u>—</u>	<u>—</u>	<u>650</u>
	<u>?</u>	<u>?</u>	<u>700</u>
Total	<u>300</u>	<u>500</u>	<u>800</u>

It is decided to form a new company 'IT Ltd.' for international tourism to take over the assets and liabilities of international division.

Financial Reporting

Accordingly 'IT Ltd.' was formed to takeover at Balance Sheet figures the assets and liabilities of international division. 'IT Ltd.' is to allot 5 crore equity shares of Rs. 10 each in the company to the members of 'Travels & Tours Ltd.' in full settlement of the consideration. The members of 'Travels & Tours Ltd.' are therefore to become members of 'IT Ltd.' as well without having to make any further investment.

- You are asked to pass journal entries in relation to the above in the books of 'Travels & Tours Ltd.' and also in 'IT Ltd.'. Also show the Balance Sheets of both the companies as on 1st January, 2010 showing corresponding figures, before the reconstruction also.
- The directors of both the companies ask you to find out the net asset value of equity shares pre and post-demerger.
- Comment on the impact of demerger on "shareholders wealth".

[Answer: Loss on reconstruction Rs. 400 crores, Total of the balance sheet of Travels & Tours Ltd. before and after reconstruction would be Rs. 800 crores and Rs. 300 crores respectively.]

Net Asset Value of an equity share	Pre-Demerger	Post-Demerger
Travels & Tours Ltd.	= Rs. 140	= Rs. 60]

Question 3

System Ltd. and HRD Ltd. decided to amalgamate as on 01.04.2010. Their Balance Sheets as on 31.03.2010 were as follows: (Rs. in '000)

Particulars	System Ltd.	HRD Ltd.
Source of Funds :		
Equity share capital (Rs. 10 each)	150	140
9% preference share Capital (Rs. 100 each)	30	20
Investment allowance Reserve	5	2
Profit and Loss Account	10	6
10 % Debentures	50	30
Sundry Creditors	25	15
Tax provision	7	4
Equity Dividend Proposed	<u>30</u>	<u>28</u>
Total	<u>307</u>	<u>245</u>
Application of Funds :		
Building	60	50
Plant and Machinery	80	70
Investments	40	25

Accounting For Corporate Restructuring

Sundry Debtors	45	35
Stock	36	40
Cash and Bank	40	25
Preliminary Expenses	<u>6</u>	<u>—</u>
Total	<u>307</u>	<u>245</u>

From the following information, you are to prepare the draft Balance Sheet as on 01.04.2010 of a new company, Intranet Ltd., which was formed to take over the business of both the companies and took over all the assets and liabilities:

- (i) 50 % Debenture are to be converted into Equity Shares of the New Company.
- (ii) Out of the investments, 20% are non-trade investments.
- (iii) Fixed Assets of Systems Ltd. were valued at 10% above cost and that of HRD Ltd. at 5% above cost.
- (iv) 10 % of sundry Debtors were doubtful for both the companies. Stocks to be carried at cost.
- (v) Preference shareholders were discharged by issuing equal number of 9% preference shares at par.
- (vi) Equity shareholders of both the transferor companies are to be discharged by issuing Equity shares of Rs. 10 each of the new company at a premium of Rs. 5 per share.

Amalgamation is in the nature of purchase.

[Answer: Value of equity shares issued to System Ltd. 1,98,500 and to HRD Ltd. 1,78,500]

Cash paid for fraction of shares = Rs. 1,98,500 less Rs. 1,98,495 = Rs. 5 to System Ltd.

Cash paid for fraction of shares = Rs. 25,000 less Rs. 24,990 = Rs. 10 to HRD Ltd.

Total of M/s Intranet balance sheet as at 1.4.2010 Rs. 5,64,985]

Question 4

The Balance Sheet of Munna Ltd as on 31st March, 2009 is as follows:

Liabilities	Rs.	Assets	Rs.
Authorised and issued Share capital		Goodwill	2,00,000
20,000 equity shares of Rs.100 each, fully paid	20,00,000	Plant & Machinery	18,00,000
10,000, 7% Preference shares of Rs.100 each	10,00,000	Stock	3,00,000
Sundry creditors	7,00,000	Debtors	7,50,000

Financial Reporting

Bank overdraft	3,00,000	Cash	1,50,000
		Preliminary expenses	1,00,000
		Profit and Loss Account	7,00,000
	40,00,000		40,00,000

Additional Information:

Two years' preference share dividend is in arrears. The company had bad time during the last two years and hopes for better business in future, earning profit and paying dividend, provided the capital base is reduced.

An internal reconstruction scheme, agreed to by all concerned, is as follows:

- (i) Creditors agreed to forego 50% of their claim.
- (ii) Preference shareholders withdrew arrear dividend claim. They also agreed to lower down their capital claim by 20% by reducing nominal value in consideration of 9% dividend effective after reconstruction, in case equity shareholder's loss exceeded 50% on the application of the scheme.
- (iii) Bank has agreed to convert overdraft into term loan to the extent required for making current ratio to 2:1.
- (iv) Revalued amount for plant and machinery was accepted as Rs.15,00,000.
- (v) Debtors to the extent of Rs.4,00,000 were considered as good.
- (vi) Equity shares shall be exchanged for the same number of equity shares at a revised denomination as required after the reconstruction.

You are required to show the following:

- (a) Total loss to be borne by the equity and preference shareholders for the reconstruction.
- (b) Share of loss to the individual class of shareholders.
- (c) New structure of share capital after reconstruction.
- (d) Working capital of the reconstructed company, and
- (e) A Performa Balance Sheet after reconstruction.

[Answer: Loss to be borne by Equity and Preference Shareholders Rs.13,00,000; New structure of share capital after reorganization Rs.17,00,000; Working capital of the reorganized company Rs. 4,25,000; Balance Sheet (total) of Munna Ltd. (and reduced) Rs. 23,50,000]

CONSOLIDATED FINANCIAL STATEMENTS OF GROUP COMPANIES

BASIC CONCEPTS

- Meaning of subsidiary : According to Section 4(1) of the Companies Act, 1956, a company shall be deemed to be a subsidiary of another if and only if, –
 - (a) that other controls the composition of its Board of directors; or
 - (b) that other :
 - (i) where the first-mentioned company is an existing company in respect of which the holders of preference shares issued before the commencement of this Act have the same voting rights in all respects as the holders of equity shares, exercises or controls more than half of the total voting power of such company;
 - (ii) where the first-mentioned company is any other company, holds more than half in nominal value of its equity share capital; or
 - (c) the first-mentioned company is a subsidiary of any company which is that other's subsidiary.
 - **In a wholly owned subsidiary**, there is no minority interest because all the shares with voting rights are held by the holding company.
 - Consolidated financial statements are prepared and presented by a parent/holding enterprise to provide financial information about a parent and its subsidiary(ies) as a single economic entity.
 - **Distinction** must be made from the point of view of the holding company, **between revenue and capital profit of the subsidiary**. In the absence of information, profits of a year may be treated as accruing from day to day

Consolidation procedures

In preparing the consolidated financial statements, the following steps are taken:

- the **carrying amount of the parent's investment** in each subsidiary and the parent's portion of equity of each subsidiary **are eliminated**.
- In case cost of acquisition exceeds or is less than the acquirer's interest, **goodwill or capital reserve** is calculated retrospectively.

Financial Reporting

- **intragroup transactions**, including sales, expenses and dividends, are **eliminated, in full**;
- **unrealised profits resulting from intragroup transactions** that are included in the carrying amount of assets, such as inventory and fixed assets, **are eliminated in full**;
- **unrealised losses resulting from intragroup transactions** that are deducted in arriving at the carrying amount of assets **are also eliminated unless cost cannot be recovered**;
- **minority interest** in the **net income of consolidated subsidiaries** for the reporting period are identified and adjusted against the income of the group in order to arrive at the net income attributable to the owners of the parent; and
- **minority interests in the net assets of consolidated subsidiaries** are identified and presented in the consolidated balance sheet separately from liabilities and the parent shareholders' equity.
- If the controlling interest was acquired during the course of a year, **profit for that year must be apportioned** into the pre-acquisition and post-acquisition portions, **on the basis of time** in the absence of information on the point.
- the financial statements of the parent and its subsidiaries are combined on a line by line basis by adding together like items of assets, liabilities, equity, income and expenses.
- **Dividend received from a subsidiary company**, must be **distinguished** between the part **received out of capital profits and that out of revenue profits** - the former is credited to Investment Account, it being a capital receipt, and the latter is adjusted as revenue income for being credited to the Profit & Loss Account.
- In respect of such goods not yet sold, the unrealised profits are to be eliminated in full. This may be done by creating a reserve in respect of total unrealised profit which has not yet been realised.
- Also, unrealised losses resulting from intragroup transactions should also be eliminated unless cost cannot be recovered.

Preparation of Consolidated Profit and Loss Account

- **All the revenue items** are to be added **on line by line** basis and from the consolidated revenue items inter-company transactions should be eliminated.
- If there **remains any unrealised profit in the stock of good**, of any of the Group Company, **such unrealised profit is to be eliminated** from the value of stock to arrive at the consolidated profit.

- Also it is necessary to eliminate the share of holding company in the proposed dividend of the subsidiary.

Preparation of Consolidated Cash Flow Statement

All the items of Cash flow from **operating activities, investing activities and financing activities** are to be added on **line by line basis** and from the consolidated items, inter-company transactions should be eliminated.

Treatment of Investment in Associates in Consolidated Financial Statements

An enterprise that presents consolidated financial statements should account for investments in associates in the consolidated financial statements in accordance with the **Accounting Standard (AS) 23**.

Accounting for Associates (AS 23)

AS 23 suggests equity method of accounting for investments in associates.

Under equity method The following procedure should be followed:

- **Investment is initially recorded at cost.** Subsequently, the carrying amount is increased on the basis of share of profit or decreased on the basis of share of loss in the associate.
- Step (1): Find out value of investments on the basis of proportionate value of net assets of the investee;
- Step (2): Find out goodwill or capital reserve arising out of the purchase consideration.
 - If the purchase price is above the value of investments determined in step (1) then there is goodwill and
 - if the purchase price is less than the value of the investments determined in step (1) then there is capital reserve.
- Step (3): Goodwill or capital reserve as determined in step (2) should be included in the carrying amount of the investments with a separate disclosure. On the contrary, investments are recognised at purchase price as per AS 13 without disclosing goodwill/capital reserve.

DISCLOSURE-Goodwill/capital reserve can be disclosed within bracket below the "Investments in Associates" in the following style and accumulated income which was not earlier recognized should be added to value of investments for first time consolidation with corresponding credit to consolidated reserve.

Equity method is not applicable

- (1) when an investment is acquired for the purpose of disposal in the near future, i.e., as short term investments; and
- (2) there is severe long term restriction on fund transfer by the associate to the investor. In these two cases AS 13 should be applied.

Financial Reporting

Treatment of Investment in Joint Ventures in Consolidated Financial Statements (AS 27)

AS 27 identifies three broad types of Joint Ventures- jointly controlled operations, jointly controlled assets and jointly controlled entities.

Jointly Controlled Operations

In respect of its interests in jointly controlled operations, a venturer should recognise in its separate financial statements and consequently in its consolidated financial statements:

- (a) the assets that it controls and the liabilities that it incurs; and
- (b) the expenses that it incurs and its share of the income that it earns from the joint venture.

Jointly Controlled Assets

In respect of its interest in jointly controlled assets, a venturer should recognise, in its separate financial statements, and consequently in its consolidated financial statements:

- (a) its share of the jointly controlled assets, classified according to the nature of the assets;
- (b) any liabilities which it has incurred;
- (c) its share of any liabilities incurred jointly with the other venturers in relation to the joint venture;
- (d) any income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and
- (e) any expenses which it has incurred in respect of its interest in the joint venture.

Jointly Controlled Entities

A jointly controlled entity maintains its own accounting records and prepares and presents financial statements in the same way as other enterprises in conformity with the requirements of AS 27 applicable to that jointly controlled entity.

Separate Financial Statements of a Venturer

In a venturer's separate financial statements, interest in a jointly controlled entity should be accounted for as an investment in accordance with Accounting Standard (AS) 13.

Consolidated Financial Statements of a Venturer

In its consolidated financial statements, a venturer should report its interest in a jointly controlled entity using proportionate consolidation except

- (a) an interest in a jointly controlled entity which is acquired and held exclusively with a view to its subsequent disposal in the near future; and
- (b) an interest in a jointly controlled entity which operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturer.

Consolidated Financial Statements of Group Companies

Problems involving one Subsidiary

Question 1

On 31st March, 2010, the Balance Sheets of H Ltd. and S Ltd. stood as follows:

	H Ltd.	S Ltd.
	(Rs. in 000's)	
<i>Liabilities</i>		
Equity Share (Capital – Authorised)	<u>5,000</u>	<u>3,000</u>
Issued and subscribed in Equity Shares of Rs. 10 each full paid	4,000	2,400
General Reserve	928	690
Profit and Loss Account	1,305	810
Bills Payable	124	80
Sundry Creditors	487	427
Provision for Taxation	220	180
Other Provisions	<u>65</u>	<u>17</u>
	<u>7,129</u>	<u>4,604</u>
<i>Assets:</i>		
Plant and Machinery	2,541	2,450
Furniture and Fittings	615	298
Investment in the Equity Shares of S Ltd.	1,500	–
Stock	983	786
Debtors	700	683
Bills Receivables	120	95
Cash and Bank Balances	410	102
Sundry Advances	<u>260</u>	<u>190</u>
	<u>7,129</u>	<u>4,604</u>

Following Additional Information is available:

- (a) H Ltd. purchased 90 thousand Equity Shares in S Ltd. on 1st April, 2009 at which date the following balances stood in the books of S Ltd.

General Reserve Rs. 1,500 thousand; Profit and Loss Account Rs. 633 thousand.

Financial Reporting

- (b) On 14th July, 2009 S Ltd. declared a dividend of 20% out of pre-acquisition profits and paid corporate dividend tax (including surcharge) at 11%. H Ltd. credited the dividend received to its Profit and Loss Account.
- (c) On 1st November, 2009 S Ltd. issued a 3 fully paid Equity Shares of Rs. 10 each, for every 5 shares held as bonus shares out of pre-acquisition General Reserve.
- (d) On 31st March, 2010, the Stock of S Ltd. included goods purchased for Rs. 50 thousand from H Ltd., which had made a profit of 25% on Cost.

Prepare a consolidated Balance Sheet as on 31st March, 2010.

Answer

Consolidated Balance Sheet of H Ltd. with its subsidiary

S Ltd. as on 31st March, 2010

Liabilities	Rs. in 000's	Assets	Rs. in 000's
<i>Share Capital</i>		<i>Fixed Assets</i>	
Authorised	<u>5,000</u>	Plant and Machinery	
Issued, Subscribed and Paid up		H Ltd.	2,541
4 lakh equity shares of Rs. 10 each, fully paid	4,000	S Ltd.	<u>2,450</u>
		Furniture and fittings	4,991
Minority Interest (Note 6)	1,560	H Ltd.	615
<i>Reserves and Surplus</i>		S Ltd.	<u>298</u>
Capital Reserve (Note 5)	660		913
General Reserve (928+ 54)	982	<i>Current assets, Loans and Advances</i>	
Profit and Loss Account:		<i>(A) Current Assets</i>	
H Ltd.	1,305	Stock H Ltd.	983
Add: Share in S Ltd.	<u>306</u>	S Ltd.	<u>786</u>
	1,611		1,769
Less: Dividend wrongly credited	<u>180</u>	Less: Unrealised profit (50x1/5)	<u>10</u>
	1,431		700
	<u>10</u>	Debtors H Ltd.	<u>683</u>
	1,421		1,383

Consolidated Financial Statements of Group Companies

Less: Unrealised profit			S Ltd.		
Current Liabilities and Provisions			Cash and Bank Balances		
(a) Current Liabilities			H Ltd.	410	
Bills payable H Ltd.	124		S Ltd.	<u>102</u>	512
S Ltd.	<u>80</u>	204	(B) Loans and Advances		
Sundry Creditors H Ltd.	487		Bills Receivables	120	
S Ltd.	<u>427</u>	914	H Ltd.		
(b) Provisions			S Ltd.	<u>95</u>	215
Provision for Taxation			Sundry Advances		
H Ltd.	220		H Ltd.	260	
S Ltd.	<u>180</u>	400	S Ltd.	<u>190</u>	450
Other Provisions H Ltd.	65				
S Ltd.	<u>17</u>	<u>82</u>			
		<u>10,223</u>			<u>10,223</u>

Working Notes:

1. S Ltd. General Reserve

	(Rs. in 000)		(Rs. in 000)
To Bonus to equity shareholders	900	By Balance b/d	1,500
$\left(\frac{2,400 \times 3}{8} \right)$		By Profit and Loss A/c	
To Balance c/d	<u>690</u>	(Balancing figure)	<u>90</u>
	<u>1,590</u>		<u>1,590</u>

2. S Ltd. Profit and Loss Account

	(Rs. in 000)		(Rs. in 000)
To General Reserve	90	By Balance b/d	633
To Dividend paid on 14.7.2009	300	By Net Profit for the year	
$\frac{\text{Rs. } 1,500 \times 20}{100}$		(Balancing figure)	600*
100			

Financial Reporting

To Corporate Dividend Tax	33	
(11% of Rs. 300)		
To Balance c/d	<u>810</u>	<u> </u>
	<u>1,233</u>	<u>1,233</u>

* Out of Rs. 6,00,000 profit for the year, Rs. 90,000 has been transferred to reserves by S Ltd.

3. Distribution of Revenue Profits	<i>Rs. in '000</i>
Revenue Profit as above	<u>600</u>
Share of H Ltd. (60%)	360
Share of Minority shareholders (Rs. 600 – Rs. 360)	<u>240</u>

4. Computation of Capital Profits

	<i>Rs. in 000</i>	<i>Rs. in 000</i>
General Reserve on the date of acquisition		1,500
Less: Bonus issue of shares		<u>900</u>
		600
Profit and Loss Account balance on the date of acquisition	633	
Less: Dividends paid	300	
Corporate tax paid	<u>33</u>	
	<u>333</u>	<u>300</u>
		<u>900</u>
Share of H Ltd.(60%)		540
Share of Minority shareholders		<u>360</u>

5. Computation of capital Reserve		
60% of share capital of S Ltd.		1,440
Add: Share of H Ltd. in the capital profits as in working note (4)		<u>540</u>
		1,980
Less: Investments in S Ltd.	1,500	
Less: Dividends received out of pre-		
acquisition profits $\frac{\text{Rs.}300 \times 60}{100}$	<u>180</u>	<u>1,320</u>
		<u>660</u>

Consolidated Financial Statements of Group Companies

6. Calculation of Minority Interest	
40% of share capital of S Ltd.	960
Add: Share of Revenue Profits (Note 3)	240
Share of Capital Profits (Note 4)	<u>360</u>
	<u>1,560</u>

Question 2

On 31st March, 2004, P Ltd. acquired 1,05,000 shares of Q Ltd. for Rs. 12,00,000. The Balance Sheet of Q Ltd. on that date was as under:

Liabilities	Rs.	Assets	Rs.
1,50,000 equity shares of Rs. 10 each fully paid	15,00,000	Fixed Assets	10,50,000
Pre-incorporation profits	30,000	Current Assets	6,45,000
Profit and Loss Account	60,000		
Creditors	<u>1,05,000</u>		
	<u>16,95,000</u>		<u>16,95,000</u>

On 31st March, 2010 the Balance Sheets of two companies were as follows:

Liabilities	P Ltd. Rs.	Q Ltd. Rs.	Assets	P Ltd. Rs.	Q Ltd. Rs.
Equity shares of Rs. 10 each fully paid (before bonus issue)	45,00,000	15,00,000	Fixed Assets	79,20,000	23,10,000
Securities Premium	9,00,000	–	1,05,000 equity shares in Q Ltd. at cost	12,00,000	–
Pre-incorporation profits	–	30,000	Current Assets	44,10,000	17,55,000
General Reserve	60,00,000	19,05,000			
Profit and Loss Account	15,75,000	4,20,000			
Creditors	<u>5,55,000</u>	<u>2,10,000</u>			
	<u>1,35,30,000</u>	<u>40,65,000</u>		<u>1,35,30,000</u>	<u>40,65,000</u>

Financial Reporting

Directors of Q Ltd. made bonus issue on 31.3.2010 in the ratio of one equity share of Rs. 10 each fully paid for every two equity shares held on that date.

Calculate as on 31st March, 2010 (i) Cost of Control/Capital Reserve; (ii) Minority Interest; (iii) Consolidated Profit and Loss Account in each of the following cases:

(i) *Before issue of bonus shares.*

(ii) *Immediately after issue of bonus shares.*

It may be assumed that bonus shares were issued out of post-acquisition profits by using General Reserve.

Prepare a Consolidated Balance Sheet after the bonus issue.

Answer

(i) Before issue of bonus shares

(i)	Cost of control/capital reserve	Rs.	Rs.
	Investment in Q Ltd.		12,00,000
	Less: Face value of investments	10,50,000	
	Capital profits (W.N.)	<u>63,000</u>	<u>11,13,000</u>
	Cost of control		<u>87,000</u>
(ii)	Minority Interest		Rs.
	Share Capital		4,50,000
	Capital profits (W.N.)		27,000
	Revenue profits (W.N.)		<u>6,79,500</u>
			<u>11,56,500</u>
(iii)	Consolidated profit and loss account – P Ltd.		Rs.
	Balance		15,75,000
	Add: Share in revenue profits of Q Ltd.(W.N.)		<u>15,85,500</u>
			<u>31,60,500</u>

(ii) Immediately after issue of bonus shares

(i)	Cost of control/capital reserve	Rs.	Rs.
	Face value of investments	15,75,000	
	(Rs. 10,50,000 + 5,25,000)		
	Capital Profits (W.N.)	<u>63,000</u>	16,38,000
	Less: Investment in Q Ltd.		<u>12,00,000</u>
	Capital reserve		<u>4,38,000</u>

Consolidated Financial Statements of Group Companies

(ii)	Minority Interest	Rs.
	Share Capital (Rs. 4,50,000 + 2,25,000)	6,75,000
	Capital Profits (W.N.)	27,000
	Revenue Profits (W.N.)	<u>4,54,500</u>
		<u>11,56,500</u>
(iii)	Consolidated Profit and Loss Account – P td.	Rs.
	Balance	15,75,000
	Add: Share in revenue profits of Q Ltd. (W.N.)	<u>10,60,500</u>
		<u>26,35,500</u>

Consolidated Balance Sheet of P Ltd. and its subsidiary Q Ltd.

as on 31st March, 2010

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Share Capital		Fixed Assets	1,02,30,000
(Shares of Rs. 10 each)	45,00,000	Current Assets	61,65,000
Securities Premium	9,00,000		
Capital Reserve	4,38,000		
General Reserve	60,00,000		
Profit and Loss Account	26,35,500		
Creditors	7,65,000		
Minority Interest	<u>11,56,500</u>		
	<u>1,63,95,000</u>		<u>1,63,95,000</u>

Working Note:

Analysis of Profits of Q Ltd.

	<i>Capital Profits</i> <i>(Before and after</i> <i>issue of bonus</i> <i>shares)</i>	<i>Revenue Profits</i>	
	<i>Rs.</i>	<i>Before</i> <i>Bonus</i> <i>Issue</i> <i>Rs.</i>	<i>After</i> <i>Bonus</i> <i>Issue</i> <i>Rs.</i>
Pre-incorporation profits	30,000		
Profit and loss account on 31.3.2004	<u>60,000</u>		
	<u>90,000</u>		
General reserve*		19,05,000	19,05,000
Less: Bonus shares			<u>7,50,000</u>
			11,55,000

Financial Reporting

Profit for period of 1st April, 2005 to
31st March, 2010 (Rs. 4,20,000 – Rs.
60,000)

	<u>3,60,000</u>	<u>3,60,000</u>
	<u>22,65,000</u>	<u>15,15,000</u>

P Ltd.'s share (70%)	63,000	15,85,500	10,60,500
----------------------	--------	-----------	-----------

Minority's share (30%)	27,000	6,79,500	4,54,500
------------------------	--------	----------	----------

*Share of P Ltd. in General reserve has been adjusted in Consolidated Profit and Loss Account.

Question 3

On 31st March, 2010 the Balance Sheets of H Ltd. and its subsidiary S Ltd. stood as follows:

	H Ltd.	S Ltd.
	Rs. in lakhs	Rs. in lakhs
<i>Liabilities</i>		
<i>Share Capital:</i>		
<i>Authorised</i>	<u>15,000</u>	<u>6,000</u>
<i>Issued and Subscribed:</i>		
<i>Equity Shares of Rs. 10 each, fully paid up</i>	12,000	4,800
<i>General Reserve</i>	2,784	1,380
<i>Profit and Loss Account</i>	2,715	1,620
<i>Bills Payable</i>	372	160
<i>Sundry Creditors</i>	1,461	854
<i>Provision for Taxation</i>	855	394
<i>Proposed Dividend</i>	<u>1,200</u>	<u>—</u>
	<u>21,387</u>	<u>9,208</u>

	H Ltd.	S Ltd.
	Rs. in lakhs	Rs. in lakhs
<i>Assets</i>		
<i>Land and Buildings</i>	2,718	—
<i>Plant and Machinery</i>	4,905	4,900
<i>Furniture and Fittings</i>	1,845	586
<i>Investments in shares in S Ltd.</i>	3,000	—
<i>Stock</i>	3,949	1,956
<i>Debtors</i>	2,600	1,363
<i>Cash and Bank Balances</i>	1,490	204

Consolidated Financial Statements of Group Companies

Bills Receivable	360	199
Sundry Advances	<u>520</u>	<u>—</u>
	<u>21,387</u>	<u>9,208</u>

The following information is also provided to you:

- H Ltd. purchased 180 lakh shares in S Ltd. on 1st April, 2009 when the balances to General Reserve and Profit and Loss Account of S Ltd. stood at Rs. 3,000 lakh and 1,200 lakh respectively.
- On 4th July, 2009 S Ltd. declared a dividend @ 20% for the year ended 31st March, 2009. H Ltd. credited the dividend received by it to its Profit and Loss Account.
- On 1st January, 2010 S Ltd. issued 3 fully paid-up shares for every 5 shares held as bonus shares out of balances to its general reserve as on 31st March, 2009.
- On 31st March, 2010 all the bills payable in S Ltd.'s balance sheet were acceptances in favour of H Ltd. But on that date, H Ltd. held only Rs. 45 lakh of these acceptances in hand, the rest having been endorsed in favour of its creditors.
- On 31st March, 2010 S Ltd.'s stock included goods which it had purchased for Rs. 100 lakh from H Ltd. which made a profit @ 25% on cost.

Prepare a Consolidated Balance Sheet of H Ltd. and its subsidiary S Ltd. as at 31st March, 2010 bearing in mind the requirements of AS 21.

Answer**Consolidated Balance Sheet of H Ltd.****and its subsidiary S Ltd. as on 31st March, 2010**

Liabilities	Rs. in lakhs	Rs. in lakhs	Assets	Rs. in lakhs	Rs. in lakhs
Share Capital			Fixed Assets		
Authorised		<u>15,000</u>	Land and Buildings		
Issued and Subscribed:			H Ltd.		2,718
Equity shares of Rs. 10 each, fully paid up		12,000	Plant and Machinery		
Minority Interest (Note 6)		3,120	H Ltd.	4,905	
			S Ltd.	<u>4,900</u>	9,805
Reserves and Surplus			Furniture and Fittings		
Capital Reserve (Note 5)		1,320	H Ltd.	1,845	
General Reserve (2,784 + 108)		2,892	S Ltd.	<u>586</u>	2,431

Financial Reporting

Profit and Loss Account:

H Ltd.	2,715				<i>Current Assets,</i>				
Less: Dividend wrongly credited	360				<i>Loans and Advances</i>				
Unrealised Profit	<u>20</u>	<u>380</u>			<i>Current Assets</i>				
		2,335			Stock				
Add: Share in S Ltd.'s					H Ltd.	3,949			
Revenue profits	<u>612</u>	2,947			S Ltd.	<u>1,956</u>			
						5,905			
<i>Current Liabilities and Provisions</i>					Less: Unrealised				
					profit	<u>20</u>	5,885		
<i>Current Liabilities</i>					Debtors				
Bills Payable					H Ltd.	2,600			
H Ltd.	372				S Ltd.	<u>1,363</u>	3,963		
S Ltd.	<u>160</u>				Cash and Bank Balances				
	532				H Ltd.	1,490			
Less: Mutual owing	<u>45</u>	487			S Ltd.	<u>204</u>	1,694		
					<i>Loans and Advances</i>				
Sundry Creditors					Bills Receivable				
H Ltd.	1,461				H Ltd.	360			
S Ltd.	<u>854</u>	2,315			S Ltd.	<u>199</u>			
						559			
<i>Provisions</i>					Less: Mutual	<u>45</u>	514		
Provision for Taxation					Owing				
					Sundry Advances				
H Ltd.	855				H Ltd.		520		
S Ltd.	<u>394</u>	1,249							
Proposed Dividend									
H Ltd.	<u>1,200</u>								
		<u>27,530</u>							<u>27,530</u>

Working Notes:

1.

S Ltd.'s General Reserve Account

	<i>Rs. in lakhs</i>		<i>Rs. in lakhs</i>
To Bonus to Equity Shareholders	1,800	By Balance b/d	3,000
To Balance c/d	1,380	By Profit and Loss A/c	180
		(Balancing figure)	
	<u>3,180</u>		<u>3,180</u>

Consolidated Financial Statements of Group Companies

2. S Ltd.'s Profit and Loss Account

	<i>Rs. in lakhs</i>		<i>Rs. in lakhs</i>
To General Reserve	180	By Balance b/d	1,200
To Dividend paid (20% on Rs.3,000 lakhs)	600	By Net Profit for the year*	1,200
To Balance c/d	<u>1,620</u>	(Balancing figure)	<u> </u>
	<u>2,400</u>		<u>2,400</u>

*Out of Rs. 1,200 lakhs profit for the year, Rs. 180 lakhs has been transferred to reserves.

3. Distribution of Revenue profits

	<i>Rs. in lakhs</i>
Revenue profits (W. N. 2)	1,200
Less: Share of H Ltd. 60%	720
(General Reserve Rs. 108 + Profit and Loss Account Rs. 612)	<u> </u>
Share of Minority Shareholders (40%)	<u>480</u>

4. Calculation of Capital Profits

	<i>Rs. in lakhs</i>
General Reserve on the date of acquisition less bonus shares (Rs. 3,000 – Rs. 1,800)	1,200
Profit and loss account on the date of acquisition less dividend paid (Rs. 1,200 – Rs. 600)	600
	<u>1,800</u>

H Ltd.'s share = 60% of Rs. 1,800 lakhs = Rs. 1,080 lakhs

Minority interest = Rs. 1,800 – Rs. 1,080 = Rs. 720 lakhs

5. Calculation of capital reserve

	<i>Rs. in lakhs</i>
Paid up value of shares held (60% of Rs.4,800)	2,880
Add: Share in capital profits	<u>1,080</u>
	3,960
Less: Cost of shares less dividend received (Rs. 3,000 – Rs. 360)	<u>2,640</u>
Capital reserve	<u>1,320</u>

Financial Reporting

6. Calculation of Minority Interest

	<i>Rs. in lakhs</i>
40% of share capital (40% of Rs. 4,800)	1,920
Add: Share in revenue profits	480
Share in capital profits	<u>720</u>
	<u>3,120</u>

7. Unrealised profit in respect of stock

$$\text{Rs. 100 lakhs} \times \frac{25}{125} = \text{Rs. 20 lakhs}$$

Question 4

The following are the summarised Balance Sheets of PD Co. Ltd. and SD Co. Ltd. as on 31.3.2010.

<i>Liabilities</i>	<i>PD Co. Ltd.</i>	<i>SD Co. Ltd.</i>
	<i>Rs.</i>	<i>Rs.</i>
<i>Share Capital:</i>		
<i>Authorised</i>	<u>70,00,000</u>	<u>30,00,000</u>
<i>Issued and Subscribed Capital</i>		
<i>Equity shares of Rs. 10 each fully paid</i>	50,00,000	20,00,000
<i>Capital Reserve</i>	5,00,000	3,10,000
<i>Revenue Reserve</i>	8,50,000	75,000
<i>Profit and Loss Account</i>	4,00,000	2,80,000
<i>Sundry Creditors</i>	2,50,000	2,25,000
<i>Bills Payable</i>	<u>1,00,000</u>	<u>10,000</u>
	<u>71,00,000</u>	<u>29,00,000</u>
 <i>Assets</i>	 <i>PD Co. Ltd.</i>	 <i>SD Co. Ltd.</i>
	<i>Rs.</i>	<i>Rs.</i>
<i>Land and Buildings</i>	20,00,000	15,20,000
<i>Plant and Machinery</i>	20,00,000	8,00,000
<i>Furniture</i>	5,00,000	1,60,000

Consolidated Financial Statements of Group Companies

Investments	16,10,000	—
Stock	3,40,000	1,00,000
Sundry Debtors	3,60,000	2,00,000
Bills Receivable	50,000	40,000
Bank	<u>2,40,000</u>	<u>80,000</u>
	<u>71,00,000</u>	<u>29,00,000</u>

PD Ltd. acquired 80% shares of SD Ltd. on 30.09.2009 at a cost of Rs. 18,10,000. On 1.10.2009 SD Ltd. declared and paid dividend on Equity Shares. PD Ltd. appropriately adjusted its share of dividend in Investment Account.

On 1.4.2009, the Capital Reserve and Profit and Loss Account stood in the books of SD Ltd. at Rs. 50,000 and Rs. 2,75,000 respectively.

Land and Buildings standing in the books of SD Ltd. at Rs. 16,00,000 on 1.4.2009, revalued at Rs.20,00,000 on 1.10.2009. Furniture, which stood in the books at Rs. 2,00,000 on 1.4.2009 revalued at Rs.1,50,000 on 1.10.2009. In both the cases the effects have not yet been given in the books.

SD Ltd. bought an item of machinery from PD Ltd. on hire-purchase basis. The following are the balances in respect of this machinery in the books on 31.03.2010:

	Rs.
Instalment due	20,000
Instalment not due	8,000
Hire-purchase stock reserve	1,600

The above items stood included under appropriate heads in Balance Sheet.

Prepare a Consolidated Balance Sheet of PD Ltd. and its subsidiary SD Ltd. as at 31.03.2010, complying with the requirements of AS 21.

Answer**Consolidated Balance Sheet of PD Co. Ltd. with its subsidiary****SD Co. Ltd. as on 31st March, 2010**

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Share Capital			Fixed Assets		
Authorised		<u>70,00,000</u>	Land and buildings		
Issued and subscribed			PD Ltd.	20,00,000	
Equity shares of			SD Ltd. (W.N. 2)	<u>19,50,000</u>	39,50,000

Financial Reporting

Rs. 10 each, fully paid up	50,00,000	Plant and machinery		
Minority interest (W.N. 5)	6,14,000	PD Ltd.	20,00,000	
Reserves and surplus:		SD Ltd.	<u>8,00,000</u>	
Capital reserve (W.N.8)	12,18,000		28,00,000	
Revenue reserve (W.N. 9)	8,80,000	Less: Unrealised profit on hire purchase transaction	<u>5,600</u>	27,94,400
Profit and loss account (W.N. 10)	4,92,400	Furniture PD Ltd.	5,00,000	
Current liabilities and provisions		SD Ltd. (W.N. 2)	<u>1,35,000</u>	6,35,000
Current liabilities		Current assets, loans and advances		
Sundry creditors				
PD Ltd.	2,50,000			
SD Ltd.	<u>2,25,000</u>	Current assets		
	4,75,000	Stock		
Less: Mutual hire purchase indebtedness	<u>28,000</u>	PD Ltd.	3,40,000	
	4,47,000	SD Ltd.	<u>1,00,000</u>	
Bills payable			4,40,000	
PD Ltd.	1,00,000	Less: Hire purchase instalment not due	<u>8,000</u>	4,32,000
SD Ltd.	<u>10,000</u>			
	1,10,000	Sundry debtors		
		PD Ltd.	3,60,000	
		SD Ltd.	<u>2,00,000</u>	
			5,60,000	
		Less: Hire purchase Instalment due	<u>20,000</u>	5,40,000

Consolidated Financial Statements of Group Companies

	<i>Loans and advances</i>		
	Bills receivable		
	PD Ltd.	50,000	
	SD Ltd.	<u>40,000</u>	90,000
	Cash and Bank		
	Balances:		
	Bank		
	PD Ltd.	2,40,000	
	SD Ltd.	<u>80,000</u>	<u>3,20,000</u>
	<u>87,61,400</u>		<u>87,61,400</u>

Working Notes:**1. Analysis of reserves and profits of SD Co. Ltd. as on 31.03.2010.**

	<i>Pre-acquisition profit upto 30.09.2009</i>	<i>Post-acquisition profits (1.10.2009 – 31.3.2010)</i>		
	<i>(Capital profits)</i>	<i>Capital reserve</i>	<i>Revenue reserve</i>	<i>Profit and loss account</i>
Capital reserve as on 31.3.2010	3,10,000			
Less: Balance as on 1.4.2009	<u>50,000</u>	50,000		
Created during the year	<u>2,60,000</u>	1,30,000	1,30,000	
Revenue reserve as on 31.3.2010	75,000			
Less: balance as on 1.4.2009	<u>—</u>			
Created during the year	<u>75,000</u>	37,500	37,500	
Profit and loss account as on 31.3.2010	2,80,000			
Add: Dividend paid on 1.10.2009	2,50,000			
(out of pre-acquisition profits)	<u> </u>			

Financial Reporting

	5,30,000		
Less: balance as on 1.4.2009	<u>2,75,000</u>		
Earned during the year	<u>2,55,000</u>	1,27,500	1,27,500
Profit as on 1.4.2009	2,75,000		
Less: Dividend paid			
[(Rs.18,10,000 –			
Rs.16,10,000) × 5/4]	2,50,000		
Balance of pre-acquisition profit			
as on 31.3.2010	<u>25,000</u>	25,000	
Revaluation reserves as on			
1.10.2009:			
Profit on land and buildings			
(W.N. 2)	4,40,000		
Loss on furniture (W.N. 2)	(30,000)		
Difference in depreciation (for 6			
months) due to revaluation:			
Short depreciation on land and			
building (W.N. 3)			(10,000)
Excess depreciation on furniture			
(W.N. 3)			<u>5,000</u>
Total	<u>7,80,000</u>	<u>1,30,000</u>	<u>37,500</u>
Minority Interest (20%)	1,56,000	26,000	7,500
Share of PD Co. Ltd. (80%)	<u>6,24,000</u>	<u>1,04,000</u>	<u>30,000</u>

2. Profit or loss on revaluation of assets in the books of SD Ltd. and their book values as on 31.3.2010

	Rs.
<i>Land and buildings</i>	
Book value as on 1.4.2009	16,00,000
Depreciation at 5%* p.a. for 6 months	<u>40,000</u>
	15,60,000
Revalued on 1.10.2009	<u>20,00,000</u>
Profit on revaluation	<u>4,40,000</u>
*(80,000 × 100)/16,00,000 = 5%	

Consolidated Financial Statements of Group Companies

Value as per balance sheet on 31.3.2010	15,20,000
Add: Profit on revaluation	<u>4,40,000</u>
	19,60,000
Less: Short Depreciation (W.N. 3)	<u>10,000</u>
Value as on 31.3.2010	<u>19,50,000</u>
<i>Furniture</i>	
Book value as on 1.4.2009	2,00,000
Less: Depreciation @ 20%* p.a. for 6 months	<u>20,000</u>
	1,80,000
Revalued on 1.10.2009	<u>1,50,000</u>
Loss on revaluation	<u>30,000</u>
Value as per balance sheet on 31.3.2010	1,60,000
Less: Loss on revaluation	<u>30,000</u>
	1,30,000
Add: Excess depreciation written back (W.N. 3)	<u>5,000</u>
Value as on 31.3.2010	<u>1,35,000</u>

$$*(40,000 \times 100)/2,00,000 = 20\%$$

3. Calculation of short/excess depreciation

	<i>Building</i>	<i>Furniture</i>
Revalued figure as on 1.10.2009	20,00,000	1,50,000
Rate of depreciation	5% p.a.	20% p.a.
Depreciation for 6 months on revalued figure (1.10.2009 to 31.3.2010)	50,000	15,000
Depreciation already provided	<u>40,000</u>	<u>20,000</u>
Difference [(short)/excess]	<u>(10,000)</u>	<u>5,000</u>

4. Calculation of cost of control

	<i>Rs.</i>
Share capital in SD Ltd.	16,00,000
Add: Capital profit	<u>6,24,000</u>
	22,24,000
Less: Cost of Investments	<u>16,10,000</u>
Capital Reserve	<u>6,14,000</u>

Financial Reporting

5. Calculation of minority interest

	Rs.	Rs.
Share capital		4,00,000
Capital (pre-acquisition) profits		1,56,000
Revenue (post-acquisition) profits:		
Capital Reserve	26,000	
Revenue reserve	7,500	
Profit and loss	<u>24,500</u>	<u>58,000</u>
		<u>6,14,000</u>

6. Stock reserve (plant and machinery)

Percentage of profit on hire purchase transaction

$$\frac{1,600 \times 100}{8,000} = 20\%$$

20% on Rs. 20,000 = Rs. 4,000

Total unrealised profit = Rs. 4,000 + Rs. 1,600 = Rs. 5,600

7. Elimination of mutual indebtedness

Elimination of mutual indebtedness in respect of sale of machinery on hire purchase basis will be made as under in the Consolidated Balance Sheet.

	Creditors	Debtors	Stock	Plant and machinery
	Rs.	Rs.	Rs.	Rs.
Total (PD Ltd. and SD Ltd.)	4,75,000	5,60,000	4,40,000	28,00,000
Less: Instalment due	20,000	20,000	—	—
Less: Instalment not due	8,000	—	8,000	—
Less: Profit on plant purchased by SD Ltd. from PD Ltd. on hire purchase	<u>—</u>	<u>—</u>	<u>—</u>	<u>5,600</u>
	<u>4,47,000</u>	<u>5,40,000</u>	<u>4,32,000</u>	<u>27,94,400</u>

For consolidated balance sheet purpose, the unrealised profits will be eliminated by deducting Rs. 5,600 from Plant & Machinery and from profit and loss account.

Consolidated Financial Statements of Group Companies

8. Consolidated capital reserve as on 31.3.2010

	Rs.
Capital reserve of PD Ltd. as on 31.3.2010	5,00,000
Add: Share in post acquisition capital reserve of SD Ltd. (W.N. 1)	1,04,000
Add: Cost of control (W.N. 4)	<u>6,14,000</u>
	<u>12,18,000</u>

9. Consolidated revenue reserve as on 31.3.2010

	Rs.
Revenue reserve of PD Ltd. as on 31.3.2010	8,50,000
Add: Share in post acquisition revenue reserve of SD Ltd. (W.N. 1)	<u>30,000</u>
	<u>8,80,000</u>

10. Consolidated profit and loss account as on 31.3.2010

	Rs.
Profit and loss account balance of PD Ltd. as on 31.3.2010	4,00,000
Add: Share in post acquisition profit and loss account of SD Ltd. (W.N. 1)	98,000
Less: Unrealised profit on hire purchase	<u>(5,600)</u>
	<u>4,92,400</u>

Note: In the question, the balance of capital reserve and profit and loss account of SD Ltd., as on 1.4.2009 only has been given and not of revenue reserve. Hence, it has been assumed in the above solution that the revenue reserve is created during the year from current year's profits.

Problems involving one Subsidiary- Different Dates of Acquisition**Question 5**

The Balance Sheets of Football Ltd. and its subsidiary Hockey Ltd. as on 31st March, 2010 are as under:

Liabilities	Football Ltd. Rs.	Hockey Ltd. Rs.	Assets	Football Ltd. Rs.	Hockey Ltd. Rs.
Equity shares of Rs. 10 each	48,00,000	20,00,000	Goodwill	4,50,000	3,00,000
10% Preference shares of Rs. 10 each	7,00,000	3,80,000	Plant and machinery	12,00,000	5,00,000
			Motor vehicles	9,50,000	7,50,000

Financial Reporting

General reserve	5,50,000	4,20,000	Furniture and		
Profit and loss account	10,00,000	6,00,000	fittings	6,50,000	4,00,000
Bank overdraft	1,20,000	70,000	Investments	26,00,000	4,50,000
Sundry creditors	4,30,000	4,80,000	Stock	4,50,000	7,20,000
Bills payable	—	1,60,000	Cash at bank	2,25,000	2,10,000
			Debtors	9,30,000	7,80,000
			Bills receivable	<u>1,45,000</u>	<u>—</u>
	<u>76,00,000</u>	<u>41,10,000</u>		<u>76,00,000</u>	<u>41,10,000</u>

Details of acquisition of shares by Football Ltd. are as under:

Nature of shares	No. of shares acquired	Date of acquisition	Cost of acquisition Rs.
Preference shares	14,250	1.4.2007	3,10,000
Equity shares	80,000	1.4.2008	9,50,000
Equity shares	70,000	1.4.2009	8,00,000

Other information:

- (i) On 1.4.2009 profit and loss account and general reserve of Hockey Ltd. had credit balances of Rs. 3,00,000 and Rs. 2,00,000 respectively.
- (ii) Dividend @ 10% was paid by Hockey Ltd. for the year 2008-2009 out of its profit and loss account balance as on 1.4.2009. Football Ltd. credited its share of dividend to its profit and loss account.
- (iii) Hockey Ltd. allotted bonus shares out of general reserve at the rate of 1 share for every 10 shares held. Accounting thereof has not yet been made.
- (iv) Bills receivable of Football Ltd. were drawn upon Hockey Ltd.
- (v) During the year 2009-2010 Football Ltd. purchased goods from Hockey Ltd. for Rs. 1,00,000 at a sale price of Rs. 1,20,000. 40% of these goods remained unsold at close of the year.
- (vi) On 1.4.2009 motor vehicles of Hockey Ltd. were overvalued by Rs. 1,00,000. Applicable depreciation rate is 20%.
- (vii) Dividends recommended for the year 2009-2010 in the holding and the subsidiary companies are 15% and 10% respectively.

Prepare consolidated Balance Sheet as on 31st March, 2010.

Consolidated Financial Statements of Group Companies

Answer

**Consolidated Balance Sheet of Football Ltd. and its subsidiary Hockey Ltd.
as on 31st March, 2010**

<i>Liabilities</i>	<i>Amount</i>		<i>Assets</i>	<i>Amount</i>	
	<i>Rs.</i>	<i>Rs.</i>		<i>Rs.</i>	<i>Rs.</i>
Share Capital			<i>Fixed Assets</i>		
<i>Authorised, Issued and paid up capital</i>		—	Goodwill		
4,80,000 equity shares of Rs. 10 each		48,00,000	Football Ltd.	4,50,000	
70,000, 10% preference shares of Rs. 10 each		7,00,000	Hockey Ltd.	<u>3,00,000</u>	
				7,50,000	
<i>Minority Interest (W.N. 3)</i>		9,86,750	<i>Add: Goodwill on consolidation (W.N. 2)</i>	<u>1,97,500</u>	9,47,500
<i>Reserves and Surplus</i>			Plant and Machinery		
General reserve (W.N. 5)		7,15,000	Football Ltd.	12,00,000	
Profit and loss account (W.N. 4)		5,07,750	Hockey Ltd.	<u>5,00,000</u>	17,00,000
<i>Current Liabilities and Provisions</i>			Motor Vehicles		
Bank Overdraft			Football Ltd.	9,50,000	
Football Ltd.	1,20,000		Hockey Ltd.		
Hockey Ltd.	<u>70,000</u>	1,90,000	(7,50,000 – 1,00,000 + 20,000)	<u>6,70,000</u>	16,20,000
Sundry Creditors			Furniture & Fittings		
Football Ltd.	4,30,000		Football Ltd.	6,50,000	
Hockey Ltd.	<u>4,80,000</u>	9,10,000	Hockey Ltd.	<u>4,00,000</u>	10,50,000
Bills payable			Investments		

Financial Reporting

Hockey Ltd.	1,60,000		Football Ltd.		
Less: Mutual debt	<u>1,45,000</u>	15,000	(26,00,000 – 20,60,000)	5,40,000	
Proposed Dividend			Hockey Ltd.	<u>4,50,000</u>	9,90,000
Equity	7,20,000		<i>Current assets, loans</i>		
Preference	<u>70,000</u>	7,90,000	<i>and advances</i>		
			<i>Current assets</i>		
			Stock		
			Football Ltd.	4,50,000	
			Hockey Ltd.	<u>7,20,000</u>	
				11,70,000	
			<i>Less: Unrealised profit</i>	<u>8,000</u>	11,62,000
			Debtors		
			Football Ltd.	9,30,000	
			Hockey Ltd.	<u>7,80,000</u>	17,10,000
			Cash at Bank		
			Football Ltd.	2,25,000	
			Hockey Ltd.	<u>2,10,000</u>	4,35,000
			<i>Loans and advances</i>		
			Bills receivable		
			Football Ltd.	1,45,000	
			<i>Less: Mutual Debt</i>	<u>1,45,000</u>	<u>Nil</u>
		<u>96,14,500</u>			<u>96,14,500</u>

Consolidated Financial Statements of Group Companies

Working Notes:

(1) Analysis of Profits of Hockey Ltd.

		Capital Profits	Revenue Reserve	Revenue Profit
	Rs.	Rs.	Rs.	Rs.
(a) General Reserve as on 1.4.2009	2,00,000			
Less: Bonus issue (1/10 of Rs. 20,00,000)	<u>2,00,000</u>	—	—	
(b) Addition to General Reserve during 2009-2010 (Rs. 4,20,000 – Rs. 2,00,000)			2,20,000	
(c) Profit and Loss Account balance as on 1.4.2009	3,00,000			
Less: Dividend paid for the year 2008-2009	<u>2,00,000</u>	1,00,000		
(d) Profit for the year 2009-2010 (Rs. 6,00,000 – Rs. 1,00,000)				5,00,000
(e) Adjustment for over valuation of motor vehicles		(1,00,000)		
(f) Adjustment of revenue profit due to overcharged depreciation (20% on Rs. 1,00,000)				20,000
(g) Preference dividend for the year 2009-2010 @ 10%				<u>(38,000)</u>
		<u>—</u>	<u>2,20,000</u>	<u>4,82,000</u>
Football Ltd.'s share (3/4)			1,65,000	3,61,500
Minority Interest (1/4)			<u>55,000</u>	<u>1,20,500</u>
			<u>2,20,000</u>	<u>4,82,000</u>

(2) Cost of Control

Cost of investments in Hockey Ltd.

Less: Paid up value of equity shares (including bonus shares)

[80,000 + 70,000 + (10% of 1,50,000)] × Rs. 10

16,50,000

Rs.
Rs.
20,60,000

Financial Reporting

Paid-up value of preference shares	1,42,500	
Pre-acquisition dividend*	<u>70,000</u>	<u>18,62,500</u>
Cost of control/Goodwill		<u>1,97,500</u>
(3) Minority Interest		
Equity share capital [Rs. 5,00,000 + Rs. 50,000 (Bonus)]		5,50,000
Preference share capital (Rs. 3,80,000 – Rs. 1,42,500)		2,37,500
Share of revenue reserve		55,000
Share of revenue profit		1,20,500
Proposed preference dividend		<u>23,750</u>
		<u>9,86,750</u>
(4) Profit and Loss Account – Football Ltd.		
Balance		10,00,000
Share in profit of Hockey Ltd.		3,61,500
Share in proposed preference dividend of Hockey Ltd.		<u>14,250</u>
		13,75,750
Less: Pre-acquisition dividend credited to profit and loss account	70,000	
Unrealised profit on stock (40% of Rs.20,000)	8,000	
Proposed equity dividend	7,20,000	
Proposed preference dividend	<u>70,000</u>	<u>8,68,000</u>
		<u>5,07,750</u>
(5) General reserve – Football Ltd.		
Balance		5,50,000
Add: Share in Hockey Ltd.		<u>1,65,000</u>
		<u>7,15,000</u>

Note: No information has been given in the question regarding date of bonus issue by Hockey. It is also not mentioned whether the bonus shares are issued from pre-acquisition general reserve or post-acquisition general reserve. The above solution is given on the basis that Hockey Ltd. allotted bonus shares out of pre-acquisition general reserve.

* The dividend on 70,000 shares only (acquired on 1.4.2009) is a pre-acquisition dividend.

Consolidated Financial Statements of Group Companies

Problems involving more than one subsidiary

Question 6

From the following Balance Sheets of a group of companies and the other information provided, draw up the consolidated Balance Sheet as on 31.3.2010. Figures given are in Rupees Lakhs:

Balance Sheets as on 31.3.2010

	X	Y	Z		X	Y	Z
Shares capital (in shares of Rs. 10 each)	300	200	100	Fixed Assets less depreciation	130	150	100
Reserves	50	40	30	Cost of investment in Y Ltd.	180	—	—
Profit and loss balance	60	50	40	Cost of investment in Z Ltd.	40	—	—
Bills payables	10	—	5	Cost of investment in Z Ltd.	—	80	—
Creditors	30	10	10	Stock	50	20	20
Y Ltd. balance	—	—	15	Debtors	70	10	20
Z Ltd. balance	50	—	—	Bills receivables	—	10	20
				Z Ltd. balance	—	10	—
				X Ltd. balance	—	—	30
				Cash and bank balance	<u>30</u>	<u>20</u>	<u>10</u>
	<u>500</u>	<u>300</u>	<u>200</u>		<u>500</u>	<u>300</u>	<u>200</u>

- X Ltd. holds 1,60,000 shares and 30,000 shares respectively in Y Ltd. and Z Ltd.; Y Ltd. holds 60,000 shares in Z Ltd. These investments were made on 1.7.2009 on which date the provision was as follows:

	Y Ltd.	Z Ltd.
Reserves	20	10
Profit and loss account	30	16

- In December, 2009 Y Ltd. invoiced goods to X Ltd. for Rs. 40 lakhs at cost plus 25%. The closing stock of X Ltd. includes such goods valued at Rs. 5 lakhs.
- Z Ltd. sold to Y Ltd. an equipment costing Rs. 24 lakhs at a profit of 25% on selling price on 1.1.2010. Depreciation at 10% per annum was provided by Y Ltd. on this equipment.
- Bills payables of Z Ltd. represent acceptances given to Y Ltd. out of which Y Ltd. had discounted bills worth Rs. 3 lakhs.
- Debtors of X Ltd. include Rs. 5 lakhs being the amount due from Y Ltd.
- X Ltd. proposes dividend at 10%.

Financial Reporting

Answer

**Consolidated Balance Sheet of X Ltd.
and its subsidiaries Y Ltd. and Z Ltd.
as at 31st March, 2010**

				(Rs. in lakhs)	
Liabilities	Amount	Assets	Amount		
Share capital	300.00	Fixed Assets			
Minority Interest		X Ltd.	130.00		
Y Ltd.	63.08	Y Ltd.	150.00		
Z Ltd.	<u>16.22</u>	Z Ltd.	<u>100.00</u>		
Capital Reserve	13.40		380.00		
		Less: Unrealised profit	<u>7.80</u>	372.20	
Other Reserves	81.60	Stock			
Profit and Loss Account	56.90	X Ltd.	50.00		
Bills Payables		Y Ltd.	20.00		
X Ltd.	10.00	Z Ltd.	<u>20.00</u>		
Y Ltd.	<u>5.00</u>		90.00		
	15.00	Less: Unrealised profit	<u>1.00</u>	89.00	
Less: Mutual indebtedness	<u>2.00</u>	Debtors			
	13.00	X Ltd.	70.00		
Creditors		Y Ltd.	10.00		
X Ltd.	30.00	Z Ltd.	<u>20.00</u>		
Y Ltd.	10.00		100.00		
Z Ltd.	<u>10.00</u>	Less: Mutual indebtedness	<u>5.00</u>	95.00	
	50.00	Cash and Bank Balances		60.00	
Less: Mutual indebtedness	<u>5.00</u>	Bills Receivables			
	45.00	Y Ltd.	10.00		
Current Account Balances		Z Ltd.	<u>20.00</u>		
			30.00		
X Ltd.	50.00	Less: Mutual indebtedness	<u>2.00</u>	28.00	

Consolidated Financial Statements of Group Companies

Z Ltd.	<u>15.00</u>		
	65.00		
Less: Mutual indebtedness (10+ 30)	<u>40.00</u>	25.00	
Proposed Dividend		<u>30.00</u>	
	<u>644.20</u>		<u>644.20</u>

Working Notes:

(Rs. in lakhs)

(1) Analysis of Profits of Z Ltd.	Capital Profit	Revenue Reserve	Revenue profit
Reserves on 1.7.2009	10.00		
Profit and Loss A/c on 1.7.2009	16.00		
Increase in Reserves		20.00	
Increase in Profit			<u>24.00</u>
	<u>26.00</u>	<u>20.00</u>	<u>24.00</u>
Less: Minority Interest (10%)	<u>2.60</u>	<u>2.00</u>	<u>2.40</u>
	<u>23.40</u>	<u>18.00</u>	<u>21.60</u>
Share of X Ltd.	7.80	6.00	7.20
Share of Y Ltd.	15.60	12.00	14.40
(2) Analysis of Profits of Y Ltd.			
Reserves on 1.7.2009	20.00		
Profit and Loss A/c on 1.7.2009	30.00		
Increase in Reserves		20.00	
Increase in Profit			<u>20.00</u>
	<u>50.00</u>	<u>20.00</u>	<u>20.00</u>
Share in Z Ltd.		<u>12.00</u>	<u>14.40</u>
	<u>50.00</u>	<u>32.00</u>	<u>34.40</u>
Less: Minority Interest (20%)	<u>10.00</u>	<u>6.40</u>	<u>6.88</u>
Share of X Ltd.	<u>40.00</u>	<u>25.60</u>	<u>27.52</u>
(3) Cost of Control			
Investments in Y Ltd.			180.00
Investments in Z Ltd.			<u>120.00</u>
			300.00

Financial Reporting

Less: Paid up value of investments			
in Y Ltd.	160.00		
in Z Ltd.	<u>90.00</u>	250.00	
Capital Profit			
in Y Ltd.	40.00		
in Z Ltd.	<u>23.40</u>	<u>63.40</u>	<u>313.40</u>
Capital Reserve			<u>13.40</u>
(4) Minority Interest	Y Ltd.	Z Ltd.	
Share Capital	40.00	10.00	
Capital Profit	10.00	2.60	
Revenue Reserves	6.40	2.00	
Revenue Profits	<u>6.88</u>	<u>2.40</u>	
	63.28	17.00	
Less: Unrealised profit on stock (20% of 1)	.20		
Unrealised profit on equipment (10% of 7.8)		<u>.78</u>	
	<u>63.08</u>	<u>16.22</u>	
(5) Unrealised Profit on equipment sale			
Cost	24.00		
Profit	<u>8.00</u>		
Selling Price	<u>32.00</u>		
Unrealised profit = $8 - 8 \times \frac{10}{100} \times \frac{3}{12} = 8.00 - 0.20 = 7.80$			
(6) Profit and Loss Account – X Ltd.			
Balance	60.00		
Less: Proposed Dividend	<u>30.00</u>		
	30.00		
Share in Y Ltd.	27.52		
Share in Z Ltd.	<u>7.20</u>		
	64.72		
Less: Unrealised profit on equipment (90% of 7.8)	<u>7.02</u>		
	57.70		
Less: Unrealised profit on stock $\left(5 \times \frac{25}{125} \times 80\%\right)$	<u>.80</u>		
	<u>56.90</u>		

Consolidated Financial Statements of Group Companies

(7) Reserves – X Ltd.

X Ltd.	50.00
Share in Y Ltd.	25.60
Share in Z Ltd.	<u>6.00</u>
	<u>81.60</u>

Question 7

Following are the Balance Sheets of Mumbai Limited, Delhi Limited, Amritsar Limited and Kanpur Limited as at 31st December, 2009:

Liabilities	Mumbai Ltd.	Delhi Ltd.	Amritsar Ltd.	Kanpur Ltd.
Share Capital (Rs. 100 face value)	50,00,000	40,00,000	20,00,000	60,00,000
General Reserve	20,00,000	4,00,000	2,50,000	10,00,000
Profit & Loss Account	10,00,000	4,00,000	2,50,000	3,20,000
Sundry Creditors	<u>3,00,000</u>	<u>1,00,000</u>	<u>50,000</u>	<u>80,000</u>
	83,00,000	49,00,000	25,50,000	74,00,000
Assets				
<i>Investments:</i>				
30,000 shares in Delhi Ltd.	35,00,000	—	—	—
10,000 shares in Amritsar Ltd.	11,00,000	—	—	—
5,000 shares in Amritsar Ltd.	—	5,00,000	—	—
Shares in Kanpur Ltd. @ Rs. 120	36,00,000	18,00,000	6,00,000	—
Fixed Assets	—	20,00,000	15,00,000	70,00,000
Current Assets	<u>1,00,000</u>	<u>6,00,000</u>	<u>4,50,000</u>	<u>4,00,000</u>
	83,00,000	49,00,000	25,50,000	74,00,000

Balance in General Reserve Account and Profit & Loss Account, when shares were purchased in different companies were:

	Mumbai Ltd.	Delhi Ltd.	Amritsar Ltd.	Kanpur Ltd.
General Reserve Account	10,00,000	2,00,000	1,00,000	6,00,000
Profit & Loss Account	6,00,000	2,00,000	50,000	60,000

Required:

Prepare the consolidated Balance Sheet of the group as at 31st December, 2009 (Calculations may be rounded off to the nearest rupee).

Financial Reporting

Answer

**Consolidated Balance Sheet of Mumbai Ltd. and
its subsidiaries Delhi Ltd., Amritsar Ltd. and Kanpur Ltd.**

As at 31st December, 2009

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Share Capital	50,00,000.00	Goodwill	6,37,500.00
(Fully paid shares of Rs. 100 each)		Fixed Assets	105,00,000.00
Minority Interest	31,25,312.50	Current Assets	15,50,000.00
General Reserve	25,51,041.67		
Profit and Loss Account	14,81,145.83		
Sundry Creditors	5,30,000.00		
	<u>1,26,87,500.00</u>		<u>1,26,87,500.00</u>

Working Notes:

(i) Analysis of profits of Kanpur Ltd.

	<i>Capital Profit Rs.</i>	<i>Revenue Reserve Rs.</i>	<i>Revenue Profit Rs.</i>
General Reserve on the date of purchase of shares	6,00,000.00		
Profit and Loss A/c on the date of purchase of shares	60,000.00		
Increase in General Reserve		4,00,000.00	
Increase in profit			2,60,000.00
	<u>6,60,000.00</u>	<u>4,00,000.00</u>	<u>2,60,000.00</u>
Less : Minority Interest (1/6)	<u>1,10,000.00</u>	<u>66,666.67</u>	<u>43,333.33</u>
	<u>5,50,000.00</u>	<u>3,33,333.33</u>	<u>2,16,666.67</u>
Share of Mumbai Ltd. (1/2)	3,30,000.00	2,00,000.00	1,30,000.00
Share of Delhi Ltd. (1/4)	1,65,000.00	1,00,000.00	65,000.00
Share of Amritsar Ltd. (1/12)	55,000.00	33,333.33	21,666.67

(ii) Analysis of profits of Amritsar Ltd.

	<i>Capital Profit Rs.</i>	<i>Revenue Reserve Rs.</i>	<i>Revenue Profit Rs.</i>
General Reserve on the date of purchase of shares	1,00,000.00		
Profit and Loss A/c on the date of purchase of shares	50,000.00		
Increase in General Reserve		1,50,000.00	

Consolidated Financial Statements of Group Companies

Increase in Profit and Loss A/c			2,00,000.00
Share in Kanpur Ltd.		33,333.33	21,666.67
	1,50,000.00	1,83,333.33	2,21,666.67
Less : Minority Interest (1/4)	37,500.00	45,833.33	55,416.67
	1,12,500.00	1,37,500.00	1,66,250.00
Share of Mumbai Ltd. (1/2)	75,000	91,666.67	1,10,833.33
Share of Delhi Ltd. (1/4)	37,500	45,833.33	55,416.67
(iii) Analysis of profits of Delhi Ltd.			
	<i>Capital</i>	<i>Revenue</i>	<i>Revenue</i>
	<i>Profit</i>	<i>Reserve</i>	<i>Profit</i>
	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>
General Reserve on the date of purchase of shares	2,00,000.00		
Profit and Loss A/c on the date of purchase of shares	2,00,000.00		
Increase in General Reserve		2,00,000.00	
Increase in Profit and Loss A/c			2,00,000.00
Share in Kanpur Ltd.		1,00,000.00	65,000.00
Share in Amritsar Ltd.		45,833.33	55,416.67
	4,00,000.00	3,45,833.33	3,20,416.67
Less : Minority Interest (1/4)	1,00,000.00	86,458.33	80,104.17
Share of Mumbai Ltd. (3/4)	3,00,000.00	2,59,375.00	2,40,312.50
(iv) Cost of control			
Investments in			<i>Rs.</i>
Delhi Ltd.		35,00,000	
Amritsar Ltd.		16,00,000	
Kanpur Ltd.		<u>60,00,000</u>	
			1,11,00,000
Paid up value of investments in			
Delhi Ltd.		30,00,000	
Amritsar Ltd.		15,00,000	
Kanpur Ltd.		<u>50,00,000</u>	

Financial Reporting

Capital profits in		(95,00,000)
Delhi Ltd.	3,00,000	
Amritsar Ltd.	1,12,500	
Kanpur Ltd.	<u>5,50,000</u>	<u>(9,62,500)</u>
Goodwill		<u>6,37,500</u>
(v) Minority interest		
Share Capital :		
Delhi Ltd. (1/4)	10,00,000.00	
Amritsar Ltd. (1/4)	5,00,000.00	
Kanpur Ltd (1/6)	<u>10,00,000.00</u>	25,00,000.00
Share in profits & reserves		
(Pre and Post-Acquisitions)		
Delhi Ltd.	2,66,562.50	
Amritsar Ltd.	1,38,750.00	
Kanpur Ltd.	<u>2,20,000.00</u>	<u>6,25,312.50</u>
		<u>31,25,312.50</u>
(vi) General Reserve — Mumbai Ltd.		
Balance as on 31.12.2009 (given)		20,00,000.00
Share in		
Delhi Ltd.		2,59,375.00
Amritsar Ltd.		91,666.67
Kanpur Ltd.		<u>2,00,000.00</u>
		<u>25,51,041.67</u>
(vii) Profit and Loss Account — Mumbai Ltd.		
Balance as on 31.12.2009 (given)		10,00,000.00
Share in		
Delhi Ltd.		2,40,312.50
Amritsar Ltd.		1,10,833.33
Kanpur Ltd.		<u>1,30,000.00</u>
		<u>14,81,145.83</u>

Consolidated Financial Statements of Group Companies

Question 8

A Limited is a holding company and B Limited and C Limited are subsidiaries of A Limited. Their Balance Sheets as on 31.12.2009 are given below:

	A Ltd.	B Ltd.	C Ltd.		A Ltd.	B Ltd.	C Ltd.
	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
Share Capital	1,00,000	1,00,000	60,000	Fixed Assets	20,000	60,000	43,000
Reserves	48,000	10,000	9,000	Investments			
Profit & Loss Account				Shares in B Ltd.	95,000		
	16,000	12,000	9,000				
C Ltd. Balance	3,000			Shares in C Ltd.	13,000	53,000	
Sundry Creditors	7,000	5,000		Stock in Trade	12,000		
A Ltd. Balance		7,000		B Ltd. Balance	8,000		
				Sundry Debtors	26,000	21,000	32,000
				A Ltd. Balance			<u>3,000</u>
	<u>1,74,000</u>	<u>1,34,000</u>	<u>78,000</u>		<u>1,74,000</u>	<u>1,34,000</u>	<u>78,000</u>

The following particulars are given:

- (i) The Share Capital of all companies is divided into shares of Rs. 10 each.
- (ii) A Ltd. held 8,000 shares of B Ltd. and 1,000 shares of C Ltd.
- (iii) B Ltd. held 4,000 shares of C Ltd.
- (iv) All these investments were made on 30.6.2009.
- (v) On 31.12.2008, the position was as shown below:

	B Ltd.	C Ltd.
	Rs.	Rs.
Reserve	8,000	7,500
Profit & Loss Account	4,000	3,000
Sundry Creditors	5,000	1,000
Fixed Assets	60,000	43,000
Stock in Trade	4,000	35,500
Sundry Debtors	48,000	33,000

- (vi) 10% dividend is proposed by each company.

Financial Reporting

(vii) The whole of stock in trade of B Ltd. as on 30.6.2009 (Rs. 4,000) was later sold to A Ltd. for Rs. 4,400 and remained unsold by A Ltd. as on 31.12.2009.

(viii) Cash-in-transit from B Ltd. to A Ltd. was Rs. 1,000 as at the close of business.

You are required to prepare the Consolidated Balance Sheet of the group as on 31.12.2009.

Answer

Consolidated Balance Sheet of A Ltd. and its subsidiaries B Ltd. and C Ltd. as on 31st December, 2009

Liabilities	Amount Rs.	Assets	Amount Rs.
Share Capital	1,00,000	Goodwill	5,525
Minority Interest	37,820	Fixed Assets	1,23,000
Reserves	49,325	Stock in Trade	12,000
Profit & Loss Account	10,980	Less: Provision for	
Sundry Creditors	12,000	unrealised profit	400
Proposed Dividend	10,000	Sundry Debtors	79,000
		Cash in Transit (8,000 – 7,000)	1,000
	<u>2,20,125</u>		<u>2,20,125</u>

Working Notes:

(1) Position on 30.06.2009

	Reserves Rs.	Profit and Loss Account Rs.
B Ltd.		
Balance on 31.12.2009	10,000	12,000
Less: Balance on 31.12.2008	<u>8,000</u>	<u>4,000</u>
Increase during the year	<u>2,000</u>	<u>8,000</u>
Estimated increase for half year	1,000	4,000
Balance on 30.06.2009	9,000 (8,000 + 1,000)	8,000 (4,000 + 4,000)
C Ltd.		
Balance on 31.12.2009	9,000	9,000
Balance on 31.12.2008	<u>7,500</u>	<u>3,000</u>
Increase during the year	<u>1,500</u>	<u>6,000</u>
Estimated increase for half year	750	3,000
Balance on 30.06.2009	8,250 (7,500 + 750)	6,000 (3,000 + 3,000)

Consolidated Financial Statements of Group Companies

(2) Analysis of Profits of C Ltd.

	<i>Capital Profit</i>	<i>Revenue Reserve</i>	<i>Revenue profit</i>
	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>
Reserves on 30.6.2009	8,250		
Profit and Loss A/c on 30.6.2009	6,000		
Increase in reserves		750	
Increase in profit			<u>3,000</u>
	<u>14,250</u>	<u>750</u>	<u>3,000</u>
Less: Minority interest (1/6)	<u>2,375</u>	<u>125</u>	<u>500</u>
	<u>11,875</u>	<u>625</u>	<u>2,500</u>
Share of A Ltd. (1/6)	2,375	125	500
Share of B Ltd. (4/6)	9,500	500	2,000

(3) Analysis of Profits of B Ltd.

	<i>Capital Profit</i>	<i>Revenue Reserve</i>	<i>Revenue profit</i>
	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>
Reserves on 30.6.2009	9,000		
Profit and Loss A/c on 30.6.2009	8,000		
Increase in reserves		1,000	
Increase in profit			4,000
Share in C Ltd.		<u>500</u>	<u>2,000</u>
	<u>17,000</u>	<u>1,500</u>	<u>6,000</u>
Less: Minority interest (2/10)	<u>3,400</u>	<u>300</u>	<u>1,200</u>
Share of A Ltd. (8/10)	<u>13,600</u>	<u>1,200</u>	<u>4,800</u>

(4) Cost of control

	<i>Rs.</i>	<i>Rs.</i>
Investments in		
B Ltd.	95,000	
C Ltd.	<u>66,000</u>	1,61,000
Less : Paid up value of investments in		
B Ltd.	80,000	
C Ltd.	<u>50,000</u>	
		(1,30,000)

Financial Reporting

Capital profits in		
B Ltd.	13,600	
C Ltd.	<u>11,875</u>	
		<u>(25,475)</u>
Goodwill		<u>5,525</u>
(5) Minority Interest		
(5) Minority Interest	Rs.	Rs.
Share Capital:		
B Ltd.	20,000	
C Ltd.	<u>10,000</u>	30,000
Share in profits and reserves (Pre and Post-Acquisitions)		
B Ltd.	4,900	
C Ltd.	<u>3,000</u>	<u>7,900</u>
		37,900
Less: Provision for unrealized profit (20% of Rs. 400)		<u>80</u>
		<u>37,820</u>
(6) Reserves – A Ltd.		
		Rs.
Balance as on 31.12.2009 (given)		48,000
Share in		
B Ltd.		1,200
C Ltd.		<u>125</u>
		<u>49,325</u>
(7) Profit and Loss Account – A Ltd.		
		Rs.
Balance as on 31.12.2009 (given)		16,000
Share in		
B Ltd.		4,800
C Ltd.		<u>500</u>
		21,300

Consolidated Financial Statements of Group Companies

Less: Proposed dividend (10% of Rs. 1,00,000)	10,000
Provision for unrealised profit on stock	320
80% of (Rs. 4,400 – Rs. 4,000)	
	<u>10,980</u>

Note: The above solution has been done by direct method. Alternatively, students may follow indirect method. In indirect method, the share in pre-acquisition profits of B Ltd. in C Ltd. amounting Rs. 9,500 will be included as capital profit while analysing the profits of B Ltd. and will not be considered for the purpose of cost of control. Thus, in this case, the amounts of goodwill and minority interest will increase by Rs. 1,900 (2/10 of Rs. 9,500). Goodwill and minority interest will be shown at Rs. 7,425 and Rs. 39,720 respectively in the consolidated balance sheet. Therefore, the total of the assets and liabilities side of the consolidated balance sheet will be Rs. 2,22,025.

Question 9

On 31st March, 2009 Bee Ltd. became the holding company of Cee Ltd. and Dee Ltd. by acquiring 450 lakhs fully paid shares in Cee Ltd. for Rs. 6,750 lakhs and 240 lakhs fully paid shares in Dee Ltd. for Rs. 2,160 lakhs. On that date, Cee Ltd. showed a balance of Rs. 2,550 lakhs in General Reserve and a credit balance of Rs. 900 lakhs in Profit and Loss Account. On the same date, Dee Ltd. showed a debit balance of Rs. 360 lakhs in Profit and Loss Account. While its Preliminary Expenses Account showed a balance of Rs. 30 lakhs.

After one year, on 31st March, 2010 the Balance Sheets of three companies stood as follows:

(All amounts in lakhs of Rupees)

Liabilities	Bee Ltd.	Cee Ltd.	Dee Ltd.
Fully paid equity shares of Rs. 10 each	27,000	7,500	3,000
General Reserve	33,000	3,150	—
Profit and Loss Account	9,000	1,200	750
15 lakh fully paid 9.5%			
Debentures of Rs. 100 each	—	—	1,500
Loan from Cee Ltd.	—	—	75
Bills Payable	—	—	150
Sundry Creditors	<u>14,100</u>	<u>2,700</u>	<u>930</u>
	<u>83,100</u>	<u>14,550</u>	<u>6,405</u>

(All amounts in lakhs of Rupees)

Assets	Bee Ltd.	Cee Ltd.	Dee Ltd.
Machinery	39,000	7,500	2,100
Furniture and Fixtures	6,000	1,500	600

Financial Reporting*Investments:*

450 lakhs shares in Cee Ltd.	6,750	—	—
240 lakhs shares in Dee Ltd.	2,160	—	—
3 lakhs debentures in Dee Ltd.	294	—	—
Stocks	16,500	3,000	1,500
Sundry Debtors	9,000	1,350	1,290
Cash and Bank balances	3,201	1,050	900
Loan to Dee Ltd.	—	90	—
Bills Receivable	195	60	—
Preliminary Expenses	—	—	15
	<u>83,100</u>	<u>14,550</u>	<u>6,405</u>

The following points relating to the above mentioned Balance Sheets are to be noted:

- (i) All the bills payable appearing in Dee Ltd.'s Balance Sheet were accepted in favour of Cee Ltd. out of which bills amounting to Rs. 75 lakhs were endorsed by Cee Ltd. in favour of Bee Ltd. and bills amounting to Rs. 45 lakhs had been discounted by Cee Ltd. with its bank.
- (ii) On 29th March, 2010 Dee Ltd. remitted Rs. 15 lakhs by means of a cheque to Cee Ltd. to return part of the loan; Cee Ltd. received the cheque only after 31st March, 2010.
- (iii) Stocks with Cee Ltd. includes goods purchased from Bee Ltd. for Rs. 200 lakhs. Bee Ltd. invoiced the goods at cost plus 25%.
- (iv) In August, 2009 Cee Ltd. declared and distributed dividend @ 10% for the year ended 31st March, 2009. Bee Ltd. credited the dividend received to its Profit and Loss Account.

You are required to prepare a Consolidated Balance Sheet of Bee Ltd. and its subsidiaries Cee Ltd. and Dee Ltd. as at 31st March, 2010.

Answer

**Consolidated Balance Sheet of Bee Ltd. and
its subsidiaries Cee Ltd. and Dee Ltd.
as at 31st March, 2010**

<i>Liabilities</i>	<i>Rs. in lakhs</i>	<i>Assets</i>	<i>Rs. in lakhs</i>
Share Capital		Fixed Assets	
Authorised	?	Goodwill (W.N. 3)	246
Issued and subscribed		Machinery	48,600
Fully paid equity shares of Rs. 10 each	27,000	Furniture and Fixtures	8,100

Consolidated Financial Statements of Group Companies

Minority interest (W.N. 2)	5,487	Current Assets, Loans and Advances:		
Reserves and Surplus		(A) Current Assets		
General Reserve (W.N. 4)	33,360	Stock	21,000	
Profit and Loss A/c (W.N. 4)	10,040	Less: Unrealised profit	<u>40</u>	20,960
Secured Loans		Sundry debtors		11,640
Debentures	1,200	Cash and bank balances		5,151
<i>Current Liabilities</i>		Cash in transit		15
Acceptances	150	(B) Loan and Advances		
Less: Mutual owing	<u>105</u>	45 Bills receivable	255	
Sundry creditors	<u>17,730</u>	Less: Mutual owing (W.N.5)	<u>105</u>	<u>150</u>
	<u>94,862</u>			<u>94,862</u>

Working Notes:

(1) Calculation of pre and post acquisition profits of subsidiaries:

			<i>Rs. in lakhs</i>	
			<i>Post-acquisition</i>	
		<i>Pre-acquisition capital profit</i>	<i>General Reserve</i>	<i>Profit/Loss A/c</i>
Cee Ltd.				
General Reserve (Cr.)		2,550	600	
Profit and Loss A/c (Cr.)	900			
(–) Dividend	<u>750</u>	<u>150</u>	<u>—</u>	<u>1,050</u>
		<u>2,700</u>	<u>600</u>	<u>1,050</u>
Holding (60%)		1,620	360	630
Subsidiary (40%)		<u>1,080</u>	<u>240</u>	<u>420</u>

			<i>Rs. in lakhs</i>	
			<i>Post-acquisition</i>	
		<i>Pre-acquisition capital profit</i>	<i>Preliminary expenses</i>	<i>Profit / Loss A/c</i>
Dee Ltd.				
Profit and Loss A/c (Cr.)		(360)		1,110

Financial Reporting

Preliminary expenses (Dr.)	<u>(30)</u>	<u>15</u>	
(–) Dividend	<u>(390)</u>	<u>15</u>	<u>1,110</u>
Holding (80%)	(312)	12	888
Subsidiary (20%)	<u>(78)</u>	<u>3</u>	<u>222</u>
(2) Minority Interest			(Rs. in lakhs)
Cee Ltd.			
Share capital		3,000	
Capital profit	1,080		
Revenue General Reserve	240		
Profit/Loss	<u>420</u>	<u>1,740</u>	4,740
Dee Ltd.			
Share capital		600	
Capital profit	(78)		
Revenue profit (Cr.)	222		
Add: Preliminary expenses written off	<u>3</u>	<u>225</u>	<u>147</u>
			<u>5,487</u>
(3) Cost of Control			(Rs. in lakhs)
Cee Ltd.			
Investment	6,750		
Less: Dividend received and wrongly credited to Profit and Loss	<u>450</u>	<u>6,300</u>	
Less: Paid-up share capital (60%)	4,500		
Capital profit	<u>1,620</u>	<u>6,120</u>	180
Dee Ltd.			
Investment in Shares	2,160		
in debentures	<u>294</u>	2,454	
Less: Paid-up share capital (80%)	2,400		
Nominal value of debentures	300		
Capital profit	<u>(312)</u>	<u>2,388</u>	<u>66</u>
Goodwill			<u>246</u>

Consolidated Financial Statements of Group Companies

(4) Consolidated General Reserve and Profit and Loss Account

	<i>General Reserve</i>	<i>Profit and Loss A/c</i>
Bee Ltd.	33,000	9,000
Less: Wrong dividend credited	<u> — </u>	<u> 450 </u>
	33,000	8,550
Cee Ltd.	360	630
Dee Ltd. (888 + 12)	<u> — </u>	<u> 900 </u>
	33,360	10,080
Less: Unrealised profit on stock	<u> — </u>	<u> 40 </u>
	<u> 33,360 </u>	<u> 10,040 </u>

(5) Mutual owing regarding bills = Rs. (150 – 45) lakhs = Rs. 105 lakhs.

(6) Unrealised profit = $\left(200 \times \frac{25}{125}\right)$ lakhs = Rs. 40 lakhs

(7) Amount of dividend wrongly credited to Profit and Loss A/c = 60% of Rs. 750 lakhs = Rs. 450 lakhs.

Question 10

The following are the Balance Sheets of Arun Ltd., Brown Ltd. and Crown Ltd. as at 31.12.2009:

<i>Liabilities:</i>	<i>Arun Ltd.</i>	<i>Brown Ltd.</i>	<i>Crown Ltd.</i>
	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>
Share Capital (Shares of Rs.100 each)	6,00,000	4,00,000	2,40,000
Reserves	80,000	40,000	30,000
Profit and Loss Account	2,00,000	1,20,000	1,00,000
Sundry Creditors	80,000	1,00,000	60,000
Arun Ltd.	<u> — </u>	<u> 40,000 </u>	<u> 32,000 </u>
Total	<u> 9,60,000 </u>	<u> 7,00,000 </u>	<u> 4,62,000 </u>
<i>Assets:</i>			
	<i>Arun Ltd.</i>	<i>Brown Ltd.</i>	<i>Crown Ltd.</i>
	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>
Goodwill	80,000	60,000	40,000
Fixed Assets	2,80,000	2,00,000	2,40,000

Financial Reporting

Shares in:

Brown Ltd. (3,000 Shares)	3,60,000	--	--
Crown Ltd. (400 Shares)	60,000	--	--
Crown Ltd. (1,400 Shares)	--	2,08,000	--
Due from: Brown Ltd.	48,000	--	--
Crown Ltd.	32,000	--	--
Current Assets	<u>1,00,000</u>	<u>2,32,000</u>	<u>1,82,000</u>
Total	<u>9,60,000</u>	<u>7,00,000</u>	<u>4,62,000</u>

(i) All shares were acquired on 1.7.2009.

(ii) On 1.1.2009 the balances to the various accounts were as under:

Particulars	Arun Ltd. Rs.	Brown Ltd. Rs.	Crown Ltd. Rs.
Reserves	40,000	40,000	20,000
Profit and Loss account	20,000	(Dr.) 20,000	12,000

(iii) During 2009, Profits accrued evenly.

(iv) In August, 2009, each company paid interim dividend of 10%. Arun Ltd. and Brown Ltd. have credited their profit and loss account with the dividends received.

(v) During 2009, Crown Ltd. sold an equipment costing Rs.40,000 to Brown Ltd. for Rs.48,000 and Brown Ltd. in turn sold the same to Arun Ltd. for Rs.52,000.

Prepare the consolidated Balance Sheet as at 31.12.2009, of Arun Ltd. and its subsidiaries.

Answer**Consolidated Balance Sheet of Arun Ltd. and its subsidiaries****as on 31.12.2009**

Liabilities	Rs.	Assets	Rs.
Share Capital (Shares of Rs. 100 each)	6,00,000	Goodwill (W. N. 5)	1,81,000
Minority Interest (W. N. 4)	2,33,729	Fixed Assets	7,08,000
Reserves (W. N. 8)	83,021	Current Assets	5,14,000
Profit & Loss A/c (W. N. 8)	2,54,250	Cash in Transit (W. N. 7)	8,000
Sundry Creditors	<u>2,40,000</u>		
	<u>14,11,000</u>		<u>14,11,000</u>

Working Notes**1. Shareholding Pattern**

<i>In Brown Ltd.:</i>	<i>Number of Shares</i>	<i>%age of Holding</i>
Arun Ltd.	3,000	75%
Minority Interest	1,000	25%
<i>In Crown Ltd.:</i>		
Arun Ltd.	400	16.667%
Brown Ltd.	1,400	58.333%
Minority Interest	600	25%

2. Analysis of apportionment of profit in Crown Ltd.**(a) Calculation of Unrealized Profit in Equipment**

Crown Ltd sold equipment to Brown Ltd. at a profit of Rs. 8,000 and this would be apportioned to

	<i>Rs.</i>
Arun Ltd.	1,333
Brown Ltd.	4,667
Minority Interest	<u>2,000</u>
	<u>8,000</u>

Brown Ltd sold the equipment to Arun Ltd. at a profit of Rs. 4,000. This would be apportioned to:

	<i>Rs.</i>
Arun Ltd.	3,000
Minority Interest	<u>1,000</u>
	<u>4,000</u>

The above amounts are to be deducted from the respective share of profits.

(b) Reserves

	<i>Rs.</i>	
Closing balance	30,000	
Opening balance	<u>20,000</u>	Capital Profit
Current year Appropriation	<u>10,000</u>	
Apportionment of Profit from 1.1.2009 to 30.6.2009	<u>5,000</u>	Capital Profit
Apportionment of Profit from 1.7.2009 to 31.12.2009	<u>5,000</u>	Revenue Reserve

Financial Reporting(c) *Profit and Loss Account*

Closing balance	1,00,000	
Opening balance	<u>12,000</u>	Capital Profit
Current year profits before interim dividend	<u>1,12,000</u>	
Apportionment of Profit from 1.1.2009 to 30.6.2009	56,000	
Less: Interim Dividend	<u>24,000</u>	
	32,000	Capital Profit
From 1.7.2009 to 31.12.2009	<u>56,000</u>	Revenue Profit

(d) *Apportionment of profits of Crown Ltd.*

	Pre-Acquisition	Post Acquisition	
	<i>Capital Profit</i>	<i>Revenue</i>	<i>Revenue Profit</i>
	<i>Rs.</i>	<i>Reserve</i>	<i>Rs.</i>
		<i>Rs.</i>	
Reserves	25,000	5,000	--
Profit & Loss Account	<u>44,000</u>	<u>--</u>	<u>56,000</u>
	<u>69,000</u>	<u>5,000</u>	<u>56,000</u>
Arun Ltd [16.667%]	11,500	833	9,333
Brown Ltd. [58.333%]	40,250	2,917	32,667
Minority Interest [25%]	17,250	1,250	14,000

3. Analysis of Profit of Brown Ltd(a) *Reserves*

	<i>Rs.</i>
Closing balance	40,000
Opening balance	<u>40,000</u> (Capital Profit)
Current year Appropriation	<u>Nil</u>

(b) *Profit and Loss Account*

	<i>Rs.</i>
Closing balance	1,20,000
Opening balance (Dr.)	<u>20,000</u>
Current year Appropriation after interim dividend	1,40,000
Interim Dividend	<u>40,000</u>
Profit before Interim Dividend	1,80,000
Less: Dividend from Crown Ltd.	<u>14,000</u>
	<u>1,66,000</u>

Consolidated Financial Statements of Group Companies

Apportionment of Profit from 1.1.2009 to 30.6.2009	83,000
Less: Interim Dividend	<u>40,000</u>
Capital profit	<u>43,000</u>
Apportionment of Profit from 1.7.2009 to 31.12.2009 (Revenue profit)	<u>83,000</u>

(c) *Apportionment of Profit of Brown Ltd.*

	Pre-Acquisition	Post-Acquisition	
	Capital Profit Rs.	Revenue Reserve Rs.	Revenue Profit Rs.
Reserves	40,000	--	--
Profit & Loss Account (Opening balance (-) 20,000+43,000)	23,000		83,000
Less: Unrealised Profit of Equipment from Crown Ltd.			(4,667)
Share of Post-Acquisition Profit of Crown Ltd.	--	2,917	<u>32,667</u>
	<u>63,000</u>	<u>2,917</u>	<u>1,11,000</u>
Arun Ltd. 75%	47,250	2,188	83,250
Minority Interest 25%	15,750	729	27,750

4. Minority Interest

	Brown Ltd. Rs.	Crown Ltd. Rs.
Share Capital	1,00,000	60,000
Capital Profit	15,750	17,250
Revenue: Reserves	729	1,250
Profit & Loss Account	27,750	14,000
Unrealised Profit on Equipment	<u>(1,000)</u>	<u>(2,000)</u>
	<u>1,43,229</u>	<u>90,500</u>

Total Minority Interest: Rs.1,43,229+ Rs.90,500 =
Rs.2,33,729

Financial Reporting

5. Cost of Control

	<i>Arun Ltd. in Brown Ltd. Rs.</i>	<i>Arun Ltd. in Crown Ltd. Rs.</i>	<i>Brown Ltd in Crown Ltd. Rs.</i>
Amount Invested	3,60,000	60,000	2,08,000
Less: Pre-acquisition dividend*	<u>30,000</u>	<u>4,000</u>	<u>14,000</u>
Adjusted Cost of Investment (A)	<u>3,30,000</u>	<u>56,000</u>	<u>1,94,000</u>
Share capital	3,00,000	40,000	1,40,000
Capital Profit	<u>47,250</u>	<u>11,500</u>	<u>40,250</u>
(B)	<u>3,47,250</u>	<u>51,500</u>	<u>1,80,250</u>
Capital Reserve/Goodwill (A)-(B)	(17,250)	4,500	13,750
Net Goodwill	Rs.1,000		
Goodwill on Consolidation Rs. (80,000+ 60,000+40,000+1,000) = Rs.1,81,000			

6. Dividend declared

	<i>Brown Ltd. Rs.</i>	<i>Crown Ltd. Rs.</i>
Dividend declared	<u>40,000</u>	<u>24,000</u>
Share of: Arun Ltd.	30,000	4,000
Brown Ltd.		14,000
Minority	10,000	6,000

7. Inter-Company Transactions

(a) Owings

	<i>Dr. Arun Ltd. Rs.</i>	<i>Cr. Brown Ltd. Rs.</i>	<i>Cr. Crown Ltd. Rs.</i>
Balance in books	80,000	40,000	32,000
Less: Inter- co. owings	<u>72,000</u>	<u>40,000</u>	<u>32,000</u>
Cash-in-transit	<u>8,000</u>	<u>NIL</u>	<u>NIL</u>

* The entire amount of interim dividend of 10 % has been treated as pre-acquisition dividend.

Consolidated Financial Statements of Group Companies

(b) Fixed Assets

	Rs.
Total Fixed Assets	7,20,000
Less: Unrealised Profit on sale of equipment	<u>12,000</u>
Amount to be taken to consolidated Balance Sheet	<u>7,08,000</u>

8. Reserves and Profit and Loss Account balances in the Consolidated Balance Sheet

	Reserves Rs.	Profit and Loss A/c Rs.
Balance in Books	80,000	2,00,000
Add: Shares of Post Acquisition Profits:		
From Brown Ltd.	2,188	83,250
From Crown Ltd	833	9,333
Less: Pre-Acquisition dividend:		
From Brown Ltd.		(30,000)
From Crown Ltd		(4,000)
Less: Unrealised Profit on Equipment:		
From Brown Ltd.		(3,000)
From Crown Ltd.		<u>(1,333)</u>
	<u>83,021</u>	<u>2,54,250</u>

Question 11

The following information has been extracted from the Books of 'X' Limited group (as at 31st December, 2009):

	X Ltd. Rs.	Y Ltd. Rs.	Z Ltd. Rs.		X Ltd. Rs.	Y Ltd. Rs.	Z Ltd. Rs.
Share capital				Fixed Assets less Depreciation	4,20,000	3,76,000	5,22,000
(Fully paid equity shares of Rs.10 each)	8,00,000	6,00,000	4,00,000	Investment at Cost Current	6,30,000	4,00,000	---
Profit and Loss Account	2,10,000	1,90,000	1,28,000	Assets	1,20,000	60,000	40,000

Financial Reporting

Dividend received:

From Y Ltd. in 2008 60,000

From Y Ltd. in 2009 60,000

From Z Ltd. in 2009 36,000

Current

Liabilities	<u>40,000</u>	<u>10,000</u>	<u>34,000</u>			
	<u>11,70,000</u>	<u>8,36,000</u>	<u>5,62,000</u>	<u>11,70,000</u>	<u>8,36,000</u>	<u>5,62,000</u>

All the companies pay dividends of 12 percent of paid-up share capital in March following the end of the accounting year. The receiving companies account for the dividends in their books when they are received.

'X' Limited acquired 50,000 equity shares of Y Ltd. on 31st December, 2007.

'Y' Limited acquired 30,000 equity shares of Z Ltd. on 31st December, 2008.

The detailed information of Profit and Loss Accounts is as follows:

	X Ltd. Rs.	Y Ltd. Rs.	Z Ltd. Rs.
Balance of Profit and Loss Account on 31 st December, 2007 after dividends of 12% in respect of calendar year 2007, but excluding dividends received	86,000	78,000	60,000
Net profit earned in 2008	<u>1,20,000</u>	<u>84,000</u>	<u>56,000</u>
	2,06,000	1,62,000	1,16,000
Less – Dividends of 12% (paid in 2009)	<u>96,000</u>	<u>72,000</u>	<u>48,000</u>
	1,10,000	90,000	68,000
Net profit earned in 2009 (Before taking into account proposed dividends of 12% in respect of calendar year 2009)	<u>1,00,000</u>	<u>1,00,000</u>	<u>60,000</u>
	<u>2,10,000</u>	<u>1,90,000</u>	<u>1,28,000</u>

Taking into account the transactions from 2007 to 2009 and ignoring taxation, you are required to prepare:

- The Consolidated Balance Sheet of X Limited group as at 31st December, 2009.
- The Consolidated Profit and Loss Account for the year ending 31st December, 2009.
- Cost of control.
- Minority shareholders interest.

Consolidated Financial Statements of Group Companies

Answer

(i) Consolidated Balance Sheet of X Ltd. and its subsidiaries Y Ltd. and Z Ltd.

as on 31st December, 2009

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
<i>Share Capital:</i>		<i>Fixed Assets:</i>	
80,000 Equity shares of Rs.10 each fully paid	8,00,000	Goodwill [Refer (iii)]	18,000
Minority Interest [Refer (iv)]	2,47,167	Other Fixed Assets less depreciation	13,18,000
<i>Reserves and Surplus:</i>		<i>Current Assets, Loans and Advances:</i>	
Profit and Loss Account [Refer (ii)]	3,04,833	Current Assets	2,20,000
<i>Current Liabilities and Provision:</i>			
Current Liabilities	84,000		
Proposed Dividend:			
X Ltd.	96,000		
Minority Interest [Refer (iv)]	<u>24,000</u>		
	<u>15,56,000</u>		<u>15,56,000</u>

(ii) Consolidated Profit and Loss Account
for the year ending 31st December, 2009

(in Rs.)

Particulars	X Ltd.	Y Ltd.	Z Ltd.	Adjustments	Total	Particulars	X Ltd.	Y Ltd.	Z Ltd.	Adjustments	Total
To Dividend (paid for 2008)	96,000	72,000	48,000	96,000	1,20,000	By Balance b/d	2,06,000	1,62,000	1,16,000	-	4,84,000
To Minority Interest	-	39,167	32,000	-	71,167	By Dividend received in 2008 (for 2007)	60,000	-	-	-	60,000
To Capital Reserve (Cost of Control)	-	65,000	51,000	-	1,16,000	By Dividend received in 2009 (for 2008)	60,000	36,000	-	96,000	-
To Investments Accounts						By Profit for the year	1,00,000	1,00,000	60,000	-	2,60,000
(Dividend received out of capital profit)	60,000*	36,000*	-	-	96,000						
To Proposed Dividend	96,000	-	-	-	96,000						
To Balance c/d	<u>1,74,000</u>	<u>85,833</u>	<u>45,000</u>	<u>-</u>	<u>3,04,833</u>						
	<u>4,26,000</u>	<u>2,98,000</u>	<u>1,76,000</u>	<u>96,000</u>	<u>8,04,000</u>		<u>4,26,000</u>	<u>2,98,000</u>	<u>1,76,000</u>	<u>96,000</u>	<u>8,04,000</u>

Financial Reporting**Notes:***

- (1) X Ltd. receives from Y Ltd., dividend amounting to Rs.60,000 for the year 2007 in the year 2008 for shares acquired in 2007. It is a capital profit, therefore it has been transferred to cost of control to reduce the cost of investment.
- (2) Y Ltd. receives a dividend of Rs.36,000 from Z Ltd. for the year 2008 in the year 2009. The shares were acquired by Y Ltd on 31st December, 2008. The entire amount is therefore, a capital profit and hence transferred to cost of control to reduce the cost of investment.

(iii) Cost of Control:

	Rs.	Rs.
Cost of Investment in Y Ltd. on 31 st December 2007	6,30,000	
Less: Dividend of the year 2007 received in 2008 out of Pre-acquisition profit	<u>60,000</u>	5,70,000
Cost of Investment in Z Ltd.	4,00,000	
Less: Dividend of the year 2008 received in 2009 out of Pre-acquisition Profit	<u>36,000</u>	<u>3,64,000</u>
		9,34,000
Less: Paid up value of shares in Y Ltd.	5,00,000	
Paid up value of shares in Z Ltd.	3,00,000	
Capital Profits in Y Ltd. (Refer W.N. 2)	65,000	
Capital Profits in Z Ltd. (Refer W.N. 2)	<u>51,000</u>	<u>9,16,000</u>
Goodwill		<u>18,000</u>

(iv) Minority shareholders' interest:

	Y Ltd. Rs.	Z Ltd. Rs.
Share Capital (Y Ltd. – 1/6 and Z Ltd. – 1/4)	1,00,000	1,00,000
Capital Profits (Refer W.N. 2)	13,000	17,000
Revenue Profits (Refer W.N. 2)	<u>26,167</u>	<u>15,000</u>
	<u>1,39,167</u>	<u>1,32,000</u>
Total (1,39,167 + 1,32,000)		2,71,167
Less: Minority shareholders' share of proposed dividend (shown separately in the Balance Sheet)		
$\left(\frac{1}{6} \text{ of Rs. 72,000} + \frac{1}{4} \text{ of Rs. 48,000} \right)$		<u>24,000</u>
Balance		<u>2,47,167</u>

Consolidated Financial Statements of Group Companies

Working Notes:

1. Shareholding Pattern	<i>Number of shares</i>	<i>share of holding</i>
In Y Ltd.		
X Ltd.	50,000	5/6
Minority Interest	10,000	1/6
In Z Ltd.		
Y Ltd.	30,000	3/4
Minority Interest	10,000	1/4
2. Analysis of Profits	<i>Pre - acquisition</i>	<i>Post - acquisition</i>
	<i>Capital Profit</i>	<i>Revenue Profit</i>
Z Ltd.	<i>Rs</i>	<i>Rs.</i>
Balance on 31 st December, 2008 after dividend for 2008 (1,16,000 – 48,000)	68,000	-
Profit for the year ending 31 st December, 2009 before proposed dividends for 2009	<u>-</u>	<u>60,000</u>
	<u>68,000</u>	<u>60,000</u>
Share of Y Ltd. (3/4)	51,000	45,000
Minority Interest (1/4)	<u>17,000</u>	<u>15,000</u>
Y Ltd.		
Balance on 31 st December, 2007	78,000	-
Profit for the year 2008 after payment of dividend for 2008 (84,000 – 72,000)	-	12,000
Profit for the year 2009 (before payment of dividend of the year 2009)	-	1,00,000
Revenue Profit from Z Ltd.	<u>-</u>	<u>45,000</u>
	<u>78,000</u>	<u>1,57,000</u>
Share of X Ltd. (5/6)	65,000	1,30,833
Share of Minority Shareholders' Interest (1/6)	<u>13,000</u>	<u>26,167</u>

Note: This problem has been solved by following 'direct approach'.

Financial Reporting

Question 12

The draft Balance Sheets of 3 Companies as at 31st March, 2010 are as below:

	(In Rs.000's)		
	Morning Ltd.	Evening Ltd.	Night Ltd.
Liabilities			
Share Capital – shares of Rs.100 each	40,000	20,000	10,000
Reserves	1,800	1,000	900
P/L A/c (1.4.09)	1,500	2,000	800
Profit for 2009-10	7,000	3,800	1,800
Loan from Morning Ltd.	—	5,000	—
Creditors	<u>2,500</u>	<u>1,000</u>	<u>1,400</u>
	<u>52,800</u>	<u>32,800</u>	<u>14,900</u>
Assets			
Investments:			
1,60,000 shares in Evening	18,000	—	—
75,000 shares in Night	8,000	—	—
Loan to Evening Ltd.	5,000	—	—
Sundry assets	<u>21,800</u>	<u>32,800</u>	<u>14,900</u>
	<u>52,800</u>	<u>32,800</u>	<u>14,900</u>

Following additional information is also available:

- Dividend is proposed by each company at 10%.
- Stock transferred by Night Ltd. to Evening Ltd. fully paid for was Rs.8 lacs on which the former made a Profit of Rs.3 lacs. On 31st March, 2010, this was in the inventory of the latter.
- Loan referred to is against 8% interest. Neither Morning Ltd. nor Evening Ltd. has considered the interest.
- Reserves as on 1.4.2009 of Evening Ltd. and Night Ltd. were Rs.8,00,000 and Rs.7,50,000 respectively.
- Cash-in-transit from Evening Ltd. to Morning Ltd. was Rs.1,00,000 as on 31.3.2010.
- The shares of the subsidiaries were all acquired by Morning Ltd. on 1st April, 2009.

Prepare consolidated Balance Sheet as on 31st March, 2010. Workings should be part of the answer.

Consolidated Financial Statements of Group Companies

Answer

Consolidated Balance Sheet of Morning Ltd. with its subsidiaries
Evening Ltd. and Night Ltd.As on 31st March, 2010

(Rs. in thousand)

Liabilities	Rs.	Rs.	Rs.	Assets	Rs.	Rs.	Rs.
Share Capital			40,000	Sundry Assets*			
Minority Interest				Morning Ltd.		21,800	
Evening Ltd.		4,880		Evening Ltd.	32,800		
Night Ltd.		<u>3,125</u>	8,005	Less: Unrealized profit	<u>300</u>	32,500	
Capital Reserve [Refer Note 5]			902.5	Night Ltd.		<u>14,900</u>	69,200
General Reserve							
Morning Ltd.		1,800					
Evening Ltd.		160					
Night Ltd.		<u>112.5</u>	2,072.5				
Profit & Loss A/c							
Balance on 1.04.09	1,500						
Profit during 09- 10	7,000						
Add: Interest on Loan	<u>400</u>						
	8,900						
Less: Proposed dividend	<u>4,000</u>	4,900					
Add: P & L A/c of Evening Ltd.		2,720					
Add: P & L A/c of Night Ltd		<u>1,050</u>	8,670				

* The total of Sundry Assets of the Group mutually sets off the effect of Cash-in-transit of Rs.1 lac from Evening Ltd. to Morning Ltd. Hence, cash in transit has not been separately shown.

Financial Reporting

Creditors

Morning Ltd.	2,500	
Evening Ltd.	1,000	
Night Ltd	<u>1,400</u>	4,900

Proposed Dividend

Morning Ltd.	4,000		
Evening Ltd. (Minority)	400		
Night Ltd. (Minority)	<u>250</u>	<u>4,650</u>	
		<u>69,200</u>	<u>69,200</u>

Workings Notes:

- A. Morning Ltd.'s holding in Evening Ltd. is 1,60,000 shares out of 2,00,000 shares, i.e., 4/5th or 80%; Minority holding 1/5th or 20%.
- B. Morning Ltd.'s holding in Night Ltd. is 75,000 shares out of 1,00,000 shares, i.e., 3/4th or 75%; Minority holding 1/4th or 25%.

Analysis of Reserves and Profits of Subsidiary Companies

	Evening Ltd. (Rs.'000)	Night Ltd Rs.('000)	Minority interest in Evening Ltd. (1/5) Rs.('000)	Minority interest in Night Ltd. (1/4) Rs.('000)
1. Capital Reserve (pre-acquisition reserves and profits)				
Reserves on 1.04.2009	800	750		
Profit on 1.04.2009	<u>2,000</u>	<u>800</u>		
	2,800	1,550		
Less: Minority interest	<u>560</u>	<u>387.5</u>	560	387.5
	<u>2,240</u>	<u>1,162.5</u>		
2. General Reserve				
Reserves as per Balance Sheet	1,000	900		
Less: Capital Reserve	<u>800</u>	<u>750</u>		
	200	150		
Less: Minority interest	<u>40</u>	<u>37.5</u>	40	37.5
	<u>160</u>	<u>112.5</u>		

Consolidated Financial Statements of Group Companies

3. Profit and Loss Account

Profit for the year as per Balance Sheet	3,800	1,800		
Less: Interest on Loan (5,000 x 8%)	<u>400</u>			
	3,400			
Less: Minority Interest	<u>680</u>	<u>450</u>	680	450
	2,720	1,350		
Less: Unrealised profit on stock transfer	<u> </u>	<u>300*</u>		
	<u>2,720</u>	<u>1,050</u>		

4. Share Capital

As per Balance sheet	20,000	10,000		
Less: Minority interest	<u>4,000</u>	<u>2,500</u>	<u>4,000</u>	<u>2,500</u>
Transferred for computation of Goodwill/Capital Reserve	<u>16,000</u>	<u>7,500</u>	5,280	3,375
Less: Proposed dividend shown separately			<u>400</u>	<u>250</u>
Transferred to Consolidated Balance Sheet			<u>4,880</u>	<u>3,125</u>

5. Computation of Cost of Control i.e. Goodwill / Capital Reserve on consolidation

(Rs. In thousand)

	Evening Ltd.	Night Ltd.
Cost of Investments	18,000	8,000
Less: Paid up value of shares [Refer Note 4]	<u>16,000</u>	<u>7,500</u>
	2,000	500
Less: Capital Reserve [Refer Note 1]	<u>2,240</u>	<u>1,162.5</u>
	<u>-240</u>	<u>-662.5</u>
Total Capital Reserve (Rs.240 + Rs.662.5)	902.5	

* As per para 17 of AS 21, 'Unrealised profits resulting from intragroup transactions that are included in the carrying amount of assets, such as inventory and fixed assets, are eliminated in full.

Financial Reporting

Question 13

The Balance Sheets of three companies Angle Ltd., Bolt Ltd., and Canopy Ltd., as at 31st December, 2009 are given below:

Liabilities	Angle Ltd. Rs.	Bolt Ltd. Rs.	Canopy Ltd. Rs.
Share capital			
(Equity shares of Rs.100 each)	15,00,000	10,00,000	6,00,000
Reserves	2,00,000	1,25,000	75,000
Profit and Loss A/c	5,00,000	2,75,000	2,50,000
Sundry creditors	2,00,000	2,50,000	1,00,000
Bills payable	-	-	50,000
Angle Ltd.	-	1,00,000	80,000
	<u>24,00,000</u>	<u>17,50,000</u>	<u>11,55,000</u>
Goodwill	2,50,000	5,80,000	4,50,000
Plant and Machinery	4,00,000	2,50,000	3,25,000
Furniture and Fittings	2,00,000	1,50,000	1,40,000
Shares in-			
Bolt Ltd. (7,500 shares)	9,00,000	-	-
Canopy Ltd. (1,000 shares)	1,50,000		
Canopy Ltd. (3,500 shares)	-	5,20,000	-
Stock in trade	1,00,000	1,50,000	1,60,000
Sundry debtors	1,40,000	70,000	70,000
Bills receivable	50,000	20,000	-
Due from-			
Bolt Ltd.	1,20,000	-	-
Canopy Ltd.	80,000	-	-
Cash in hand	<u>10,000</u>	<u>10,000</u>	<u>10,000</u>
Total	<u>24,00,000</u>	<u>17,50,000</u>	<u>11,55,000</u>

(a) All shares were acquired on 1st July, 2008.

Consolidated Financial Statements of Group Companies

(b) On 1st January, 2008, the balances were:

	Angle Ltd.	Bolt Ltd.	Canopy Ltd.
	Rs.	Rs.	Rs.
Reserves	1,00,000	1,00,000	50,000
Profit and Loss account	50,000	(50,000)Dr.	30,000
Profit during 2008 were earned evenly over the year	3,00,000	2,50,000	1,00,000

- (c) Each company declared a dividend of 10% in the year 2009 on its shares out of Profits for the year 2008; Angle Ltd. and Bolt Ltd. have credited their Profit and Loss account with the dividends received.
- (d) The increase in reserves in case of Angle Ltd., Bolt Ltd., and Canopy Ltd., was effected in the year 2008.
- (e) All the bills payable appearing in Canopy Ltd.'s Balance Sheet were accepted in favour of Bolt Ltd., out of which bills amounting Rs.30,000 were endorsed by Bolt Ltd., in favour of Angle Ltd.
- (f) Stock with Bolt Ltd. includes goods purchased from Angle Ltd., for Rs.18,000. Angle Ltd., invoiced the goods at cost plus 20%.

Prepare consolidated Balance Sheet of the group as at 31st December, 2009. Working should be part of the answer. Ignore taxation including dividend distribution tax, disclose minority interest as per AS 21.

Answer**Consolidated Balance Sheet of Angle Ltd. and its subsidiaries****Bolt Ltd and Canopy Ltd****as at 31st December, 2009**

Liabilities	Rs.	Assets	Rs.
Share Capital (Equity shares of Rs.100 each)	15,00,000	Goodwill	
Minority Interest (W.N. 6)		Angle Ltd. 2,50,000	
Bolt Ltd. 3,97,396		Bolt Ltd. 5,80,000	
Canopy Ltd. <u>2,31,250</u>		Canopy Ltd. <u>4,50,000</u>	12,80,000
Reserves (2,00,000+14,844+2,083)	2,16,927	Add: Cost of control(W.N.7)	<u>1,55,833</u>
Profit and Loss Account (W.N.4)	7,62,260	Plant & Machinery	
		Angle Ltd. 4,00,000	
		Bolt Ltd. 2,50,000	
		Canopy Ltd. <u>3,25,000</u>	9,75,000

Financial Reporting

Sundry Creditors			Furniture & Fittings		
Angle Ltd.	2,00,000	5,50,000	Angle Ltd.	2,00,000	
Bolt Ltd.	2,50,000		Bolt Ltd.	1,50,000	
Canopy Ltd.	<u>1,00,000</u>		Canopy Ltd.	<u>1,40,000</u>	4,90,000
Bills Payable	50,000		Stock-in-Trade		
Less: Mutually held	<u>50,000</u>	Nil	Angle Ltd.	1,00,000	
			Bolt Ltd.	1,50,000	
			Canopy Ltd.	<u>1,60,000</u>	
				4,10,000	
			Less: Provision for unrealised Profit	<u>3,000</u>	4,07,000
			Sundry Debtors		
			Angle Ltd.	1,40,000	
			Bolt Ltd.	70,000	
			Canopy Ltd.	<u>70,000</u>	2,80,000
			Bills Receivable		
			Angle Ltd.	50,000	
			Bolt Ltd.	<u>20,000</u>	
				70,000	
			Less: Mutually held	<u>50,000</u>	20,000
			Cash-in-hand		
			Angle Ltd.	10,000	
			Bolt Ltd.	10,000	
			Canopy Ltd.	<u>10,000</u>	30,000
			Cash-in-Transit / Dues from Bolt Ltd. (W.N. 8)		
					<u>20,000</u>
		<u>36,57,833</u>			<u>36,57,833</u>

Disclosure of Minority Interest in accordance with AS 21**Amount of Equity attributable to minorities on the date of Investment ie. 1.7.2008**

	Bolt Ltd	Canopy Ltd.
Share capital	2,50,000	1,50,000
Share in Capital Reserve as on 1.1.08	25,000	12,500
Share in Capital Profits as on 1.1.08	(12,500)	7,500
Share in Capital Profits for the period 1.1.08 to 30.6.08	<u>31,250</u>	<u>12,500</u>
	<u>2,93,750</u>	<u>1,82,500</u>
Total amount of Equity attributable to minorities	4,76,250	

Consolidated Financial Statements of Group Companies

Disclosure in accordance with AS 21

Minority Interest as on 31.12.2009

Amount of equity as on the date of Investment ie. 1.7.2008	4,76,250
Add: Movement in equity and proportionate share of Profit less dividend from the date of Investment upto 31.12.09	<u>1,52,396</u>
	<u>6,28,646</u>

Working Notes:

1. Ascertainment of Profits for the year 2009

	Angle Ltd. Rs.	Bolt Ltd. Rs.	Canopy Ltd. Rs.
Balance as on 1 st January, 2008	50,000	(50,000)	30,000
Add: Profits earned during 2008	<u>3,00,000</u>	<u>2,50,000</u>	<u>1,00,000</u>
	3,50,000	2,00,000	1,30,000
Less: Dividend Declared	<u>1,50,000</u>	<u>1,00,000</u>	<u>60,000</u>
	2,00,000	1,00,000	70,000
Less: Transfer to Reserve	<u>1,00,000</u>	<u>25,000</u>	<u>25,000</u>
	1,00,000	75,000	45,000
Profit for the year 2009 (Balancing Figure)	<u>4,00,000</u>	<u>2,00,000</u>	<u>2,05,000</u>
Balance as on 31 st December, 2009	<u>5,00,000</u>	<u>2,75,000</u>	<u>2,50,000</u>

2. Undistributed profits for the year 2008

	Bolt Ltd. Rs.	Canopy Ltd. Rs.
Profits for the year 2008	2,50,000	1,00,000
Less: Dividends declared	<u>1,00,000</u>	<u>60,000</u>
	1,50,000	40,000
Less: Transfer to Reserves	<u>25,000</u>	<u>25,000</u>
	<u>1,25,000</u>	<u>15,000</u>

3. Analysis of Profits

	Capital Profits Rs.	Revenue Reserve Rs.	Revenue Profits Rs.
Canopy Ltd.			
Reserves as on 1 st January, 2008	50,000		
Transfer to Reserve in the year 2008 [(75,000-50,000)/2]	12,500	12,500	

Financial Reporting

Profit & Loss Account

Balance as on 1 st January, 2008	30,000		
Profit for 2008 remaining undistributed [(1,00,000-25,000-60,000)/2]	7,500		7,500
Profit for the year 2009 (2,50,000-30,000-15,000)			<u>2,05,000</u>
(A)	1,00,000	12,500	2,12,500
Minority Interest [$\frac{1}{4}$ th of (A)]	<u>25,000</u>	<u>3,125</u>	<u>53,125</u>
	75,000	9,375	1,59,375
Share of Angle Ltd. [$\frac{1}{6}$ th of (A)]	<u>16,667</u>	<u>2,083</u>	<u>35,417</u>
Share of Bolt Ltd.	<u>58,333</u>	<u>7,292</u>	<u>1,23,958</u>
Bolt Ltd.			
Reserves as on 1 st January, 2008	1,00,000		
Transfer to Reserves 2008 [(1,25,000-1,00,000)/2]	12,500	12,500	
Profit & Loss Account - Balance (Dr.) as on 1 st January, 2008	(50,000)		
Undistributed Profits for 2008 [(2,50,000-25,000-1,00,000)/2]	62,500		62,500
Share in profits of Canopy Ltd.	58,333	7,292	1,23,958
Profit for the year, 2009 (2,75,000+50,000-1,25,000)			<u>2,00,000</u>
(B)	1,83,333	19,792	3,86,458
Less: Minority Interest [$\frac{1}{4}$ th of (B)]	<u>45,833</u>	<u>4,948</u>	<u>96,615</u>
Share of Angle Ltd.	<u>1,37,500</u>	<u>14,844</u>	<u>2,89,843</u>

4. Consolidated Profit and Loss Account of Angle Ltd.

		Rs.
Profit & Loss Account balance as on 31.12.2009		5,00,000
Add: Share in revenue profits of Canopy Ltd.		35,417
Share in revenue profits of Bolt Ltd.		<u>2,89,843</u>
Less: Pre-acquisition dividend		8,25,260
Angle Ltd. $\frac{1}{2}$ (Rs. 75,000 +Rs. 10,000)	42,500	
Bolt Ltd. ($\frac{1}{2}$ of Rs. 35,000)	<u>17,500</u>	<u>60,000</u>
		7,65,260
Less: Unrealised Profit in Closing Stock ($20/120 \times 18,000$)		<u>3,000</u>
		<u>7,62,260</u>

Consolidated Financial Statements of Group Companies

5. Consolidated Reserves of Angle Ltd.

	Rs.
Reserves as on 31.12.2009	2,00,000
Add: Share in revenue reserves of Canopy Ltd.	2,083
Add: Share in revenue reserves of Bolt Ltd.	<u>14,844</u>
	<u>2,16,927</u>

6. Minority Interest

	<i>Bolt Ltd.</i>	<i>Canopy Ltd.</i>
	Rs.	Rs.
Share Capital	2,50,000	1,50,000
Share of Capital Profits	45,833	25,000
Share of Revenue Reserves	4,948	3,125
Share of Revenue Profits	<u>96,615</u>	<u>53,125</u>
Total	<u>3,97,396</u>	<u>2,31,250</u>
Grand total		<u>6,28,646</u>

7. Cost of Control/Goodwill

	Rs.	Rs.
Cost of investments (9,00,000+1,50,000+5,20,000)		15,70,000
Less: Dividend Attributable to Pre-Acquisition Profits for 6 months i.e. [(75,000+45,000)/2]		<u>60,000</u>
		15,10,000
Less: Face value of Shares		
Bolt Ltd.	7,50,000	
Canopy Ltd.	4,50,000	
Capital Profits		
Bolt Ltd.	1,37,500	
Canopy Ltd.	<u>16,667</u>	<u>13,54,167</u>
Goodwill		<u>1,55,833</u>

8 Cash in Transit /Dues from Bolt Ltd.

	Rs.	Rs.
(i) Due to Angle Ltd.		
From Bolt Ltd.	1,20,000	
From Canopy Ltd.	<u>80,000</u>	2,00,000

Financial Reporting

(ii) Due by Angle Ltd.

To Bolt Ltd.	1,00,000	
To Canopy Ltd.	<u>80,000</u>	<u>1,80,000</u>
		<u>20,000</u>

Question 14

The following are the Balance Sheets of Ram Ltd., Shyam Ltd. and Tom Ltd. as on 31.03.2008:

Particulars	Ram Ltd.	Shyam Ltd.	Tom Ltd.
Liabilities			
Equity Share Capital (Rs. 100 each)	8,000	4,000	1,600
General Reserve	1,600	280	-
Profit and Loss Account	1,360	960	-
Current Liabilities	<u>1,280</u>	<u>3,000</u>	<u>1,120</u>
Total	<u>12,240</u>	<u>8,240</u>	<u>2,720</u>

Particulars	Ram Ltd.	Shyam Ltd.	Tom Ltd.
Investments :			
32,000, shares in Shyam Ltd.	4,800	-	-
4,000, shares in Tom Ltd.	200	-	-
12,000, shares in Tom Ltd.	-	720	-
Profit and Loss Account	-	-	640
Current Assets	<u>7,240</u>	<u>7,520</u>	<u>2,080</u>
Total	<u>12,240</u>	<u>8,240</u>	<u>2,080</u>

From the following information, prepare consolidated Balance Sheet of Ram Ltd. and its subsidiaries as on 31.03.2008:

- Shyam Ltd. has advanced Rs. 8, 00,000 to Tom Ltd.
- Current Liabilities of Ram Ltd. includes Rs. 4, 00,000 due to Tom Ltd.
- Shyam Ltd. and Tom Ltd. have not paid any Dividend.
- Ram Ltd. acquired its investments on 01.04.2007 from Shyam Ltd. and then amount standing to credit of General reserve and Profit and Loss account were Rs. 2,80,000 and Rs. 5,20,000 respectively.
- Ram Ltd. acquired investments in Tom Ltd. on 01.04.2007, when the debit balance in Profit and Loss account in books of Tom Ltd. was Rs. 4, 80,000.

Consolidated Financial Statements of Group Companies

- (vi) Shyam Ltd. acquired its investments in Tom Ltd. on 01.04.2005 and then the Debit balance in profit and Loss account was Rs. 1,60,000.
- (vii) Shyam Ltd.'s stock includes stock worth Rs. 4,80,000 which was invoiced by Ram Ltd. at 20% above cost.

Answer

**Consolidated Balance Sheet of Ram Ltd. and its subsidiaries
Shyam Ltd and Tom Ltd.**

as on 31.3.08

Liabilities	Rs. in 000s	Assets	Rs. in 000s
Share Capital	8,000	Goodwill (W. N. 5)	688
Minority Interest (W. N. 7)	952		
General Reserve	1,600		
Profit and Loss A/c (W. N. 6)	1,496		
Current Liabilities		Current Assets	
Ram Ltd.	1,280	Ram Ltd.	7,240
Shyam Ltd.	3,000	Shyam Ltd.	7,520
Tom Ltd.	<u>1,120</u>	Tom Ltd.	<u>2,080</u>
	5,400		16,840
Less: Mutual Owings	<u>1,200</u>	Less: Mutual Owings	<u>1,200</u>
	4,200		15,640
		Less: Unrealised Profit	<u>80</u>
	<u>16,248</u>		<u>15,560</u>
			<u>16,248</u>

Working Notes:**1. General Reserve and Profit and Loss Account of Shyam Ltd.****General Reserve Account of Shyam Ltd.**

	Rs. '000		Rs. '000
31.3.08 To Balance c/d	<u>280</u>	1.4.07 By Balance b/d	<u>280</u>

Profit and Loss Account of Shyam Ltd.

	Rs. '000		Rs. '000
31.3.08 To Balance c/d	960	1.4.07 By Balance b/d	520
		By Profit earned during the year (Bal. Fig.)	<u>440</u>
	<u>960</u>		<u>960</u>

Financial Reporting

2. Profit and Loss Account of Tom Ltd.

Rs.'000				Rs.'000			
1.4.05	To	Balance b/d	<u>160</u>	31.3.06	By	Balance c/d	<u>160</u>
			<u>160</u>				<u>160</u>
1.4.06	To	Balance b/d	160	31.3.07	By	Balance c/d	480
	To	Loss incurred during the year (Bal. Fig.)	<u>320</u>				<u> </u>
			<u>480</u>				<u>480</u>
1.4.07	To	Balance b/d	480	31.3.08	By	Balance c/d	640
	To	Loss incurred during the year (Bal. Fig.)	<u>160</u>				<u> </u>
			640				640

3. Analysis of Profits of Tom Ltd.

		Capital Profits Rs.'000	Revenue Profits Rs'000.
(i)	From the viewpoint of Shyam Ltd.		
	Debit Balance in Profit and Loss Account as on 1.4.2005	(160)	
	Loss incurred between 1.4.2005 to 31.3.2008 [(320 + 160) – Refer W.N. 2]		<u>(480)</u>
		<u>(160)</u>	<u>(480)</u>
	Share of Shyam Ltd.-75% [carried forward to W. N. 4]	<u>(120)</u>	<u>(360)</u>
(ii)	From the view point of Ram Ltd.		
	Debit Balance of Profit and Loss Account as on 1.4.07	(480)	
	Loss during the year 2007-08		<u>(160)</u>
		<u>(480)</u>	<u>(160)</u>
	Share of Ram Ltd. (25%)	<u>(120)</u>	<u>(40)</u>

Consolidated Financial Statements of Group Companies

4. Analysis of Profits of Shyam Ltd. (From the viewpoint of Ram Ltd.)

	<i>Capital Profits</i> Rs. '000	<i>Revenue Profits</i> Rs. '000
General Reserve as on 1.4.07	280	
Profit and Loss Account Balance as on 1.4.07	520	
Profit earned during 2007-08 (W.N.1)		440
Brought forward Shyam Ltd.'s share of loss in Tom Ltd. [W. N. 3(i)]	(120)	(360)
Share of Shyam Ltd. in revenue loss of Tom Ltd. for the period 1.4.05 to 31.3.07 [75% of (360- 40)] being treated as capital loss from view point of Ram Ltd.	<u>(240)</u>	<u>240</u>
	440	320
Less: Share of Minority Interest (20%)	<u>88</u>	<u>64</u>
Balance taken to Ram Ltd. (80%)	<u>352</u>	<u>256</u>
5. Cost of Control		Rs. '000

Investment by Ram Ltd. in Shyam Ltd.	4,800	.
Tom Ltd.	200	
Investment by Shyam Ltd. in Tom Ltd.	<u>720</u>	5,720
Less: Paid up value of shares of:		
Shyam Ltd.	3,200	
Tom Ltd. (400 + 1,200)	<u>1,600</u>	
	4,800	
Capital loss of Ram Ltd. in Tom Ltd. [W.N. 3(ii)]	(120)	
Capital Profit of Ram Ltd. in Shyam Ltd. (W.N. 4)	<u>352</u>	<u>5,032</u>
Goodwill		<u>688</u>
		Rs. '000

6. Consolidated Profit and Loss A/c of Ram Ltd.

Profit and Loss A/c Balance	1,360
Post acquisition share of loss from Tom Ltd.	(40)
Post acquisition share of profit from Shyam Ltd.	<u>256</u>

Financial Reporting

	1,576
Less: Unrealised Profit on Stock ($\frac{1}{6}$ th of 480)	<u>80</u>
	<u>1,496</u>
7. Minority Interest	Rs. '000
Paid up value of shares in Shyam Ltd. (20% of 4,000)	800
Share of Capital Profit (W.N. 4)	88
Share of Revenue Profit (W.N. 4)	<u>64</u>
	<u>952</u>

Question 15

From the following details, prepare a consolidated Balance Sheet of Sun Limited and its subsidiaries as on 31st March, 2009:

	(Rs. in Lakhs)		
Assets	Sun Ltd.	Moon Ltd.	Star Ltd.
Fixed assets (net)	816	312	126
Investment (at cost)			
7,50,000, equity shares of Moon Ltd.	75	-	-
2,40,000 equity shares of Star Ltd.	24	-	-
4,80,000, equity shares of Star Ltd.	-	60	-
30,000 cumulative preference shares of Sun Ltd.	-	-	30
4,500 mortgage debentures of Sun Ltd.	-	-	42
Current assets	1,059	369	336
Profit and loss account	288	108	63
	<u>2,262</u>	<u>849</u>	<u>597</u>
Liabilities			
Equity share capital (Rs.10 each fully paid up)	180	144	120
7.5% cumulative preference share capital (Rs.100 each fully paid)	45	36	30
Capital reserve (revaluation of fixed assets)	360	-	-
General reserve	75	45	30
7,500, 8% mortgage debenture bonds of Rs.1,000 each	75	-	-
Secured loans and advances:			

Consolidated Financial Statements of Group Companies

From banks	513	249	165
Unsecured loans:			
From Moon Ltd.	-	-	36
From Star Ltd.	45	-	-
Current liabilities and provisions:			
Inter-company balances	27	-	-
Other liabilities	942	375	216
	2,262	849	597

Other information are as follows:

- Moon Ltd. Subscribed for 2,40,000 shares of Star Ltd. at par at the time of first issue and further acquired 2,40,000 shares from the market at Rs.15 each, when the Reserve and Surplus account of Star Ltd. Stood at Rs.15 lakhs.
- Sun Ltd. Subscribed for shares of Moon Ltd. and Star Ltd. at par at the time of first issue of shares by both the companies.
- Current assets of Moon Ltd. and Star Ltd. Includes Rs.12 lakhs and Rs.18 lakhs respectively being Current account balance against Sun Ltd.

Answer

Consolidated Balance Sheet of Sun Limited and Its subsidiaries as on 31st March, 2009

Liabilities	Rs.	Assets	Rs.	Rs.
Share capital		Goodwill		3,00,000
(18,00,000 Equity Shares of Rs.10 each)	180,00,000	Fixed assets		12,54,00,000
15,000, 7½% Cumulative Preference shares of Rs. 100 each	15,00,000	Current assets	17,64,00,000	
Minority interest	132,18,750			
Reserves and surplus		Less: Inter-company owing	81,00,000	
Capital reserve	360,00,000		16,83,00,000	
Secured loan		Less: Inter-company balances	27,00,000	16,56,00,000
8% Mortgage debentures	30,00,000	Profit and loss account		264,18,750

Financial Reporting

Loans and advances

Secured loan from bank 927,00,000

Current liabilities and provisions 15,33,00,000

31,77,18,750

31,77,18,750

Working Notes:

(1) Shareholding Pattern		In Moon Ltd.	In Star Ltd.
(i)	Sun Limited	$\frac{25}{48}$	$\frac{2}{10}$
(ii)	Moon Limited		$\frac{4}{10}$
(iii)	Minority Interest	$\frac{23}{48}$	$\frac{4}{10}$
(2) Analysis of Profits		<i>Capital</i>	<i>Revenue</i>
(a)	Star Limited	<i>Rs.</i>	<i>Rs.</i>
	Balance at acquisition	15,00,000	
	Balance as per P&L A/c	(-)63,00,000	
	Less: General reserve	30,00,000	
	Less: Profit on debentures	<u>3,00,000</u>	
	Net loss as on 31.3.09	(-)30,00,000	
	Less: Capital profit	<u>15,00,000</u>	
		(-)45,00,000	(-)45,00,000
	Minority interest (4/10)	6,00,000	(-)18,00,000
	Share of Moon Limited (4/10)	6,00,000	(-)18,00,000
	Share of Sun Limited (2/10)	<u>3,00,000</u>	(-)9,00,000
(b)	Moon Limited		
	P&L A/c as on 31.3.09		(-)1,08,00,000
	General Reserve		<u>45,00,000</u>
	Loss after acquisition		(-)63,00,000
	Share of revenue loss in Star Ltd.		(-)18,00,000
			<u>(-)81,00,000</u>
	Minority Interest (23/48)		(-)38,81,250
	Sun Limited (25/48)		<u>(-)42,18,750</u>

Consolidated Financial Statements of Group Companies

		Moon Ltd.	Star Ltd.
(3) Goodwill/Capital Reserve			
Share capital		75,00,000	72,00,000
Capital profit		3,00,000	6,00,000
		<u>78,00,000</u>	<u>78,00,000</u>
Less: Cost of investment		75,00,000	84,00,000
Capital reserve/(Goodwill)		<u>3,00,000</u>	<u>(6,00,000)</u>
Goodwill (6,00,000 less 3,00,000)		3,00,000	
(4) Minority Interest			
Share capital		69,00,000	48,00,000
Capital profit		-	6,00,000
Revenue profit		(-)38,81,250	(-)18,00,000
Preference shares (36,00,000+30,00,000)		-	66,00,000
		<u>30,18,750</u>	<u>1,02,00,000</u>
(5) Profit and Loss Account – Sun Ltd.			
Balance as on 31.03.09		(-)2,88,00,000	
General reserve		75,00,000	
Share of Star Limited		(-)9,00,000	
Share of Moon Limited		<u>(-)42,18,750</u>	
		<u>(-)2,64,18,750</u>	

Note: In this question, Inter-company balances amounting Rs. 27 lakhs have been shown in the balance sheet of Sun Ltd as on 31st March, 2009. However, Information (c) of the question states that current assets of Moon Ltd. and Star Ltd. includes Rs. 12 lakhs and Rs. 18 lakhs respectively being current account balance against Sun Ltd. The candidates may assume that Rs. 30 lakhs is in addition to inter-company balance of Rs. 27 lakhs. In that case, current assets and current liabilities will be reduced by Rs. 30 lakhs and will be shown at Rs. 1626 lakhs and Rs. 1503 lakhs respectively. The total of the consolidated balance sheet will also be reduced by Rs. 30 lakhs

Question 16

P Ltd. owns 80% of S and 40% of J and 40% of A. J is jointly controlled entity and A is an associate. Balance Sheet of four companies as on 31.03.09 are:

	P Ltd.	S	J	A
				(Rs. in lakhs)
Investment in S	800	-	-	-
Investment in J	600	-	-	-

Financial Reporting

Investment in A	600	-	-	-
Fixed assets	1000	800	1400	1000
Current assets	<u>2200</u>	<u>3300</u>	<u>3250</u>	<u>3650</u>
Total	<u>5200</u>	<u>4100</u>	<u>4650</u>	<u>4650</u>
<i>Liabilities:</i>				
<i>Share capital Re. 1</i>				
Equity share	1000	400	800	800
Retained earnings	4000	3400	3600	3600
Creditors	<u>200</u>	<u>300</u>	<u>250</u>	<u>250</u>
Total	<u>5200</u>	<u>4100</u>	<u>4650</u>	<u>4650</u>

P Ltd. acquired shares in 'S' many years ago when 'S' retained earnings were Rs. 520 lakhs. P Ltd. acquired its shares in 'J' at the beginning of the year when 'J' retained earnings were Rs. 400 lakhs. P Ltd. acquired its shares in 'A' on 01.04.08 when 'A' retained earnings were Rs. 400 lakhs.

The balance of goodwill relating to S had been written off three years ago. The value of goodwill in 'J' remains unchanged.

Prepare the Consolidated Balance Sheet of P Ltd. as on 31.03.09 as per AS 21, 23, and 27.

Answer**Consolidated Balance Sheet of P Ltd.**

<i>Liabilities</i>	<i>Rs. in lakhs</i>	<i>Assets</i>	<i>Rs. in lakhs</i>
Share Capital	1,000	Goodwill (W.N.1)	120
Retained Earnings(W.N.2)	8,800	Fixed Assets	2,360
		[1,000 + 800 + 560 (1400 x 40%)]	
Creditors (200+ 300 + 40% of 250)	600	Current Assets	6,800
		[2,200+3,300+1,300(3,250x 40%)]	
Minority Interest (W.N.3)	<u>760</u>	Investment in Associates (W.N.4)	<u>1,880</u>
	<u>11,160</u>		<u>11,160</u>

Consolidated Financial Statements of Group Companies

Working Notes:**1. Computation of Goodwill****S (subsidiary)**

		<i>Rs. in lakhs</i>
Cost of investment		800
Less: Paid up value of shares acquired	320	
Share in pre- acquisition profits of S Ltd. (520 × 80%)	<u>416</u>	<u>736</u>
Goodwill		<u>64</u>

J (Jointly Controlled Entity)

		<i>Rs. in lakhs</i>
Cost of Investment		600
Less: Paid up value of shares acquired (40% of 800)	320	
Share in pre-acquisition profits (40% of 400)	<u>160</u>	<u>480</u>
Goodwill		<u>120</u>

Note : Jointly controlled entity 'J' to be consolidated on proportionate basis i.e. 40% as per AS 27

Associate A (AS 23)

		<i>Rs. in lakhs</i>
Cost of investment		600
Less: Paid up value of shares acquired (800 x 40%)	320	
Share in pre-acquisition profits (400 x 40%)	<u>160</u>	<u>480</u>
Goodwill		<u>120</u>

Goodwill shown in the Consolidated Balance Sheet

	<i>Rs. in lakhs</i>
Goodwill of 'J'	120
Goodwill of 'S'	64
Less: Goodwill written off of 'S'	<u>64</u>
Goodwill	<u>120</u>

2. Consolidated Retained Earnings

	<i>Rs. in lakhs</i>
P Ltd.	4,000
Share in post acquisition profits of S - 80% (3,400 – 520)	2,304

Financial Reporting

Share in post acquisition profits of J - 40% (3,600 – 400)	1,280
Share in post acquisition profits of A - 40% (3,600 – 400)	1,280
Less: Goodwill written off	<u>(64)</u>
	<u>8,800</u>

3. Minority Interest 'S'

	<i>Rs. in lakhs</i>
Share Capital (20% of 400)	80
Share in Retained Earnings (20% of 3,400)	<u>680</u>
	<u>760</u>

4. Investment in Associates

	<i>Rs. in lakhs</i>
Cost of Investments (including goodwill Rs. 120 lakhs)	600
Share of post acquisition profits	<u>1,280</u>
Carrying amount of Investment (including goodwill Rs. 120 lakhs)	<u>1,880</u>

Consolidated Financial Statements of Group Companies

EXERCISES

Question 1

Following are the draft Balance Sheets of two companies A Ltd. and B Ltd. as at 31.03.2010:

(Rs. in lakhs)					
Liabilities	A Ltd.	B Ltd.	Assets	A Ltd.	B Ltd.
Share Capital (Rs. 100 each)	6.00	3.00	Fixed Assets	5.00	1.50
Profits:			Investment:		
Capital Profit	0.80	0.85	2,400 Shares in B Ltd.	3.00	—
Reserve Profit	3.20	0.29	1,200 Shares in A Ltd.	—	2.00
Creditors	1.50	0.81	Current Assets:		
			Debtors	2.00	0.80
			Stock	0.40	0.30
			Cash and Bank	<u>1.10</u>	<u>0.35</u>
	<u>11.50</u>	<u>4.95</u>		<u>11.50</u>	<u>4.95</u>

The following adjustments were not yet made:

1. Stock worth Rs. 5,000 in B Ltd. was found to be obsolete with no value.
2. A Ltd. acquires an asset costing Rs. 50,000 on 31.3. 2010. No effect has been given for both the purchase and payment.
3. During the year A Ltd. sold an asset for Rs. 60,000 (original cost Rs. 40,000). The profit was included in the revenue profit.
4. Debtors of A Ltd. included a sum of Rs. 50,000 owed by B Ltd.

You are required to prepare the consolidated Balance Sheet of both the companies as on 31.3.2010 after giving effect to the above adjustments.

[Answer: CBS Total Rs.1,130 (in'000s); Minority Interest Rs.105 (in'000s); Cost of control Rs.40 (in'000s)]

Question 2

War Ltd. purchased on 31st March, 2008, 48,000 shares in Peace Ltd. at 50% premium over face value by issue of 8% debentures at 20% premium. The balance sheets of War and Peace Ltd. as on 31.3.2008, the date of purchase were as under:

Liabilities	War Ltd.	Peace Ltd.	Assets	War Ltd.	Peace Ltd.
	Rs.	Rs.		Rs.	Rs.
Share Capital (Rs. 10)	10,50,000	6,00,000	Fixed assets	6,50,000	2,00,000
General reserve	1,20,000	40,000	Stock in trade	3,00,000	1,80,000

Financial Reporting

Profit and loss account	80,000	—	Sundry debtors	3,20,000	2,00,000
Sundry Creditors	1,00,000	60,000	Cash in hand	60,000	30,000
			Preliminary expenses	20,000	10,000
			Profit and loss account	—	80,000
	<u>13,50,000</u>	<u>7,00,000</u>		<u>13,50,000</u>	<u>7,00,000</u>

Particulars of War Ltd:

- (i) Profit made: Rs.
- 2008-2009 1,60,000
- 2009-2010 2,00,000
- (ii) The above profit was made after charging depreciation of Rs. 60,000 and Rs. 40,000 respectively.
- (iii) Out of profit shown above every year Rs. 20,000 had been transferred to general reserve.
- (iv) 10% dividend had been paid in both the years.
- (v) It has been decided to write down investment to face value of shares in 10 years and to provide for share of loss to subsidiary.

Particulars of Peace Ltd.:

The company incurred losses of Rs. 40,000 and Rs. 60,000 in 2008-2009 and 2009-2010 after charging depreciation of 10% p.a. of the book value as on 1.4.2008.

Prepare consolidated balance sheet as at 31.3.2010 of War Ltd., and its subsidiary.

[Answer: CBS Total Rs. 20,82,000; Minority Interest Rs.90,000; Cost of control Rs.2,32,000]

Question 3

The Balance Sheets of Sun Ltd. and Moon Ltd. as on 31.3.2010 are given below:

	Sun Ltd. (Rs.)	Moon Ltd. (Rs.)	Assets	Sun Ltd. (Rs.)	Moon Ltd. (Rs.)
Share Capital (Rs. 10)	1,20,000	1,00,000	Fixed Assets	44,000	84,000
General Reserve	20,000	36,000	Investment in Moon Ltd.		
Profit and Loss Account	12,000	20,000	8,000 Shares @ Rs. 11	88,000	
Bills Payable	2,000	5,000			
Sundry Creditors	4,000	7,000	Sundry Debtors	6,000	15,000

Consolidated Financial Statements of Group Companies

Contingent Liability of Sun Ltd.: Bills Discounted not yet matured Rs.2,500		Bills Receivable	4,000	16,000
		Stock in Trade	10,000	40,000
		Cash at Bank	<u>6,000</u>	<u>13,000</u>
	<u>1,58,000</u>		<u>1,58,000</u>	<u>1,68,000</u>

Shares were purchased on 1.4.2007. When the shares were purchased General Reserve and Profit and Loss Account of Moon Ltd. stood at Rs. 30,000 and Rs. 16,000 respectively. Dividends have been paid @ 10% every year after acquisition of shares, first dividend being paid out of pre-acquisition profits. No dividend has been proposed for 2009-2010 as yet and no provision need be made in consolidated Balance Sheet. Sun Ltd. has credited all dividends received to Profit and Loss Account.

On 31.3.2010, Bonus shares has been declared by Moon Ltd. @ 1 fully paid share for 5 held, but no effect has been given to that in the above accounts. The Bonus was declared out of profits earned prior to 1.4.2007 from General Reserve.

When the shares were purchased, agreed valuations of Fixed Assets of Moon Ltd. was Rs. 1,08,000 although no effect has been given thereto in accounts.

Depreciation has been charged @ 10% p.a. on the book value as on 1.4.2007, (on straight line method), there being no addition or sale since then.

Out of Current Profits, Rs. 2,000 has been transferred to general reserve every year. Bills receivable of Sun Ltd. include Rs. 2,000 bills accepted by Moon Ltd. and bills discounted by Sun Ltd., but not yet matured include Rs. 1,500 accepted by Moon Ltd. Sundry creditors of Sun Ltd. include Rs. 2,000 due to Moon Ltd. whereas Sundry Debtors of Moon Ltd. include Rs. 4,000 due from Sun Ltd. It is found that Sun Ltd. has remitted a cheque of Rs. 2,000, which has not yet been received by Moon Ltd.

Prepare consolidated Balance Sheet as at 31.3.2010 of Sun Ltd. and its Subsidiary.

[Answer: CBS Total Rs.2,25,600; Minority Interest Rs. 29,520; Cost of control (Rs.19,200)]

Question 4

The Balance Sheets of Bat Ltd. and Ball Ltd. as on 31.3.2010 are as follows:

	Bat Ltd. Rs.	Ball Ltd. Rs.		Bat Ltd. Rs.	Ball Ltd. Rs.
Share Capital (Shares of Rs. 10 each)	1,60,000	2,00,000	Investments Shares in Ball Ltd.	1,96,000	—
Profit and Loss account	50,000	60,000	Debtors	—	1,20,000
Creditors	—	16,000	Stock	—	80,000
			Cash at Bank	—	70,000
			Cash in hand	<u>14,000</u>	<u>6,000</u>
	<u>2,10,000</u>	<u>2,76,000</u>		<u>2,10,000</u>	<u>2,76,000</u>

Financial Reporting

Particulars of Bat Ltd.:

- (1) This company was formed on 1.4.2009.
- (2) It acquired the shares of Ball Ltd. as under:

Date of Acquisition	No. of Shares	Cost Rs.
1.4.2009	8,000	1,10,000
31.7.2009	6,000	86,000

- (3) The shares purchased on 31.7.2009 are ex-dividend and ex-bonus from existing holders.
- (4) On 31.7.2009 dividend at 10% was received from Ball Ltd. and was credited to Profit and Loss Account.
- (5) On 31.7.2009 it received bonus shares from Ball Ltd. in the ratio of one share on every four shares held.
- (6) Bat Ltd. incurred an expenditure of Rs. 500 per month on behalf of Ball Ltd. and this was debited to the Profit and Loss Account of Bat Ltd., but nothing has been done in the books of Ball Ltd.
- (7) The balance in the Profit and Loss Account as on 31.3.2010 included Rs. 36,000 being the net profit made during the year.
- (8) Dividend proposed for 2009-2010 at 10% was not provided for as yet.

Particulars of Ball Ltd.:

- (1) The balance in the Profit and Loss Account as on 31.3.2010 is after the issue of bonus shares made on 31.7.2009.
- (2) The net profit made during the year is Rs. 24,000 including Rs. 6,000 received from insurance company in settlement of the claim towards loss of stock by fire on 30.06.2009 (Cost Rs. 10,800 included in opening stock).
- (3) Dividend proposed for 2009-2010 at 10% was not provided for in the accounts.

Prepare the Consolidated Balance Sheet of Bat Ltd. as on 31.3.2010.

[Answer: CBS Total Rs.2,90,000; Minority Interest Rs. 50,800; Cost of control (Rs.30,400)]

Question 5

The summarised Balance Sheets of A Ltd. and B Limited are as follows:

Balance Sheets as at 31st December, 2009

	A Ltd.	B Ltd.
Sources of Funds:	Rs.	Rs.
Share Capital in equity shares of Rs. 10 each	2,00,000	50,000

Consolidated Financial Statements of Group Companies

Reserves	20,000	5,000
Profit and Loss Account as on 1st January, 2009	30,000	10,000
Profit for the year	8,000	8,000
Add: Dividends from B Ltd.	4,000	—
Less: Dividends paid	—	(5,000)
Creditors	<u>30,000</u>	<u>20,000</u>
Total	<u>2,92,000</u>	<u>88,000</u>
Application of Funds:		
Fixed Assets	2,00,000	80,000
Current Assets	32,000	8,000
Shares in B Ltd. at cost – 3,000 shares	<u>60,000</u>	<u>—</u>
Total	<u>2,92,000</u>	<u>88,000</u>

A Limited had acquired 4,000 shares in B Ltd. at Rs. 20 each on 1st January, 2009 and sold 1,000 of them at the same price on 1st October, 2009. The sale is cum dividend. An interim dividend of 10% was paid by B Limited on 1st July, 2009.

Draft the consolidated Balance Sheet as at 31st December, 2009.

[Answer: CBS Total Rs.3,41,000; Minority Interest Rs. 27,200; Cost of control Rs.21,000]

Question 6

The Balance Sheet of Golden and Silver Limited as on 31.3.2010 are given below:

Liabilities	Golden Ltd. (Rs.)	Silver Ltd.(Rs.)	Assets	Golden Ltd. (Rs.)	Silver Ltd. (Rs.)
Equity share capital	2,40,000	2,40,000	Fixed assets	88,000	1,68,000
General reserve	40,000	32,000	Investment	1,80,000	10,000
Profit and Loss account	24,000	39,000	Sundry debtors	12,000	30,000
Bills payable	4,000	10,000	Bills receivable	8,000	32,000
Sundry creditors	8,000	15,000	Stock in trade	20,000	80,000
			Cash at bank	<u>8,000</u>	<u>16,000</u>
	<u>3,16,000</u>	<u>3,36,000</u>		<u>3,16,000</u>	<u>3,36,000</u>

Note: Contingent liability of Golden Ltd.: Bills discounted not yet matured at Rs.5,000.

Financial Reporting

Additional information:

- (i) On 1.10.2007, Golden Ltd. acquired 16,000 shares of Rs.10 each at the rate of Rs.11 per share.
- (ii) Balances to General reserve and Profit and Loss account of Silver Ltd. stood on 1.4.2007 at Rs.60,000 and Rs.32,000 respectively.
- (iii) Dividends have been paid @ 10% for each of the years 2007-08 and 2008-09. Dividend for the year 2007-08 was paid out of the pre-acquisition profits. No dividend has been proposed for the year 2009-10 as yet and no provision need to be made in consolidated Balance Sheet. Golden Ltd. has credited all dividends received to profit and Loss account.
- (iv) On 1.3.2010, bonus shares were issued by Silver Ltd. at the rate of one fully paid share for every five held and effect has been given to that in the above accounts. The bonus was declared from general reserves from out of profits earned prior to 1.4.2007.
- (v) On 1.10.2007, Fixed assets was revalued at Rs.2,16,000, but no adjustment had been made in the books.
- (vi) Depreciation had been charged @ 10% p.a. on the book value as on 1.4.2007 (on straight line method), there being no addition or sale since then.
- (vii) Out of Current profits Rs.4,000 have been transferred to General reserve every year.
- (viii) Bills receivable of Golden Ltd. include Rs.4,000 bills accepted by Silver Ltd. Bills discounted by Golden Ltd., but not yet matured include Rs.3,000 accepted by Silver Ltd.
- (ix) Sundry creditors of Golden Ltd. include Rs.4,000 due to Silver Ltd. Sundry debtors of Silver Ltd. include Rs.8,000 due from Golden Ltd.
- (x) It is found that Golden Ltd. has remitted a cheque of Rs.4,000, which has not yet been received by Silver Ltd.

Prepare consolidated Balance Sheet as at 31.3.2010 of Golden Ltd. and its Subsidiary.

[Answer: CBS Total Rs.459,000; Minority Interest Rs.60,400; Capital Reserve Rs.53,200]

Question 7

Astha Ltd. acquired 80% of both classes of shares in Birat Ltd. on 1.4.2009. The draft Balance Sheets of two companies on 31st March, 2010 were as follows:

(Rs. in 000's)					
Liabilities	Astha Ltd.	Birat Ltd.	Assets	Astha Ltd.	Birat Ltd.
Share Capital:					
Equity shares of Rs.10 each, full paid up	3,000	600	Plant & machinery	2,060	600

Consolidated Financial Statements of Group Companies

14% Preference shares of Rs.100 each, fully paid up	-	400	Furniture & fixtures	600	540
General reserve	1,900	40	Investments in equity shares of Birat Ltd.	1,920	-
Profit and loss account	1,600	720	in preference shares of Birat Ltd.	320	-
Creditors	300	320	Stock	680	404
			Debtors	560	316
			Cash at bank	<u>660</u>	<u>220</u>
	<u>6,800</u>	<u>2,080</u>		<u>6,800</u>	<u>2,080</u>

Note:

Contingent liability – Astha Ltd.: Claim for damages lodged by a contractor against the company pending in a law-suit – Rs.1,55,000.

Additional Information:

- (i) General reserve balance of Birat Ltd. was the same as on 1.4.2009.
- (ii) The balance in Profit and Loss A/c of Birat Ltd. on 1.4.2009 was Rs.3,20,000, out of which dividend of 16% p.a. on the Equity capital of Rs.6,00,000 was paid for the year 2008-09.
- (iii) The dividend in respect of preference shares of Birat Ltd. for the year 2009-10 was still payable as on 31.3.2010.
- (iv) Astha Ltd. credited its Profit and Loss A/c for the dividend received by it from Birat Ltd. for the year 2008-09.
- (v) Sundry creditors of Astha Ltd. included an amount of Rs.1,20,000 for purchases from Birat Ltd., on which the later company made a loss of Rs.10,000.
- (vi) Half of the above goods were still with the closing stock of Astha Ltd. as at 31.3.2010.
- (vii) At the time of acquisition by Astha Ltd., while determining the price to be paid for the shares in Birat Ltd. it was considered that the value of plant and machinery was to be increased by 25% and that of furniture and fixtures reduced to 80%. There was no transaction of purchase or sale of these assets during the year. The directors wish to give effect to these revaluations in the consolidated balance sheet.
- (viii) The directors of Astha Ltd. are of opinion that disclosure of its contingent liability will seriously prejudice the company's position in dispute with the contractor.

Financial Reporting

Prepare consolidated balance sheet as at 31st March, 2010, assuming the rate of depreciation charged as 25% p.a. and 10% p.a. on plant and machinery and furniture and fixtures respectively. Workings should be part of the answer.

[Answer: CBS Total Rs.7,655; Minority Interest Rs. 360.4; Cost of control Rs.1,088]

Question 8

The Balance Sheets of Aqua Ltd. and Baqa Ltd. as on the dates of last closing of accounts are as under:

	Aqua Ltd. as on 31.03.2009 Rs.	Baqa Ltd. as on 31.12.2008 Rs.
Liabilities		
Share capital (equity shares of Rs.10 each)	11,00,000	5,00,000
Accumulated Profits & Reserves	4,50,000	2,05,000
15% Rs.100 non-convertible debentures	-	3,00,000
Accounts Payable	4,80,000	2,80,000
Other liabilities	1,00,000	40,000
Tax Provision	1,50,000	2,50,000
Total	22,80,000	15,75,000
Assets		
Fixed Assets at Cost	8,45,000	5,26,500
Less: Depreciation	1,95,000	1,21,500
	6,50,000	4,05,000
Investments:		
40,000 shares in Baqa Ltd.	8,00,000	—
1,000 debentures in Baqa Ltd.	1,50,000	—
Current Assets:		
Inventories	2,00,000	3,50,000
Accounts Receivable	2,50,000	4,65,000
Cash & Bank	2,30,000	3,55,000
Total	22,80,000	15,75,000

The following information is also available:

- On 8th February, 2009 there was a fire at the factory of Baqa Ltd., resulting in inventory worth Rs.20,000 being destroyed. Baqa received 75 per cent of the loss as insurance.

Consolidated Financial Statements of Group Companies

2. The same fire resulted in destruction of a machine having a written down value of Rs.1,00,000. The Insurance company admitted the Company's claim to the extent of 80 per cent. The machine was insured at its fair value of Rs.1,50,000.
3. On 13th March, 2009, Aqua sold goods costing Rs.1,50,000 to Baqa at a mark-up of 20 per cent. Half of these goods were resold to Aqua who in turn was able to liquidate the entire stock of such goods before closure of accounts on 31st March, 2009. As on 31st March, 2009 Baqa's accounts payable show Rs.60,000 due to Aqua on the two transactions.
4. Aqua acquired the holdings in Baqa on 1st January, 2007 when the reserves and accumulated profits of Baqa Ltd. stood at Rs.75,000.
5. Both Companies have not provided for tax on current year profits. The current year taxable profits are Rs.33,000 and Rs.66,000 for Aqua Ltd. and Baqa Ltd. respectively. The tax rate is 33%.
6. The incremental profits earned by Baqa Ltd. for the period January, 2009 to March 2009 over that earned in the corresponding period in 2008 was Rs.56,000. Except for the profits that resulted from the transactions with Aqua in the aforesaid period, the entire profits have been realised in cash before 31st March, 2009.

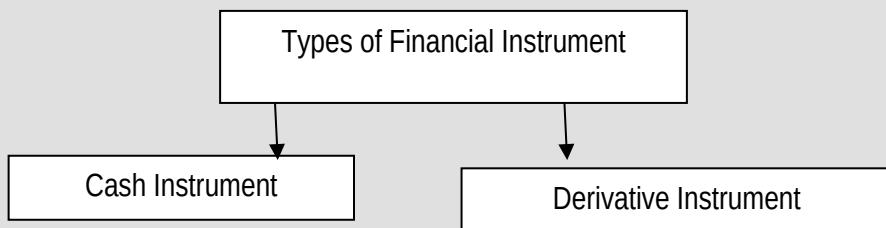
You are requested to consolidate the accounts of the two companies and prepare a Consolidated Balance Sheet of Aqua Limited and its subsidiary as at 31st March, 2009.

[Answer: CBS Total Rs. 33,51,000; Minority Interest Rs. 1,50,844; Cost of control Rs.3,90,000]

ACCOUNTING AND REPORTING OF FINANCIAL INSTRUMENTS

BASIC CONCEPTS

Financial Instrument is contract that may give rise to financial asset of one entity and a financial liability of another entity.



There are four categories of Financial Assets and two categories of Financial Liabilities. Their recognition, measurement, presentation and disclosure in financial Statements depend upon the classification of Financial Assets and Liabilities.

CATEGORIES OF FINANCIAL ASSETS

The four categories are:

- a) Financial Assets at fair Value through Profit and Loss-it has two sub categories-financial assets held for trading and those designated to the category at inception
- b) Held to maturity investments
- c) Loans & Recievable
- c) Available for sale

Held for trading: A financial asset or financial liability is classified as held for trading if it is:

- (i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term; or
- (ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking;

Financial Reporting

- (iii) a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

For example- Hemakshi Ltd intends to sell the loan in the near term to Sona Ltd at 9% yield. The loan clause allows the initiator to sell the loan to a third party.

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity other than:

- (a) those that the entity upon initial recognition designates as at fair value through profit or loss;
- (b) those that meet the definition of loans and receivables; and
- (c) those that the entity designates as available for sale.

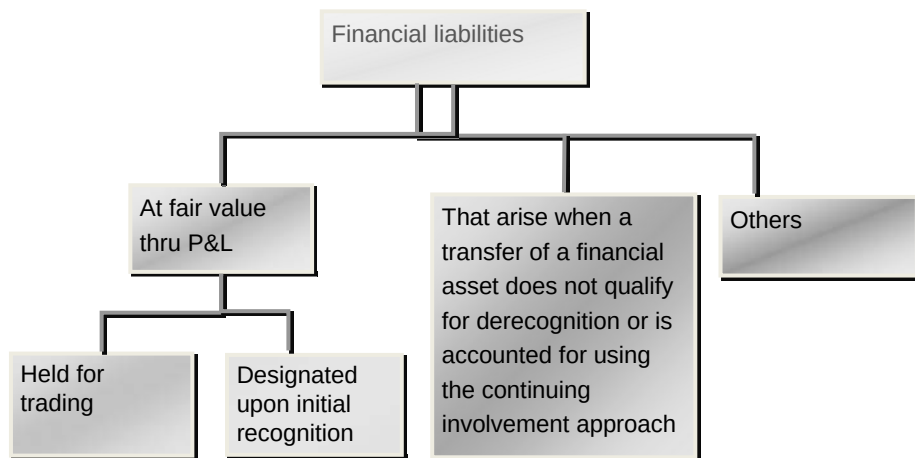
For Example- Sona Ltd has medium term deposits amounting to 300000 with HDFC bank and they will mature in three years. Sona Ltd intends to hold them till maturity. These will be classified as maturity investments. However if after Two years, Sona Ltd withdraws 2,00,000 from the deposits, then balance will have to be reclassified as Financial Assets held for sale.

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than: (a) those that the entity intends to sell immediately or in the near term, which should be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss; (b) those that the entity upon initial recognition designates as available for sale; or (c) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which should be classified as available for sale.

Available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as

- (a) loans and receivables,
- (b) held-to-maturity investments, or
- (c) Financial assets at fair value through profit or loss.

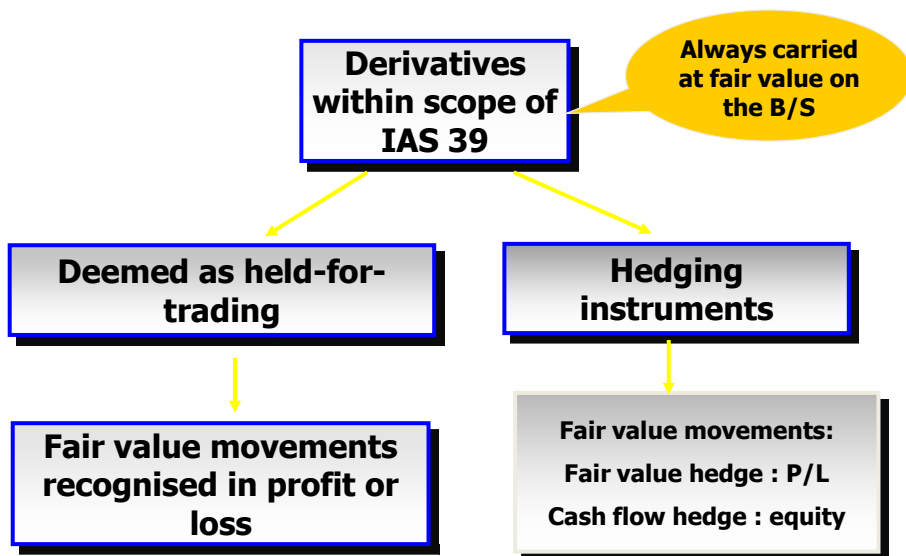
Classification: Financial Liabilities



Derivatives

Derivatives are financial instruments that drive their value from changes in benchmark based on stock prices, interest rates, mortgage rates, currency rates, commodity prices or some other agreed upon base. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and it is settled at a future date.

Classification of Derivatives



2

Hedge Accounting

For hedge accounting purposes, only instruments that involve a party external to the reporting entity (i.e., external to the group, segment or individual entity that is being reported on) can be designated as hedging instruments. There is normally a single fair value measure for a hedging instrument in its entirety

Hedging relationships are of three types:

- (a) fair value hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss.
- (b) cash flow hedge: a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss.
- (c) hedge of a net investment in a foreign operation as defined in AS 11.

Forwards and Options

A forward contract is basically a contractual arrangement in which one party buys and other party sells designated currency at a forward rate mutually agreed upon on the date of contract

for delivery at designated future date. The difference between the forward rate and the exchange rate at the date of transaction should be recognised as income or expense over the life of the contract, except in respect of liabilities incurred for acquiring fixed assets, in which case, such difference should be adjusted in carrying amount of the respective fixed assets.

Embedded Derivatives

An embedded derivative is a component of a hybrid instrument that combines the derivative and a non-derivative host contract – with the effect that some of the cash flows of the combined instrument vary in a way similar to stand-alone derivative.

Question 1

- (a) *Explain currency options related to foreign exchange.*
- (b) *Write short note on Interest Rate Swaps.*

Answer

- (a) Currency Options give the client the right, but not the obligation, to buy/sell a specific amount of currency at a specific price on a specific date. Currency options provide a tool for hedging foreign exchange risk arising out of the firm's operations. Currency options enable the business house to remove downside risk without limiting the upside potential. Options can be put option or call option. A put option is a contract that specifies the currency that the holder has the right to sell. A call option is a contract that specifies the currency that the holder has the right to buy.
- (b) Interest rate swap can be defined as a financial contract between two parties (called counter parties) to exchange on a particular date in the future, one series of cash flows (fixed interest) for another series of cash flows (variable or floating interest) in the same currency on the same principal (an agreed amount called notional principal) for an agreed period of time. The contract will specify the interest rates, the benchmark rate to be followed, the notional principal amount for the transaction, etc. Interest rates are of two types, fixed interest rates and floating rates which vary according to changes in a standard benchmark interest rate. An investor holding a security which pays a floating interest rate is exposed to interest rate risk. The investor can manage this risk by entering into an interest rate swap.

Question 2

ABC Ltd. grants a loan of Rs. 10 crore for five years, to XYZ at a fixed rate of 8% payable half yearly. XYZ Ltd. in turn grants, independently a separate loan of equal amount and equal period at a floating rate, to ABC Ltd. The arrangement envisages payment of interest on net basis. The chief accountant of ABC Ltd. says that the loan is not a derivative instrument. Comment if it is a derivative.

Financial Reporting

Answer

Yes. The contract should be considered as a derivative, since in substance, it is a fixed-to-floating rate swap.

Question 3

On 1 April, 2010 Omega Ltd. issued Rs.10,00,000, 6 % convertible debentures of face value of Rs. 100 per debenture at par. The debentures are redeemable at a premium of 10% on 31.03.12 or these may be converted into ordinary shares at the option of the holder, the interest rate for equivalent debentures without conversion rights would have been 10%.

The present value of Re. 1 receivable at the end of the end of each year based on discount rates of 6% and 10% can be taken as:

	6%	10%
End of year 1	0.94	0.91
2	0.89	0.83
3	0.84	0.75
4	0.79	0.68

Being compound financial instrument, you are required to calculate the debt portion of the debentures as on 01.04.10.

Answer

Computation of Debt Component of Convertible Debentures as on 1.4.2010

	Rs.
Present value of the principal repayable after four years [10,00,000 × 1.10 × 0.68 (10% Discount factor)]	7,48,000
Present value of Interest [60,000 × 3.17 (4 years cumulative 10% discount factor)]	1,90,200
Value of debt component	938,200

Question 4

Comforts Ltd. granted Rs.10,00,000 loan to its employees on January 1, 2009 at a concessional interest rate of 4% per annum. Loan is to be repaid in five equal annual instalments along with interest. Market rate of interest for such loan is 10% per annum. Following the principles of recognition and measurement as laid down in AS 30 'Financial Instruments : Recognition and Measurement', record the entries for the year ended 31st December, 2009 for the loan transaction, and also calculate the value of loan initially to be

Accounting and Reporting of Financial Instruments

recognised and amortised cost for all the subsequent years. The present value of Re.1 receivable at the end of each year based on discount factor of 10% can be taken as:

Year end	1	0.9090
	2	0.8263
	3	0.7512
	4	0.6829
	5	0.6208

Answer

- (i) **Journal Entries in the books of Comfort Ltd.
for the year ended 31st December, 2009 (regarding loan to employees)**

		Dr. (Rs.)	Cr. (Rs.)
Staff loan A/c Dr. To Bank A/c (Being the disbursement of loans to staff)		10,00,000	10,00,000
Staff cost A/c (10,00,000 – 8,54,763) Dr. [Refer part (ii)] To Staff loan A/c (Being the write off of excess of loan balance over present value thereof, in order to reflect the loan at its present value of Rs. 8,54,763)		1,45,237	1,45,237
Staff loan A/c Dr. To Interest on staff loan A/c (Being the charge of interest @ market rate of 10% to the loan)		85,476	85,476
Bank A/c Dr. To Staff loan A/c (Being the repayment of first instalment with interest for the year)		2,40,000	2,40,000
Interest on staff loan A/c Dr. To Profit and loss A/c (Being transfer of balance in staff loan Interest account to profit and loss account)		85,476	85,476

Financial Reporting

Profit and loss A/c	Dr.	1,45,237	
To Staff cost A/c			1,45,237
(Being transfer of balance in staff cost account to profit and loss account)			

(ii) Calculation of initial recognition amount of loan to employees

Year end	Cash Inflow		Total	P.V. factor	Present value
	Principal	Interest @ 4%			
	Rs.	Rs.	Rs.		Rs.
2009	2,00,000	40,000	2,40,000	0.9090	2,18,160
2010	2,00,000	32,000	2,32,000	0.8263	1,91,702
2011	2,00,000	24,000	2,24,000	0.7512	1,68,269
2012	2,00,000	16,000	2,16,000	0.6829	1,47,506
2013	2,00,000	8,000	2,08,000	0.6208	<u>1,29,126</u>
Present value or Fair value					<u>8,54,763</u>

(iii) Calculation of amortised cost of loan to employees

Year	Amortised cost (Opening balance) [1]	Interest to be recognised@10% [2]	Repayment (including interest) [3]	Amortised Cost (Closing balance) [4]=[1]+ [2] – [3]
	Rs.	Rs.	Rs.	Rs.
2009	8,54,763	85,476	2,40,000	7,00,239
2010	7,00,239	70,024	2,32,000	5,38,263
2011	5,38,263	53,826	2,24,000	3,68,089
2012	3,68,089	36,809	2,16,000	1,88,898
2013	1,88,898	19,102 (Bal. fig.)*	2,08,000	Nil

Question 5

Identify the host and embedded derivative in the case when A Co. holds a debenture bond in B Co. which is convertible into ordinary shares of entity B at the option of entity A.

* The difference of Rs. 212 (Rs. 19,102 - Rs. 18,890) is due to approximation in computations.

Answer

The debenture bond is the host contract. The option to convert to shares is the embedded derivative.

Question 6

In the following derivative contracts, identify the underlying variable:

- (a) Interest Rate Swap
- (b) Currency Swap (Foreign Exchange Swap)
- (c) Commodity Swap
- (d) Equity Swap
- (e) Credit Swap

Answer

<i>Type of Contract</i>	<i>Main Pricing-Settlement Variable (Underlying Variable)</i>
a. Interest Rate Swap	Interest rates
b. Currency Swap (Foreign Exchange Swap)	Currency rates
c. Commodity Swap	Commodity prices
d. Equity Swap	Equity prices (equity of another entity)
e. Credit Swap	Credit rating, credit index or credit price

Question 7

X Ltd. purchases 1000 6% Rs. 100 Debentures of ABC Ltd. for Rs. 99 redeemable at Rs. 102 after 5 years. These debentures are unquoted. Can the holder classify the financial asset (Investment redeemable preference shares) as loans and receivables?

Answer

Yes. The holder has, of course, the choice to classify them as available for sale.

Question 8

ABC bank has a deposit with other banks which are negotiable but the depositor has not negotiated these deposit documents. How will you categorize this deposit as a financial asset?

Answer

It should be loans and receivables. In case the entity has the intention to sell the instrument in the near term, it should be classified as held for trading.

Financial Reporting

Question 9

Should the embedded derivative, which is an option, be valued at zero at initial recognition?

Answer

Unlike the embedded derivative which is a non-option, it can have non- zero fair value at initial recognition. For the option-based derivatives like call, put, cap etc. critical factor of the fair value determination is strike price. To make the fair value of the option zero, the strike price should be deep out of the money. So there is almost zero probability that the option will be exercised. This assumption will be inconsistent with the feature of embedded derivative wherein probability of exercising the option is not zero.

EXERCISES

Question 1

What are derivatives and what are its characteristics?

Question 2

Write short note on Forward Contract.

Question 3

For determining whether or not an interest rate swap is a derivative contract, would it be necessary to consider the aspect of whether the parties pay interest payments to each other (gross) or settle on a net basis?

[Answer: No. The definition of a derivative does not depend on whether or not the settlement is on net or gross basis.]

Question 4

Alpha Co. has a bond asset with interest payments indexed to the price of gold. The bond has a fixed payment at maturity and a fixed maturity date. Whether there is an embedded derivative in the bond? If yes, identify the host contract and the derivative.

[Answer: Yes, there is an embedded derivative. Interest payments contain an embedded derivative (indexation to gold) that is separated and accounted for as derivative at fair value. Once the embedded derivative is separated, the host debt instrument can be classified as held-to-maturity provided Company G has the positive intention and ability to hold the bond till maturity.]

Question 5

Is gold bullion a financial instrument (like cash) or is it a commodity?

[Answer: It is a commodity. Although bullion is highly liquid, there is no contractual right to receive cash or another financial asset inherent in bullion.]

Question 6

In the following derivative contracts, identify the underlying variable:

- (i) Currency Futures
- (ii) Commodity Futures
- (iii) Interest Rate Forward Linked to Government Debt
- (iv) Currency Forward
- (v) Commodity Forward

Financial Reporting

[Answer:

Currency Futures

Currency Rates

Commodity Futures

Commodity price

Interest Rate Forward Linked to Government Debt

Interest rates

Currency Forward

Currency rate

Commodity Forward

Commodity prices

Question 7

Hena Limited issued 1 million 10.5% 10 year callable convertible bond at RS 1000 .Straight bonds (NCD) of similar maturity would carry 12% coupon. Each bond may be converted any time into 40 equity shares of Hena Limited. How will Hena Ltd present the bond issue in Balance Sheet?

[Answer: -B/S(on the year of Issue); Equity-84.75 million; Financial Liability(Loan) -915.25 million]

Question 8

ABC purchases a five year debt instrument issued by XYZ with the principal amount of RS 5 million that is indexed to Nifty. At maturity, ABC will receive from XYZ the principal amount plus or minus the change in the value of Nifty times 100.The current Nifty Value is 3250.No separate interest payment are made by XYZ. The purchase price is Rs 5 million.ABC classified the debt instrument as available fro sale. It is embedded derivative?

[Answer: Yes]

SHARE BASED PAYMENTS

BASIC CONCEPTS

Share based payments cover all forms of share-based payment for goods and services supplied to the reporting entity, including:

- ◆ employee share or share option schemes – employees are defined widely and include others providing similar services
- ◆ share-based payments to parties other than employees that have supplied goods or services to the entity
- ◆ payments to be settled in cash or other assets at amounts that depend on share values, eg share appreciation rights.

Share based Payment Plans

Share-based payment plans generally take the form of Employee Stock Option Plans (ESOP), Employee Stock Purchase Plans (ESPP) and Stock Appreciation Rights (SAR).

These are being defined as follows:

- a) **The Employee Stock Option Plan (ESOP)** is a contract that gives the employees of an enterprise the right, but not obligation, for a specified period to purchase or subscribe to the specified number shares of the enterprise at a fixed or determinable price, called the exercise price.
- b) **The Employee Stock Purchase Plan (ESPP)**, is a plan under which the enterprise offers shares to its employees at a discounted price as part of public issue or otherwise.
- c) **The Stock Appreciation Rights (SAR)** are rights that entitle the employees to receive cash or shares for an amount equivalent to the excess of market price on exercise date over a stated price.

Accounting Approach-For accounting purposes, employee share-based payment plans are classified into the following categories:

- (a) **Equity-settled**: Under these plans, the employees receive shares, e.g. ESOP
- (b) **Cash-settled**: Under these plans, the employees receive cash based on the price (or value) of the enterprise's shares, e.g. Stock Appreciation Rights (SAR).

Financial Reporting

- (c) **Employee share- based payment plans with cash alternatives**: Under these plans, either the enterprise or the employee has a choice of whether the enterprise settles the payment in cash or by issue of shares.

I. Accounting procedure for ESOP

The amount recognised as expense in a period is debited to 'Employees' Compensation A/c' with a corresponding credit to an equity account called 'Stock Options Outstanding A/c' which may ultimately be transferred to share capital, securities premium account and/or general reserve at the time of settlement.

Disclosure : Till such transfer, the credit balance of Stock Options Outstanding A/c is shown in balance sheet under a separate heading, between 'Share Capital' and 'Reserves and Surplus'.

Accounting for Balance option not exercised-The balance of Employees' Compensation A/c is transferred to the Profit & Loss A/c of the period.

On exercise of the option, the consideration for such shares comprises of the exercise price and the aggregate value of option recognised as expense, standing to the credit of Stock Options Outstanding A/c. In a situation where the right to obtain shares or stock options expires unexercised, the balance standing to the credit of the relevant equity account should be transferred to General Reserve.

Variation in vesting period

In case of revision of vesting period, the basis of allocation of option value to a particular accounting period should be based on revised estimate of vesting period.

Where the vesting condition is a market condition, the fair value of option is reduced due to the possibility that the vesting condition may not be satisfied. Such fair values are recognised as expense whether or not the market condition is satisfied, over the vesting period estimated on grant date. The estimates of vesting periods are not revised subsequently in these cases.

Graded Vesting

Graded vesting refers to a situation where options under a plan vest on different dates. Since one of the factors affecting fair value of an option is expected life, the fair value for each group should be computed separately. Fair value of a group is then allocated to accounting periods and recognised as expense for the period with reference to vesting period for the group.

In the same way as fair value, intrinsic value of a group is allocated to accounting periods and recognised as expense for the period with reference to vesting period for the group.

II. Employees' Stock Purchase Plans (ESPP)

Under these plans, employees are given an option to subscribe to shares of employer in a public issue or otherwise. The exercise price is set at a specified rate of discount on the issue price/market price on the date of exercise. The fair value of ESPP is recognised over the vesting period in the same way as ESOP.

Modifications

If the modification reduces the fair value of the options granted, the modification should be ignored.

If the modification increases the fair value of the options granted (e.g., when exercise price is reduced), the **incremental fair value** is recognised as expense over the remaining vesting period.

Where, the incremental fair value is the difference between (i) fair value of the modified option estimated on the date of the modification and (ii) fair value of the original option estimated on the date of modification.

When to Recognise incremental fair value- If the modification occurs after the vesting date, the incremental fair value is recognised immediately, or over the additional vesting period if the employee is required to complete an additional period of service before becoming unconditionally entitled to the options.

Cancellation and settlements during vesting period

If an enterprise cancels or settles a grant of shares or stock options during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

- (a) The entire amount of unamortised value of option should be recognised immediately.
- (b) Payments made to the employees on cancellation or settlement should be debited to ESOP Outstanding A/c to the maximum extent of fair value of options granted, measured at the cancellation / settlement date. Any payment in excess of the fair value is recognised as an expense.
- (c) If new options are granted to the employees in replacement for the cancelled options, the replacement is regarded as modification. The net fair value of the cancelled option is their fair value, immediately before the cancellation, less the amount of any payment made to the employee on cancellation, that is debited to ESOP Outstanding A/c, in accordance with (b) above.

Dilution of Earning per share (EPS) due to ESOP granted-Applicability of AS-20

Dilution occurs when expected proportionate increase in number of shares is more than expected proportionate increase in profit available to equity shareholders. This happens because issue of shares at less than fair value implies issue of certain number of shares for no consideration. These shares are taken in computation of diluted EPS as potential equity.

$$\text{Number of shares issued for consideration} = \frac{\text{Expected issue proceeds}}{\text{Fair value per share}}$$

No. of shares issued for no consideration = No. of shares issued – No. of shares issued for consideration

Issue of shares under a scheme of share-based payment, increases the number of shares

Financial Reporting

outstanding. Since the shares are issued at exercise price, which is lower than the fair value of shares issued, an ESOP gives rise to situation of dilution of EPS. In calculating the number of shares issued for no consideration, the expected proceeds from the exercise of option is taken as sum of (i) Exercise Price (ii) Value of services to be rendered by employees in future upto the vesting date. This value of services is measured as unamortised value of option.

III. Stock Appreciation Rights (SAR)

Stock Appreciation Rights (SAR) entitle the employees to claim cash payment to the extent of excess of market price of underlying shares on exercise date over the exercise price. The accounting procedures for ESOP and SAR are similar except that: (i) The liability for SAR is recognised as Provision instead of ESOP Outstanding and (ii) value per option is reassessed at each reporting date.

Employee Share-Based Payment Plans With Cash Alternatives

These plans consist of two components viz., (i) liability, i.e., the employer's obligation to pay price differential in cash and (ii) equity, i.e., the employer's obligation to issue shares at exercise price. The company should first measure, on the grant date, fair value of the plan on the assumption that all employees will exercise their options in favour of (i) cash settlement (ii) equity settlement. The fair value of plan for cash settlement is the fair value of the liability component. The excess, if any, of fair value of plan for equity settlement over the liability component is the fair value of equity component. The accounting procedure for equity component is same as that for ESOP. The accounting procedure for liability component is same as that for SAR.

On the date of settlement, the company should remeasure the liability to its fair value. If the employees opt for shares, the amount of liability should be treated as the consideration for the shares issued. If the employees opt for cash settlement, the balance in ESOP Outstanding A/c should be transferred to general reserve.

Question 1

Choice Ltd. grants 100 stock options to each of its 1,000 employees on 1.4.2007 for Rs.20, depending upon the employees at the time of vesting of options. The market price of the share is Rs.50. These options will vest at the end of year 1 if the earning of Choice Ltd. increases 16%, or it will vest at the end of the year 2 if the average earning of two years increases by 13%, or lastly it will vest at the end of the third year if the average earning of 3 years will increase by 10%. 5,000 unvested options lapsed on 31.3.2008. 4,000 unvested options lapsed on 31.3.2009 and finally 3,500 unvested options lapsed on 31.3.2010.

Following is the earning of Choice Ltd. :

Year ended on	Earning (in %)
31.3.2008	14%

Share Based Payments

31.3.2009 10%

31.3.2010 7%

850 employees exercised their vested options within a year and remaining options were unexercised at the end of the contractual life. Pass Journal entries for the above.

Answer

Journal Entries

Date	Particulars		Rs.	Rs.
31.3.2008	Employees compensation expenses A/c	Dr.	14,25,000	
	To ESOS outstanding A/c			14,25,000
	(Being compensation expense recognized in respect of the ESOP i.e. 100 options each granted to 1,000 employees at a discount of Rs. 30 each, amortised on straight line basis over vesting years- Refer W.N.)			
31.3.2008	Profit and Loss Account	Dr.	14,25,000	
	To Employees compensation expenses A/c			14,25,000
	(Being compensation expense charged to Profit & Loss A/c)			
31.3.2009	Employees compensation expenses A/c	Dr.	3,95,000	
	To ESOS outstanding A/c			3,95,000
	(Being compensation expense recognized in respect of the ESOP- Refer W.N.)			
31.3.2009	Profit and Loss Account	Dr.	3,95,000	
	To Employees compensation expenses A/c			3,95,000
	(Being compensation expense charged to Profit & Loss A/c)			
31.3.2010	Employees compensation Expenses A/c	Dr.	8,05,000	
	To ESOS outstanding A/c			8,05,000
	(Being compensation expense recognized in respect of the ESOP – Refer W.N.)			
31.3.2010	Bank A/c (85,000 X Rs.20)	Dr.	17,00,000	
	ESOS outstanding A/c [(26,25,000/87,500)x85,000]	Dr.	25,50,000	
	To Equity share capital (85,000 x 10)			8,50,000
	To Securities premium A/c (85,000 X Rs.40)			34,00,000
	(Being 85,000 options exercised at an exercise price of Rs. 50 each)			

Financial Reporting

Profit and Loss A/c	Dr.	8,05,000	
To Employees compensation expenses			8,05,000
A/c			
(Being compensation expenses charged to Profit & Loss A/c)			
ESOS outstanding A/c	Dr.	75,000	
To General Reserve A/c			75,000
(Being ESOS outstanding A/c on lapse of 2,500 options at the end of exercise of option period transferred to General Reserve A/c)			

Working Note:**Statement showing compensation expenses to be recognised**

Particulars	Year 1 (31.3.2008)	Year 2 (31.3.2009)	Year 3 (31.3.2010)
Expected vesting period (at the end of the year)	2 nd year	3 rd year	3 rd year
Number of options expected to vest	95,000 options	91,000 options	87,500 options
Total compensation expenses accrued @ 30 (i.e. 50-20)	<u>Rs. 28,50,000</u>	<u>Rs. 27,30,000</u>	<u>Rs. 26,25,000</u>
Compensation expenses of the year	28,50,000 x ½ = Rs.14,25,000	27,30,000 x 2/3 = Rs.18,20,000	Rs. 26,25,000
Compensation expenses recognized previously	<u>Nil</u>	<u>Rs.14,25,000</u>	<u>Rs. 18,20,000</u>
Compensation expenses to be recognized for the year	<u>Rs.14,25,000</u>	<u>Rs. 3,95,000</u>	<u>Rs. 8,05,000</u>

Question 2

ABC Ltd. grants 1,000 employees stock options on 1.4.2007 at Rs.40, when the market price is Rs.160. The vesting period is 2½ years and the maximum exercise period is one year. 300 unvested options lapse on 1.5.2009. 600 options are exercised on 30.6.2010. 100 vested options lapse at the end of the exercise period. Pass Journal Entries giving suitable narrations.

Answer**Journal Entries in the Books of ABC Ltd.**

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
31.3.2008	Employees compensation expenses account	Dr. 48,000	

Share Based Payments

	To Employees stock option outstanding account		48,000	
	(Being compensation expenses recognized in respect of the employees stock option i.e. 1,000 options granted to employees at a discount of Rs. 120 each, amortised on straight line basis over $2\frac{1}{2}$ years)			
	Profit and loss account	Dr.	48,000	
	To Employees compensation expenses account			48,000
	(Being expenses transferred to profit and loss account at the end of the year)			
31.3.2009	Employees compensation expenses account	Dr.	48,000	
	To Employees stock option outstanding account			48,000
	(Being compensation expenses recognized in respect of the employee stock option i.e. 1,000 options granted to employees at a discount of Rs. 120 each, amortised on straight line basis over $2\frac{1}{2}$ years)			
	Profit and loss account	Dr.	48,000	
	To Employees compensation expenses account			48,000
	(Being expenses transferred to profit and loss account at the end of the year)			
31.3.2010	Employees stock option outstanding account (W.N.1)	Dr.	12,000	
	To General Reserve account (W.N.1)			12,000
	(Being excess of employees compensation expenses transferred to general reserve account)			
30.6.2010	Bank A/c (600 x Rs.40)	Dr.	24,000	

Financial Reporting

	Employee stock option outstanding account Dr.	72,000	
	(600 x Rs.120)		
	To Equity share capital account		6,000
	(600 x Rs. 10)		
	To Securities premium account		90,000
	(600 x Rs.150)		
	(Being 600 employees stock option exercised at an exercise price of Rs. 40 each)		
01.10.2010	Employee stock option outstanding account Dr.	12,000	
	To General reserve account		12,000
	(Being Employees stock option outstanding A/c transferred to General Reserve A/c, on lapse of 100 options at the end of exercise of option period)		

Working Note:

On 31.3.2010, ABC Ltd. will examine its actual forfeitures and make necessary adjustments, if any to reflect expenses for the number of options that have actually vested. 700 employees stock options have completed 2.5 years vesting period, the expense to be recognized during the year is in negative i.e.

	Rs.
No. of options actually vested (700 x Rs.120)	84,000
Less: Expenses recognized Rs.(48,000 + 48,000)	<u>96,000</u>
Excess expenses transferred to general reserve	<u>12,000</u>

Question 3

Santosh Ltd. granted 500 options to each of its 2,500 employees in 2005 at an exercise price of Rs.50 when the market price was the same. The contractual life (vesting and exercise period) of the options granted is 6 years with the vesting period and exercise period being 3 years each. The expected life is 5 years and the expected annual forfeitures are estimated at 3 per cent. The fair value per option is arrived at Rs.15. Actual forfeitures in 2005 were 5 per cent. However at the end of 2005 the management of Santhosh Ltd. still expects that the actual forfeitures would average only 3 per cent over the entire vesting period. During 2006 the management revises its estimated forfeiture rate to 10 per cent per annum. Of the 2,500 employees 1,900 employees have completed the 3 year vesting period. 1,000 employees exercise their right to obtain shares vested in them in pursuance of ESOP at the end of 2009 and 500 employees exercise their right at the end of 2010. The rights of the remaining employees expire unexercised at the end of 2010. The face value per share is Rs.10. Show the necessary journal entries with suitable narrations. Workings should form part of the answer.

Answer**Journal Entries**

			Rs.	Rs.
<i>Year 2005</i>				
Employee Compensation Expense A/c	Dr.	57,04,205		
To Employee Stock Options Outstanding A/c				57,04,205
(Being the compensation expenses recognized in respect of the ESOP)				
Profit and Loss A/c	Dr.	57,04,205		
To Employee Compensation Expense A/c				57,04,205
(Being Expenses of the year transferred to P & L A/c)				
<i>Year 2006</i>				
Employee Compensation Expense A/c	Dr.	34,08,295		
To Employee Stock Options Outstanding A/c				34,08,295
(Being the compensation expenses recognized in respect of the ESOP)				
Profit and Loss A/c	Dr.	34,08,295		
To Employee Compensation Expense A/c				34,08,295
(Being Expenses of the year transferred to P & L A/c)				
<i>Year 2007</i>				
Employee Compensation Expense A/c	Dr.	51,37,500		
To Employee Stock Options Outstanding A/c				51,37,500
(Being the compensation expenses recognized in respect of the ESOP)				
Profit and Loss A/c	Dr.	51,37,500		
To Employee Compensation Expense A/c				51,37,500
(Being Expenses of the year transferred to P & L A/c)				
<i>Year 2009</i>				
Bank A/c	Dr.	250,00,000		
Employee Stock Options Outstanding A/c	Dr.	75,00,000		
To Share Capital A/c				50,00,000
To Securities Premium				275,00,000
(Being shares issued to employees against options vested in them in pursuance of the ESOP)				

Financial Reporting

Year 2010

Bank A/c	Dr.	125,00,000	
Employee Stock Options Outstanding A/c	Dr.	37,50,000	
To Share Capital A/c			25,00,000
To Securities Premium A/c			137,50,000

(Being shares issued to employees against options vested in them in pursuance of the ESOP)

Employee Stock Options Outstanding A/c	Dr.	30,00,000	
To General Reserve A/c			30,00,000

(Being the balance standing to the credit of stock options outstanding account, in respect of vested options expired unexercised, transferred to general reserve account)

Working Notes:

1. Fair value of options recognized as expense

Year 2005

Number of options expected to vest = $500 \times 2,500 \times .97 \times .97 \times .97 = 11,40,841$ options

Fair value of options expected to vest = $11,40,841 \times \text{Rs.}15 = \text{Rs.}171,12,615$

One third of fair value recognized as expense = $\text{Rs.}171,12,615 / 3 = \text{Rs.}57,04,205$

Year 2006

Fair Value of options revised in the year = $500 \times 2500 \times 0.90 \times 0.90 \times 0.90 \times \text{Rs.}15 = \text{Rs.}136,68,750$

Revised cumulative expenses in year 2006	91,12,500
$= 136,68,750 \times \frac{2}{3}$	

Less: Already recognized in year 2005	<u>57,04,205</u>
---------------------------------------	------------------

Expenses to be recognized in year 2006	<u>34,08,295</u>
--	------------------

Year 2007

Number of options actually vested = $1900 \times 500 = 9,50,000$

Fair Value of options actually vested = $9,50,000 \times 15$	1,42,50,000
--	-------------

Less: Expense recognized till year 2007	<u>91,12,500</u>
---	------------------

Balance amount to be recognized	<u>51,37,500</u>
---------------------------------	------------------

Share Based Payments

2. Amount recorded in share capital account and securities premium account upon issue of shares

<i>Particulars</i>	<i>Year 2009</i>	<i>Year 2010</i>
Number of employees exercising option	1,000	500
Number of shares issued upon exercise of option @ 500 per employee	5,00,000	2,50,000
Exercise price received @ Rs.50 per share	2,50,00,000	1,25,00,000
Corresponding amount recognized in the 'Employee stock options outstanding A/c' @ Rs.15 per option	<u>75,00,000</u>	<u>37,50,000</u>
Total consideration	<u>325,00,000</u>	<u>162,50,000</u>
Amount to be recorded in 'Share capital A/c' @ Rs.10 per share	50,00,000	25,00,000
Amount to be recorded in 'Securities premium A/c' @ Rs.55 (i.e.65 –10) per share	<u>275,00,000</u>	<u>137,50,000</u>
	<u>3,25,00,000</u>	<u>1,62,50,000</u>

Financial Reporting

EXERCISES

Question 1

At the beginning of year 1, an enterprise grants 300 options to each of its 1,000 employees. The contractual life (comprising the vesting period and the exercise period) of options granted is 6 years. The other relevant terms of the grant are as below:

Vesting Period 3 years

Exercise Period 3 years

Expected Life 5 years

Exercise Price Rs. 50

Market Price Rs. 50

Expected forfeitures per year 3%

The fair value of options, calculated using an option pricing model, is Rs. 15 per option. Actual forfeitures, during the year 1, are 5 per cent and at the end of year 1, the enterprise still expects that actual forfeitures would average 3 per cent per year over the 3-year vesting period. During the year 2, however, the management decides that the rate of forfeitures is likely to continue to increase, and the expected forfeiture rate for the entire award is changed to 6 per cent per year. It is also assumed that 840 employees have actually completed 3 years vesting period.

200 employees exercise their right to obtain shares vested in them in pursuance of the ESOP at the end of year 5 and 600 employees exercise their right at the end of year 6. Rights of 40 employees expire unexercised at the end of the contractual life of the option, i.e., at the end of year 6. Face value of one share of the enterprise is Rs. 10.

[Answer: The enterprise estimates the fair value of the options expected to vest at the end of the vesting period as No. of options expected to vest = $300 \times 1,000 \times 0.97 \times 0.97 \times 0.97 = 2,73,802$ options

Fair value of options expected to vest = $2,73,802 \text{ options} \times \text{Rs. } 15 = \text{Rs. } 41,07,030$

In the first year it recognizes Rs. $41,07,030/3$ towards the employee services.

Expense to be recognized in year 2 = Rs. 11,22,740

Expense to be recognized in year 3 = Rs. 12,88,250]

Question 2

Write short note on Stock Appreciation Rights.

Question 3

What are the disclosure requirements in respect of share based payments?

FINANCIAL REPORTING FOR FINANCIAL INSTITUTIONS

BASIC CONCEPTS

MUTUAL FUNDS

In India, mutual funds are regulated by SEBI (Mutual Funds) Regulations, 1996. According to the SEBI (Mutual Funds) Regulations, 1996, a 'mutual fund' means a fund established in the form of a trust to raise monies through the sale of units to the public under one or more schemes for investing in securities including money market instruments. A mutual fund should be registered with SEBI.

A Mutual Fund is a trust that pools the savings of a number of investors who share a common financial goal.

The money thus collected is invested by the fund manager in different types of securities depending upon the objective of the scheme. These could range from shares to debentures to money market instruments

Types of Mutual Funds

On the basis of Structure- The mutual fund schemes can be classified as open ended and close ended. The open-ended schemes permit entry by subscription or exit by sale of units on a continuous basis. The mutual fund announces daily sale and repurchase prices of units for the purpose. . The sale and repurchase prices announced by a mutual fund are based on Net Asst Value (NAV) and hence are called the NAV related prices. The close-ended funds have fixed maturity periods e.g. 5-7 years. These schemes are kept open for subscription only during a specified period at the time of launch of the scheme. To provide liquidity, the units are however listed on stock exchanges.

On the basis of Investors Objectives- In terms of investment objectives, mutual fund schemes can be classified as the growth funds and income funds. The growth funds invest major parts of their corpus in equity instruments and hence are exposed to comparatively higher risks. These schemes are expected to provide higher return in form of dividends and capital appreciation. Income funds invest in fixed income debt instruments, e.g. corporate debentures, Government securities and money market instruments and hence are also

Financial Reporting

called the debt funds. They provide steady flow of comparatively lower return for lower risks. Mutual funds sell their shares to public and redeem them at current net Assets Value (NAV) which is calculated as under –

$$\frac{\text{Total market value of all MF holdings} - \text{All MF liabilities}}{\text{Unit size}}$$

The net asset value of a mutual fund scheme is basically the per unit market value of all the assets of the scheme. if the NAV is more than the face value (Rs. 10), it means your money has appreciated and *vice versa*.

Every mutual fund or the asset management company is required to prepare in respect of each financial year an annual report and annual statement of accounts of the schemes and the fund as specified in Eleventh Schedule.

NON-BANKING FINANCE COMPANY

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956, engaged in the business of providing loans and advances, acquisition of shares, debentures and other securities, leasing, hire-purchase, insurance business and chit business. The term NBFC does not include any institution whose principal business is that of agriculture activity, industrial activity or sale/purchase/construction of immovable property. For purposes of RBI Directions relating to Acceptance of Public Deposits, non-banking financial company means only the non-banking institution which is a – Loan company, Investment company, Hire purchase finance company, Equipment leasing company and Mutual benefit financial company”. No non-banking financial company is allowed to commence or carry on the business of a non-banking financial institution without obtaining a certificate of registration issued by the Reserve Bank of India.

Functions of Non-Banking Financial Companies are similar to banks. However there are a few differences:

- (a) A NBFC cannot accept demand deposits;
- (b) Non-Banking Financial Companies do not take part in the payment and settlement system and hence cannot issue cheques to its customers; and
- (c) Deposit Insurance and Credit Guarantee Corporation (DICGC) does not insure the NBFC deposits.

“Owned fund” means paid up equity capital, preference shares which are compulsorily convertible into equity, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of asset, excluding reserves created by revaluation of asset, as reduced by accumulated loss balance, book value of intangible assets and deferred revenue expenditure, if any;

Net Owned Fund = Owned Fund – Investments in shares of subsidiaries/ companies in same group/Other NBFC. – Book value of debentures, bonds, outstanding loans and advances made to and deposits with subsidiaries and companies in the same group (to the extent such sum exceeds 10% of owned fund)

Income Recognition Principle

- Income on non-performing assets (NPA) shall be recognized only when it is actually realized.-Cash Basis of Accounting
- Income relating to hire purchase asset, where installments are overdue for more than 12 months, shall be recognized only when the hire charge is actually received.
- Income relating to leased asset, where lease rentals are overdue for more than 12 months, shall be recognised only when the lease rental is actually received.
- Income from dividend on shares of corporate bodies and units of mutual funds shall be taken into account on cash basis.
- However, income from dividend on shares of corporate bodies may be taken into account on accrual basis when such dividend has been declared by the corporate body in its annual general meeting and the NBFC's right to receive payment is established. Income from bonds and debentures of corporate bodies and from Government securities/bonds may be taken into account on accrual basis.
- Income on securities of corporate bodies or public sector undertakings, the payment of interest and repayment of principal of which have been guaranteed by Central Government or a State Government may be taken into account on accrual basis.

The assets are classified as:

- (a) Standard assets;
- (b) Sub-standard assets;
- (c) Doubtful assets; and
- (d) Loss assets.

Every NBFC shall, maintain a minimum capital ratio consisting of Tier I and Tier II capital which shall not be less than 12% of its aggregate risk-weighted assets on balance sheet and of risk adjusted value of off- balance sheet items.

“Tier I Capital” means owned fund as reduced by investment in shares of other non-banking financial companies and in shares, debentures, bonds, outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group exceeding, in aggregate, ten per cent of the owned fund;

Financial Reporting

“Tier II capital” includes the following:

- (a) preference shares other than those which are compulsorily convertible into equity;
- (b) revaluation reserves at discounted rate of fifty five percent;
- (c) general provisions and loss reserves to the extent these are not attributable to actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, to the extent of one and one fourth percent of risk weighted assets;
- (d) hybrid debt capital instruments; and
- (e) subordinated debt

to the extent the aggregate does not exceed Tier I capital.

MERCHANT BANKERS

Merchant bankers are the specialised agency which manages the capital issues. They are also called the managers to the issue. A merchant banker is an organisation that acts as an intermediary between the issuers and the ultimate purchasers of securities in the primary security market. In addition to managing an issue for a client, the services offered by a merchant banker includes underwriting and providing advice on complex financings arrangements, mergers and acquisitions, and at times direct equity investments in corporations.

STOCK AND COMMODITY MARKET INTERMEDIARIES

A stock broker is a member of a recognised stock exchange(s) and is engaged in buying, selling and dealing in securities. A stock broker can deal in securities only after getting registration with SEBI. A stock broker can function as a proprietorship firm, partnership firm or a corporate. Stock brokers are also eligible to act as underwriters without obtaining a separate registration as an underwriter. He may or may not appoint sub-brokers. A sub-broker is subordinate to main stock broker and acts on behalf of a stock broker as an agent or otherwise, for assisting the investors in buying, selling or dealing in securities through such stock brokers. The stock broker as a principal, is responsible to the investor for his sub-brokers' conduct and acts.

In addition to acting as agents for others, a stockbroker may also trade directly by buying and selling securities as principals. If a stockbroker enters into a contract to buy or sale securities as principal with any person other than another stockbroker, he must secure the consent or authorization from the other party and must disclose in the agreement for buying or selling of securities that he is acting as a principal.

MUTUAL FUNDS**Question1**

What do you mean by “Net asset value” (NAV) in case of mutual fund units?

Answer

Mutual funds sell their shares to public and redeem them at current net Assets Value (NAV) which is calculated as under:

$$\frac{\text{Total market value of all Mutual Fund holdings} - \text{All Mutual Fund liabilities}}{\text{Unit size}}$$

The net asset value of a mutual fund scheme is basically the per unit market value of all the assets of the scheme. Simply stated, NAV is the value of the assets of each unit of the scheme, or even simpler value of one unit of the scheme. Thus, if the NAV is more than the face value (Rs. 10), it means your money has appreciated and vice versa. NAV also includes dividends, interest accruals and reduction of liabilities and expenses, besides market value of investments. NAV is the value of net assets under a mutual fund scheme. The NAV per unit is NAV of the scheme divided by number of units outstanding. NAV of a scheme keeps on changing with change in market value of portfolio under the scheme.

Question 2

Investors Mutual Fund is registered with SEBI and having its registered office at Pune. The fund is in the process of finalising the annual statement of accounts of one of its open ended mutual fund schemes. From the information furnished below you are required to prepare a statement showing the movement of unit holders' funds for the financial year ended 31st March, 2009.

	Rs. '000
Opening Balance of net assets	12,00,000
Net Income for the year (Audited)	85,000
8,50,200 units issued during 2008-09	96,500
7,52,300 units redeemed during 2008-09	71,320
The par value per unit is Rs100	

Financial Reporting

Answer**Statement showing the Movement of Unit Holders' Funds for the year ended
31st March, 2009**

	(Rs. '000)
Opening balance of net assets	12,00,000
Add: Par value of units issued (8,50,200 × Rs.100)	85,020
Net Income for the year	85,000
Transfer from Reserve/Equalisation fund (Refer working Note)	<u>15,390</u>
	13,85,410
Less: Par value of units redeemed (7,52,300 × Rs.100)	<u>75,230</u>
Closing balance of net assets (as on 31 st March, 2009)	<u>13,10,180</u>

Working Note:

<i>Particulars</i>	<i>Issued</i>	<i>Redeemed</i>
Units	8,50,200	7,52,300
	<i>Rs. '000</i>	<i>Rs. '000</i>
Par value	85,020	75,230
Sale proceeds/Redemption value	96,500	71,320
Profit transferred to Reserve /Equalisation Fund	11,480	3,910
Balance in Reserve/Equalisation Fund		15,390

Question 3

On 1.4.2008, a mutual fund scheme had 18 lakh units of face value of Rs.10 each was outstanding. The scheme earned Rs.162 lakhs in 2008-09, out of which Rs.90 lakhs was earned in the first half of the year. On 30.9.2008, 2 lakh units were sold at a "NAV" of Rs.70.

Pass Journal entries for sale of units and distribution of dividend at the end of 2008-09.

Financial Reporting for Financial Institutions

Answer

Allocation of Earnings	Old Unit Holders	New Unit Holders	Total
	[18 Lakh Units]	[2 Lakh Units]	
	Rs. In Lakhs	Rs. In Lakhs	Rs. In Lakhs
First half year (Rs.5 per unit)	90.00	Nil	90.00
Second half year (Rs.3.60 per unit)	64.80	7.20	72.00
	154.80	7.20	162.00
Add: Equalization payment recovered	-	-	10.00
Total available for distribution			172.00
Equalization Payment:- Rs.90 lakhs ÷ 18 Lakhs = Rs.5 per unit.			

	Old Unit Holders	New Unit Holders
	Rs.	Rs.
Dividend distributed	8.60	8.60
Less: Equalization payment	-	5.00
	8.60	3.60

Journal Entries*(Rs. in lakhs)*

30.9.2008	Bank A/c	Dr.	150.00	
	To Unit Capital			20.00
	To Reserve			120.00
	To Dividend Equilisation			10.00
	(Being the amount received on sale of 2 lakhs unit at a NAV of Rs.70/- per Unit)			
31.3.2009	Dividend Equalization	Dr.	10.00	
	To Revenue A/c			10.00
	(Being the amount transferred to Revenue Account)			

Financial Reporting

30.9.2009	Revenue A/c	Dr.	172.00	
	To Bank			172.00
	(Being the amount distributed among 20 lakhs unit holders @ Rs.8.60 per unit)			

Question 4

A Mutual Fund raised 100 lakh on April 1, 2009 by issue of 10 lakh units of Rs. 10 per unit. The fund invested in several capital market instruments to build a portfolio of Rs. 90 lakhs. The initial expenses amounted to Rs. 7 lakh. During April, 2009, the fund sold certain securities of cost Rs. 38 lakhs for Rs. 40 lakhs and purchased certain other securities for Rs. 28.20 lakhs. The fund management expenses for the month amounted to Rs. 4.50 lakhs of which Rs. 0.25 lakh was in arrears. The dividend earned was Rs. 1.20 lakhs. 75% of the realized earnings were distributed. The market value of the portfolio on 30.04.2009 was Rs. 101.90 lakh.

Determine NAV per unit.

Answer

	Rs. in lakhs	Rs. in lakhs
Opening bank balance [(100- 90-7)Rs. lakhs]	3.00	
Add: Proceeds from sale of securities	40.00	
Dividend received	<u>1.20</u>	44.20
Less:		
Cost of securities	28.20	
Fund management expenses [(4.50-0.25) Rs. lakhs]	4.25	
Capital gains distributed [75% of (40.00 – 38.00) Rs. lakhs]	1.50	
Dividends distributed (75% of Rs. 1.20 lakhs)	<u>0.90</u>	<u>(34.85)</u>
Closing bank balance		9.35
Closing market value of portfolio		<u>101.90</u>
		111.25
Less: Arrears of expenses		<u>0.25</u>
Closing net assets		<u>111.00</u>
Number of units		10,00,000
Closing Net Assets Value (NAV)		Rs. 11.10

Non- Banking Finance Companies

Question 5

Write short notes on:

- (i) *“Non-Performing Assets” as per NBFC Prudential Norms (RBI) directions.*
- (ii) *Capital adequacy ratio.*
- (iii) *Earning value (Equity share).*

Answer

(i) “Non–Performing Asset” as per NBFC Prudential Norms (RBI) directions means:

- (a) an asset, in respect of which, interest has remained overdue for a period of six months or more;
- (b) a term loan inclusive of unpaid interest, when the instalment is overdue for a period of six months or more or on which interest amount remained overdue for a period of six months or more;
- (c) a demand or call loan, which remained overdue for a period of six months or more from the date of demand or call or on which interest amount remained overdue for a period of six months or more;
- (d) a bill which remains overdue for a period of six months or more;
- (e) the interest in respect of a debt or the income on receivables under the head ‘other current assets’ in the nature of short term loans/advances, which facility remained overdue for a period of six months or more;
- (f) any dues on account of sale of assets or services rendered or reimbursement of expenses incurred, which remained overdue for a period of six months or more;
- (g) the lease rental and hire purchase instalment, which has become overdue for a period of twelve months or more;
- (h) in respect of loans, advances and other credit facilities (including bills purchased and discounted), the balance outstanding under the credit facilities (including accrued interest) made available to the same borrower/beneficiary when any of the above credit facilities becomes non-performing asset:

Provided that in the case of lease and hire purchase transactions, a non-banking financial company may classify each such account on the basis of its record of recovery.

- (ii) Non-Banking Financial Companies (NBFC) are required to maintain adequate capital.** Every NBFC shall maintain a minimum capital ratio consisting of Tier I and Tier II capital which shall not be less than 12% of its aggregate risk-weighted assets on balance sheet and of risk adjusted value of off-balance sheet items.

Financial Reporting

The total of Tier II capital, at any point of time, shall not exceed 100% of Tier I capital. Capital adequacy is calculated as under:

$$\frac{\text{Tier I + Tier II Capital}}{\text{Risk Adjusted Assets}} \times 100$$

(iii) "Earning value" means the value of an equity share computed by taking the average of profits after tax as reduced by the preference dividend and adjusted for extra-ordinary and non-recurring items, for the immediately preceding three years and further divided by the number of equity shares of the investee company and capitalised at the following rate:

- (a) in case of predominantly manufacturing company, eight per cent;
- (b) in case of predominantly trading company, ten per cent; and
- (c) in case of any other company, including non-banking financial company, twelve percent;

NOTE : If, an investee company is a loss making company, the earning value will be taken at zero.

Question 6

While closing its books of account on 31st March, 2010 a Non-Banking Finance Company has its advances classified as follows:

	<i>Rs.in lakhs</i>
<i>Standard assets</i>	16,800
<i>Sub-standard assets</i>	1,340
<i>Secured positions of doubtful debts:</i>	
– <i>upto one year</i>	320
– <i>one year to three years</i>	90
– <i>more than three years</i>	30
<i>Unsecured portions of doubtful debts</i>	97
<i>Loss assets</i>	48

Calculate the amount of provision, which must be made against the Advances.

Answer**(a) Calculation of provision required on advances as on 31st March, 2010:**

	Amount Rs. in lakhs	Percentage of provision	Provision Rs. in lakhs
Standard assets	16,800	NIL	NIL
Sub-standard assets	1,340	10	134
Secured portions of doubtful debts—			
—upto one year	320	20	64
— one year to three years	90	30	27
—more than three years	30	50	15
Unsecured portions of doubtful debts	97	100	97
Loss assets	48	100	<u>48</u>
			<u>385</u>

Question 7

Anischit Finance Ltd. is a non-banking finance company. It makes available to you the costs and market price of various investments held by it as on 31.3.2008:

(Figures in Rs. Lakhs)

		Cost	Market Price
<i>Scripts:</i>			
A.	<i>Equity Shares-</i>		
	A	60.00	61.20
	B	31.50	24.00
	C	60.00	36.00
	D	60.00	120.00
	E	90.00	105.00
	F	75.00	90.00
	G	30.00	6.00
B.	<i>Mutual funds-</i>		
	MF-1	39.00	24.00
	MF-2	30.00	21.00
	MF-3	6.00	9.00

Financial Reporting**C. Government securities-**

GV-1	60.00	66.00
------	-------	-------

GV-2	75.00	72.00
------	-------	-------

- (i) Can the company adjust depreciation of a particular item of investment within a category?
- (ii) What should be the value of investments as on 31.3.2008?
- (iii) Is it possible to off-set depreciation in investment in mutual funds against appreciation of the value of investment in equity shares and government securities?

Answer

- (i) Quoted current investments for each category shall be valued at cost or market value, whichever is lower. For this purpose, the investments in each category shall be considered scrip-wise and the cost and market value aggregated for all investments in each category. If the aggregate market value for the category is less than the aggregate cost for that category, the net depreciation shall be provided for or charged to the profit and loss account. If the aggregate market value for the category exceeds the aggregate cost for the category, the net appreciation shall be ignored. Therefore, depreciation of a particular item of investments can be adjusted within the same category of investments.

- (ii) Value of Investments as on 31.3.2008

<i>Type of Investment</i>	<i>Valuation Principle</i>	<i>Value Rs.in lakhs</i>
Equity Shares (Aggregated)	Lower of cost or market Value	406.50
Mutual Funds	NAV (Market value, assumed)	54.00
Government securities	Cost	135.00
		<u>595.50</u>

As per para 14 of AS 13 "Accounting for Investments", the carrying amount for current investments is the lower of cost and market price. Sometimes, the concern of an enterprise may be with the value of a category of related current investments and not with each individual investment, and accordingly, the investments may be computed at the lower of cost and market value computed categorywise.

- (iii) Inter category adjustments of appreciation and depreciation in values of investments cannot be done. It is not possible to offset depreciation in investment in mutual funds against appreciation of the value of investments in equity shares and Government securities.

MERCHANT BANKERS

Question 8

For what purposes inspection of records and documents of Merchant Banker is ordered by SEBI?

Answer

SEBI has the right to appoint one or more persons as inspecting authority to undertake inspection of the books of account, records and documents of the merchant banker for any of the following purposes:

- (i) To see that books of account are being maintained in the required manner;
- (ii) To ensure that provisions of SEBI Act, rules and regulations are complied with;
- (iii) To investigate into complaints received from investors, other merchant bankers, or any other person on any matter having a bearing on the activities of merchant banker;
- (iv) To investigate suo moto in the interest of securities business or investors' interest into the affairs of merchant bankers.

Question 9

Write short note on Capital adequacy requirements of merchant bankers.

Answer

Capital adequacy requirements have been specified by SEBI under the SEBI (Merchant Bankers) Regulations, 1992. Regulation 7 specifies that the requirement of capital adequacy shall be a net worth of not less than five crore rupees.*

For the purpose of this regulation, 'Net worth' means the sum of paid-up capital and free reserves of the applicant at the time of making application under sub-regulation (1) of regulation 3.

**As amended by SEBI (Merchant Banker) (Third Amendment) Regulations, 2006.*

Stock and Commodity Market Intermediaries

Question 10

Write short note on Books of account required to be maintained by a Stock Broker.

Answer

Every stock broker is required to maintain the following books of account, records and documents as per Rule 15 of the Securities Contracts (Regulation) Rules, 1957 and

Financial Reporting

Regulation 17 of the SEBI (Stock Brokers and Sub-Brokers) Rules, 1992:

- (a) Register of transactions (Sauda book);
- (b) Clients ledger;
- (c) General ledger;
- (d) Journals;
- (e) Cash book;
- (f) Bank Pass Book;
- (g) Documents register, containing, inter alia, particulars of securities received and delivered in physical form and the statement of account and other relating to receipt and delivery of securities provided by the depository participants in respect of dematerialized securities;*
- (h) Members' contract book showing details of all contracts entered into by him with other members of the stock exchange or counterfoils or duplicates of memos of confirmation issued to such other members;
- (i) Counterfoils or duplicates of contract notes issued to clients;
- (j) Written consent of clients in respect of contracts entered into as principals;
- (k) Margin deposit book;
- (l) Register of accounts of sub-brokers;
- (m) An agreement with a sub-broker specifying the scope of authority and responsibilities of the stock broker and such sub-brokers.
- (n) An agreement with the sub-broker and with the client of sub-broker to establish privities of the contract between the stock broker and the client of the stock broker.*

**Inserted by SEBI (Stock Brokers and Sub-Brokers) (Amendment) Regulations, 2003.*

EXERCISES

Question 1

Write short notes on:

- (i) Dividend Equalization for a mutual fund.
- (ii) Asset liability management for a NBFC.
- (iii) Closing out by a member broker.
- (iv) Open ended and close ended schemes of mutual funds.

Question 2

A Mutual Fund raised funds on 01.04.2010 by issuing 10 lakhs units @ 17.50 per unit. Out of this Fund, Rs. 160 lakhs invested in several capital market instruments. The initial expenses amount to Rs. 9 lakhs. During June, 2010, the Fund sold certain securities worth Rs. 100 lakhs for Rs. 125 lakhs and it bought certain securities for Rs. 90 lakhs. The Fund Management expenses amounting to Rs. 5 lakhs per month. The dividend earned was Rs. 3 lakhs. 80% of the realised earnings were distributed among the unit holders. The market value of the portfolio was Rs. 175 lakhs. Determine Net Asset value (NAV) per unit as on 30.06.2010.

[Answer: Total Funds raised by Mutual Fund = Rs. 175 Lakhs; Closing Net Assets Rs. 181.60 Lakhs; Closing NAV Rs. 18.16]

VALUATION

BASIC CONCEPTS

CONCEPT OF VALUATION

Valuation means measurement of value in monetary term.

Different measurement bases are:

- (a) *Historical cost.* Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire them at the time of their acquisition.
- (b) *Current cost.* Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset were acquired currently.
- (c) *Realisable (settlement) value.* Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal.
- (d) *Present value.* Assets are carried at the present value of the future net cash inflows that the item is expected to generate in the normal course of business.

Other valuation bases:

Net Realisable Value (NRV): This is same as the Realisable (settlement) value. This is the value (net of expenses) that can be realized by disposing off the assets in an orderly manner. Net selling price or exit values also convey the same meaning.

Economic value: This is same as the present value. The other name of it is value to business.

Replacement (cost) value: This is also same as the current cost.

Recoverable (amount) value: This is the higher of the net selling price and value in use.

Deprival value: This is the lower of the replacement value and recoverable (amount) value.

Liquidation value: this is the value (net of expenses), that a business can expect to realize by disposing of the assets in the event of liquidation. Such a value is usually lower than the NRV or exit value. This is also called break up value.

Fair value: This is not based on a particular method of valuation. It is the acceptable

Financial Reporting

value based on appropriate method of valuation in context of the situation of valuation. Thus fair value may represent current cost, NRV or present value as the case may be.

Three General Approaches to Valuation are:

- 1) Cost Approach: e.g. Adjusted Book Value
- 2) Market Approach: e.g. Comparables
- 3) Income Approach: e.g. Discounted Cash Flow

VALUATION OF TANGIBLE FIXED ASSETS

Para 9 of AS 10 has stated the components of cost as below:

- (a) The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies, any trade discounts and rebates are deducted in arriving at the purchase price.
- (b) Any directly attributable cost of bringing the asset to its working condition for its intended use;
- (c) Administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset.
- (d) The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalised as an indirect element of the construction cost.
- (e) If the interval between the date a project is ready to commence commercial production and the date at which commercial production actually begins is prolonged, all expenses incurred during this period are charged to the profit and loss statement.

The same principles that apply to value purchased fixed assets at original cost will apply to self constructed assets also.

Improvement: Expenditure which increase the future benefits from the existing asset is treated as cost of improvement. This cost of improvement or of any addition or extension which becomes integral part of the existing fixed asset is to be added to the value of the asset.

Revaluation: Revaluation of fixed assets may be made to show the assets at their current costs, particularly in context of the historical cost losing relevance in inflationary situation. Increase in value of fixed assets is shown as revaluation reserve which is not distributable. The loss on revaluation, however, transferred to profit and loss account

Government Grants related to specific fixed assets, as per AS 12, can be deducted from the cost of the said assets.

Impairment of assets: When the recoverable amount of an asset falls below its carrying amount, as per AS 28, the carrying amount has to be reduced to the recoverable amount and the loss on impairment should be charged to profit and loss account in addition to the depreciation. If subsequently the recoverable amount rises the reversal, i.e., addition shall be made to the already reduced carrying amount.

VALUATION OF INTANGIBLES (AS 26)

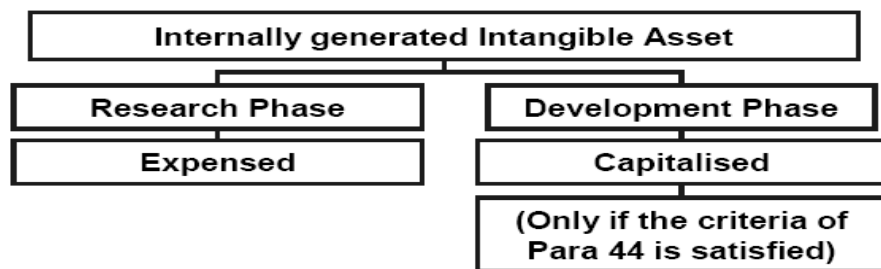
Meaning-An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

Types- Intangible fixed assets can be classified as **identifiable intangibles and not identifiable intangibles**. The identifiable intangibles include patents, trademarks and designs and brands whereas the not identifiable intangibles are clubbed together as goodwill.

When to Recognize- An intangible asset should be recognised if, and only if:

- It is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and
- The cost of the asset can be measured reliably.

If the intangible asset is **internally generated**:



Para 50 of the AS 26 clearly states that 'Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognized as intangible assets'.

- For other types of intangible assets Para 41(AS26) stated that 'No intangible asset arising from research (or **from the research phase** of an internal project) should be recognised' and
- Para 44 requires that 'An intangible asset arising **from development** (or from the development phase of an internal project) should be recognised if, and only if, all of the conditions specified therein are satisfied'.

Financial Reporting

When not recognized the expenditure on intangible item would be **treated as expense** and when recognised the expenditure on the intangible item **would be capitalized**.

Subsequent expenditure on an intangible asset after its purchase or its completion should be added to the cost of the intangible asset if:

(a) It is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and (b) the expenditure can be measured and attributed to the asset reliably.

Brand Valuation

- **No valuation** shall be made for **internally generated brand**.
- When the **brand is acquired separately**, the valuation would be made **at initial cost of acquisition** (with subsequent addition to cost, if any).

All identifiable intangible assets including Patents, Copyrights, Know-how and Designs which are acquired separately valuation would be made at initial cost of acquisition (with subsequent addition to cost, if any).

The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use.

Amortization should commence when the asset is available for use.

Valuation of Goodwill

Purchased goodwill can be defined as being the excess of fair value of the purchase consideration over the fair value of the separable net assets acquired. Para 36 of AS-10 Accounting for Fixed Assets' states that only purchased goodwill should be recognised in the accounts.

Goodwill is a thing which is not so easy to describe but in general words good-name, reputation and wide business connection which helps the business to earn more profits than the profit could be earned by a newly started business. The monetary value of the advantage of earning more profits is known as goodwill. Goodwill is an attractive force, which brings in customers to old place of business. Goodwill is an intangible but valuable asset. In a profitable concern it is not a fictitious asset.

Future maintainable profit is ascertained taking either simple or weighted average of the past profits or by fitting trend line. If the past profits do not have any definite trend, average is taken to arrive at the future maintainable profit. If the past profits show increasing or decreasing trend, linear trend equation gives better estimation of the future maintainable profit. If the past profits show increasing or decreasing trend, then more weights are given to

the profit figures of the immediate past years and less weight to the profit figures of the furthest past.

The following adjustments from past profits are generally made:

- (i) Elimination of abnormal loss arising out of strikes, lock-out, fire, etc. Profit/loss figures which contain abnormal loss should either be ignored or eliminated. Similarly, if there is any abnormal gain included in past profits that needs elimination.
- (ii) Interest/dividend or any other income from non-trading assets needs elimination because 'capital employed' used for valuation of goodwill comprises only of trading assets.
- (iii) If there is a change in rate of tax, tax charged at the old rate should be added back and tax should be charged at the new rate.
- (iv) Effect of change in accounting policies should be neutralised to have profit figures which are arrived at on the basis of uniform policies.

Valuation of Liabilities

The different bases of valuation of liabilities are:

- (a) *Historical cost.*
- (b) *Current cost.*
- (c) *Realisable (settlement) value.* Liabilities are carried at their settlement values, that is, the undiscounted amounts of cash or cash equivalents expected to be required to settle the liabilities in the normal course of business.
- (d) *Present value.*

The liability items of the balance sheet are generally carried at the settlement values.

Liabilities may be carried at the present value in case of finance lease.

In case of a finance lease, the lessee should recognize a liability equal to the fair value of the leased asset at the inception of the lease.

In regard provision, the valuation is based on settlement value and not on present value.

Valuation of Shares

For transactions concerning relatively small blocks of shares which are quoted on the stock exchange, generally the ruling stock exchange price (average price) provides the basis.

Principally two basic methods are used for share valuation; one on the basis of *net assets* and the other on the basis of *earning capacity* or yield (which, nevertheless, must take into consideration net assets used).

Net Asset Basis: According to this method, value of equity share is determined as follows:

Financial Reporting

$$\frac{\text{Net assets available to equity shareholders}}{\text{Number of equity shares}}$$

Yield Basis: Broadly, the following steps are envisaged in a yield based valuation considering the rate of return:

- (i) Determination of future maintainable profit;
- (ii) Ascertaining the normal rate of return;
- (iii) Finding out the capitalisation factor or the multiplier;
- (iv) Multiplying the future maintainable profit, by the multiplier; and
- (v) Dividing the results obtained in (iv) by the number of shares.

The steps necessary to arrive at the future maintainable profits of a company are: (a) calculation of past average taxed earnings, (b) projection of the future maintainable taxed profits, and (c) adjustment of preferred rights.

Mean between asset and yield based valuation: Average of book value and yield based value incorporates the advantages of both the methods. That is why such average is called the fair value of share.

Valuation of Preference Shares

For valuation of preference shares the following factors are generally considered:

- (i) Risk free rate plus small risk premium (i.e. market expectation rate).
- (ii) Ability of the company to pay dividend on a regular basis.
- (iii) Ability of the company to redeem preference share capital.

Ability to pay preference dividend may be judged by using the following ratio:

$$\frac{\text{Profit after tax}}{\text{Preference dividend}}$$

The value of each preference shares can be derived as below:

$$\frac{\text{Preference dividend rate}}{\text{Market expectation rate}} \times 100$$

Valuation of Business

Value of business is different from that of the aggregate value of assets.

Two alternative approaches are available for business valuation: (i) going concern and (ii) liquidation.

The following methods are used for business valuation taking it as a going concern:

- (i) Historical cost valuation
- (ii) Current cost valuation
- (iii) Economic valuation
- (iv) Asset valuation.

For piecemeal sale of the business, only 'net realisable value' basis is appropriate.

Historical cost valuation: It is also called book value method. All assets are taken at their respective historical cost. Value of goodwill is ascertained and added to such historical cost of assets.

Historical cost value of business = Historical cost of all assets + Value of goodwill.

Current cost valuation: Current cost of assets are taken for this purpose instead of historical cost.

Economic valuation: Under this method value of the business is given by the sum of discounted value of future earnings or cash flows.

Fair value

NAV on the basis of fair value of assets and liabilities is computed in the same way as computed on the basis of book value except that the fair values of assets and liabilities are considered instead of balance sheet values. The implication of fair value also varies with the objective of valuation, whether the objective is to find the going concern value or the liquidation value.

Earning based valuation of business

Earning based valuation of business = Earning capacity value per share X number of equity shares + Preference share capital + Debt capital. (Book values of preference capital and debt capital should be taken)

Market value model

This is simply the aggregate of the market capitalization and market value of preference capital and debt capital. Market capitalization means market value of equity multiplied by the number of outstanding share. The quoted price of the stock exchanges provides the market value of equity at any moment.

Financial Reporting

Valuation of Intangibles

Question 1

Discuss methods of valuation of intangible assets in brief.

Answer

Valuation of intangible assets is a complex exercise, as the non-physical form of intangible assets poses the difficulty of identifying the future economic benefits that the enterprise can expect to derive from them. There are three main approaches for valuing intangible assets:

- (1) *Cost approach:* In cost approach, historical expenditure incurred in developing the asset is aggregated. Cost is measured by purchase price, where the asset has been acquired recently.
- (2) *Market value approach:* In comparable market value approach, intangible assets are valued with reference to transactions involving similar assets that have cropped up recently in similar markets. This approach is possible when there is an active market in which arm's length transactions have occurred recently involving comparable intangible assets and adequate information of terms of transactions is available.
- (3) *Economic value approach:* This approach is based on the cash flows or earnings attributable to those assets and the capitalization thereof, at an appropriate discount rate or multiple. Some of the key parameters used in this approach are projected revenues, projected earnings, discount rate, rate of return etc. The information required can be derived from either internal sources, external sources or both. Under this approach, the valuer has to identify cash flows or earnings directly associated with the intangible assets like the cash flows arising from the exploitation of a patent or copyright, licensing of an intangible asset etc. This approach can be put to practice only if cash flows arising from the intangible assets are identifiable from the management accounts and budgets, forecasts or plans of the company. In most situations of valuation of intangible assets, the economic based approach is used, because of the uniqueness of intangible assets and the lack of comparable market data for the use of market value approach.

Question 2

Find out the average capital employed of ND Ltd. from its Balance sheet as at 31st March, 2010:

<i>Liabilities</i>	<i>(Rs. in lakhs)</i>	<i>Assets</i>	<i>(Rs. in lakhs)</i>
<i>Share Capital:</i>		<i>Fixed Assets:</i>	
<i>Equity shares of Rs.10 each</i>	<i>50.00</i>	<i>Land and buildings</i>	<i>25.00</i>
<i>9% Pref. shares fully paid up</i>	<i>10.00</i>	<i>Plant and machinery</i>	<i>80.25</i>

Valuation

<i>Reserve and Surplus:</i>	<i>Furniture and fixture</i>	5.50
<i>General reserve</i>	12.00 <i>Vehicles</i>	5.00
<i>Profit and Loss</i>	20.00 <i>Investments</i>	10.00
<i>Secured loans:</i>	<i>Current Assets:</i>	
16% debentures	5.00 <i>Stock</i>	6.75
16% Term loan	18.00 <i>Sundry Debtors</i>	4.90
Cash credit	13.30 <i>Cash and bank</i>	10.40
<i>Current Liabilities and Provisions:</i>	<i>Preliminary expenses</i>	0.50
<i>Sundry creditors</i>	2.70	
<i>Provision for taxation</i>	6.40	
<i>Proposed dividend on:</i>		
<i>Equity shares</i>	10.00	
<i>Preference shares</i>	<u>0.90</u>	
	<u>148.30</u>	<u>148.30</u>

Non-trade investments were 20% of the total investments.

Balances as on 1.4.2009 to the following accounts were:

Profit and Loss account Rs.8.70 lakhs, General reserve Rs.6.50 lakhs.

Answer

Computation of Average Capital employed

(Rs. in Lakhs)

Total Assets as per Balance Sheet	148.30
Less: Preliminary Expenses	0.50
Non-trade investments (20% of Rs. 10 lakhs)	2.00
	<u>2.50</u>
	145.80
Less: Outside Liabilities:	
16% Debentures	5.00
16% Term Loan	18.00
Cash Credit	13.30
Sundry Creditors	2.70
Provision for Taxation	<u>6.40</u>
	<u>45.40</u>
Capital Employed as on 31.03.2010	100.40
Less: ½ of profit earned:	

Financial Reporting

Increase in reserve balance	5.50	
Increase in Profit & Loss A/c	11.30	
Proposed Dividend	10.90	
	27.70 X 50 %	<u>13.85</u>
Average capital employed		<u>86.55</u>

Question 3

The following Balance Sheet of X Ltd. is given:

X Ltd.**Balance Sheet as on 31st March, 2010**

Liabilities	Rs.	Assets	Rs.
5,000 shares of Rs. 100 each fully paid	50,00,000	Goodwill	4,00,000
		Land and building at cost	32,00,000
Bank overdraft	18,60,000	Plant and machinery at cost	28,00,000
Creditors	21,10,000	Stock	32,00,000
Provision for taxation	5,10,000	Debtors considered good	20,00,000
Profit and Loss Appropriation A/c	<u>21,20,000</u>		
	<u>1,16,00,000</u>		<u>1,16,00,000</u>

In 1991 when the company commenced operation the paid up capital was same. The Loss/Profit for each of the last 5 years was – years 2005-2006 – Loss (Rs. 5,50,000); 2006-2007 Rs. 9,82,000; 2007-2008 Rs. 11,70,000; 2008-2009 Rs. 14,50,000; 2009-2010 Rs. 17,00,000;

Although income-tax has so far been paid @ 40% and the above profits have been arrived at on the basis of such tax rate, it has been decided that with effect from the year 2009-2010 the Income-tax rate of 45% should be taken into consideration. 10% dividend in 2006-2007 and 2007-2008 and 15% dividend in 2008-2009 and 2009-2010 have been paid. Market price of shares of the company on 31st March, 2010 is Rs. 125. With effect from 1st April, 2010 Managing Director's remuneration has been approved by the Government to be Rs. 8,00,000 in place of Rs. 6,00,000. The company has been able to secure a contract for supply of materials at advantageous prices. The advantage has been valued at Rs. 4,00,000 per annum for the next five years.

Ascertain goodwill at 3 year's purchase of super profit (for calculation of future maintainable profit weighted average is to be taken).

Answer**(i) Future Maintainable Profit**

Year	Profit (P) Rs.	Weight (W)	Product (PW) Rs.
2006-2007	9,82,000	1	9,82,000
2007-2008	11,70,000	2	23,40,000
2008-2009	14,50,000	3	43,50,000
2009-2010	17,00,000	<u>4</u>	<u>68,00,000</u>
		<u>10</u>	<u>1,44,72,000</u>

Weighted average annual profit (after tax) =

$$\frac{\sum PW}{\sum W} = \text{Rs. } \frac{1,44,72,000}{10} \quad 14,47,200$$

Weighted average annual profit before tax $\left(\text{Rs. } 14,47,200 \times \frac{100}{60} \right) \quad 24,12,000$

Less: Increase in Managing Director's remuneration 2,00,000
22,12,000

Add: Saving in cost of materials 4,00,000
26,12,000

Less: Taxation @ 45% 11,75,400

Future maintainable profit 14,36,600

(ii) Average Capital Employed

	Rs.	Rs.
Assets:		
Land and Buildings		32,00,000
Plant and Machinery		28,00,000
Stock		32,00,000
Sundry Debtors		<u>20,00,000</u>
		1,12,00,000
Less: Outside liabilities:		
Bank overdraft	18,60,000	
Creditors	21,10,000	

Financial Reporting

Provision for taxation	<u>5,10,000</u>	<u>44,80,000</u>
Capital employed at the end of the year		67,20,000
Add: Dividend @ 15% paid during the year		<u>7,50,000</u>
		74,70,000
Less: Half of the profit (after tax) for the year i.e. Rs. 17,00,000 × ½		<u>8,50,000</u>
Average capital employed		<u>66,20,000</u>

(iii) Normal Profit

$$\text{Average dividend for the last 4 years} \left(\frac{10+10+15+15}{4} \right) = 12.5\%$$

Market price of share = Rs. 125

$$\text{Normal rate of return} = \frac{12.5}{125} \times 100 = 10\%$$

Normal profit (10% of Rs. 66,20,000) = Rs. 6,62,000

(iv) Valuation of goodwill

	Rs.
Future maintainable profit	14,36,600
Less: Normal profit	<u>6,62,000</u>
Super profit	<u>7,74,600</u>
Goodwill at 3 years' purchase of super profits (Rs. 7,74,600 × 3)	23,23,800

Question 4

The following is the extract from the Balance Sheets of Popular Ltd.:

Liabilities	As at 31.3.2009 Rs. in lakhs	As at 31.3.2010 Rs. in lakhs	Assets	As at 31.3.2009 Rs. in lakhs	As at 31.3.2010 Rs. in lakhs
Share capital	500	500	Fixed assets	550	650
General reserve	400	425	10% investment	250	250
Profit and Loss account	60	90	Stock	260	300
18% term loan	180	165	Debtors	170	110
Sundry creditors	35	45	Cash at bank	46	45

Valuation

Provision for tax	11	13	Fictitious assets	10	8
Proposed dividend	<u>100</u>	<u>125</u>			
	<u>1,286</u>	<u>1,363</u>		<u>1,286</u>	<u>1,363</u>

Additional information:

- (i) Replacement values of Fixed assets were Rs.1,100 lakhs on 31.3.09 and Rs.1,250 lakhs on 31.3.2010 respectively.
- (ii) Rate of depreciation adopted on Fixed assets was 5% p.a.
- (iii) 50% of the stock is to be valued at 120% of its book value.
- (iv) 50% of investments were trade investments.
- (v) Debtors on 31st March, 2010 included foreign debtors of \$35,000 recorded in the books at Rs.35 per U.S. Dollar. The closing exchange rate was \$ 1 = Rs.39.
- (vi) Creditors on 31st March, 2010 included foreign creditors of \$60,000 recorded in the books at \$ 1 = Rs.33. The closing exchange rate was \$ 1 = Rs.39.
- (vii) Profits for the year 2009-10 included Rs.60 lakhs of government subsidy which was not likely to recur.
- (viii) Rs.125 lakhs of Research and Development expenditure was written off to the Profit and Loss Account in the current year. This expenditure was not likely to recur.
- (ix) Future maintainable profits (pre-tax) are likely to be higher by 10%.
- (x) Tax rate during 2009-10 was 50%, effective future tax rate will be 40%.
- (xi) Normal rate of return expected is 15%.

One of the directors of the company Arvind, fears that the company does not enjoy goodwill in the prevalent market circumstances.

Critically examine this and establish whether Popular Co. has or has not any goodwill.

If your answers were positive on the existence of goodwill, show the leverage effect it has on the company's result.

Industry average return was 12% on long-term funds and 15% on equity funds.

Answer

1. Calculation of Capital employed (CE)	Rs. in lakhs	
	As on 31.3.09	As on 31.3.10
Replacement Cost of Fixed Assets	1100.00	1250.00
Trade Investment (50%)	125.00	125.00

Financial Reporting

Current cost of stock

$$130 + 130 \times \frac{120}{100} \quad 286.00$$

$$150 + 150 \times \frac{120}{100} \quad 330.00$$

Debtors 170.00 111.40Cash-at-Bank 46.00 45.00Total (A) 1727.00 1861.40

Less: Outside Liabilities

18% term loan 180.00 165.00Sundry creditors 35.00 48.60Provision for tax 11.00 13.00Total (B) 226.00 226.60Capital employed (A-B) 1501.00 1634.80Average Capital employed at current value = $\frac{\text{CE as on 31.3.2009} + \text{CE as on 31.3.2010}}{2}$

$$= \frac{1501 + 1634.80}{2} = 1567.90 \text{ Lakhs}^*$$

2. Future Maintainable Profit

Rs. in Lakhs

Increase in General Reserve 25Increase in Profit and Loss Account 30Proposed Dividends 125Profit After Tax 180Pre-Tax Profit = $\frac{180}{1 - 0.5}$ 360Less: Fictitious Assets written off (10 – 8) 2.00Non-Trading investment income (10% of Rs.125) 12.50Subsidy 60.00Exchange Loss on creditors [0.6 lakhs × (39-33)] 3.60

* Average capital employed can also be calculated in the following manner:

Closing capital employed as on 31.3.2010 Rs.1,634.80 lakhsLess: ½ of actual post tax profit for 2009-2010 Rs. 90.00 lakhsAverage capital employed Rs.1,544.80 lakhs

Valuation

Additional Depreciation on increase in value of Fixed Assets (current year) $(1250 - 650 = 600 \times \frac{5}{100})$ i.e.,		<u>30.00</u>	<u>108.10</u>
			251.90
Add: Exchange Gain on Debtors $[0.35 \text{ lakhs} \times (39-35)]$		1.40	
Research and development expenses written off		125.00	
Stock Adjustment (30-26)		<u>4.00</u>	<u>130.40</u>
			382.30
Add: Expected increase of 10%			<u>38.23</u>
Future Maintainable Profit before Tax			420.53
Less: Tax @ 40% (40% of Rs.420.53)			<u>168.21</u>
Future Maintainable Profit			<u>252.32</u>
3. Valuation of Goodwill			Rs. in lakhs
(i) According to Capitalisation of Future Maintainable Profit Method			
Capitalised value of Future Maintainable Profit			1682.13
$= \frac{252.32}{15} \times 100$			
Less: Average capital employed			<u>1567.90</u>
Value of Goodwill			<u>114.23</u>
Or			
(ii) According to Capitalization of Super Profit Method			Rs. In lakhs
Future Maintainable Profit			252.32
Less: Normal Profit @ 15% on average capital employed $(1567.90 \times 15\%)$			<u>235.19</u>
Super Profit			<u>17.13</u>
Capitalised value of super profit $\frac{17.13}{15} \times 100$ i.e. Goodwill			114.2

Goodwill exists; hence director's fear is not valid.

Financial Reporting

Leverage Effect on Goodwill

Rs. in lakhs

Future Maintainable Profit on equity fund	252.32
Future Maintainable Profit on Long-term Trading Capital employed	
Future Maintainable Profit After Tax	252.32
Add: Interest on Long-term Loan (Term Loan)	
(After considering Tax) $165 \times 18\% = 29.7 \times \frac{50}{100}$	<u>14.85</u>
	267.17
Average capital employed (Equity approach)	1567.90
Add: 18% Term Loan $(180+165)/2$	<u>172.50</u>
Average capital employed (Long-term Fund approach)	<u>1740.40</u>
Value of Goodwill	
(A) Equity Approach	
Capitalised value of Future Maintainable Profit = $\frac{252.32}{15} \times 100 =$	1682.13
Less: Average capital employed	<u>1567.90</u>
Value of Goodwill	<u>114.23</u>
(B) Long-Term Fund Approach	
Capitalized value of Future Maintainable Profit = $\frac{267.17}{12} \times 100 =$	2226.42
Less: Average capital employed	<u>1740.40</u>
Value of Goodwill	<u>486.02</u>

Comments on Leverage effect of Goodwill:

Adverse Leverage effect on goodwill is 371.79 lakhs (i.e., Rs.486.02-114.23). In other words, Leverage Ratio of Popular Ltd. is low for which its goodwill value has been reduced when calculated with reference to equity fund as compared to the value arrived at with reference to long term fund.

Working Notes:

(1) Stock adjustment	Rs. in lakhs
(i) Excess current cost of closing stock over its Historical cost	30.00
(330 – 300)	

Valuation

(ii) Excess current cost of opening stock over its Historical cost (286-260)	<u>26.00</u>
(iii) Difference [(i- ii)]	<u>4.00</u>
(2) Debtors' adjustment	
(i) Value of foreign exchange debtors at the closing exchange rate (\$35,000×39)	13.65
(ii) Value of foreign exchange debtors at the original exchange rate (\$35,000×35)	<u>12.25</u>
(iii) Difference [(i) – (ii)]	<u>1.40</u>
(3) Creditors' adjustment	
(i) Value of foreign exchange creditors at the closing exchange rate (\$60,000×39)	23.40
(ii) Value of foreign exchange creditors at the original exchange rate(\$60,000×33)	<u>19.80</u>
(iii) Difference [(i) – (ii)]	<u>3.60</u>

Question 5

The Balance Sheet of Domestic Ltd. as on 31st March, 2010 is as under:

(All figures are in lacs)

Liabilities	Rs.	Assets	Rs.
Equity Shares Rs.10 each	3,000	Goodwill	744
Reserves (including provision for taxation of Rs.300 lacs)	1,000	Premises and Land at cost	400
5% Debentures	2,000	Plant and Machinery	3,000
Secured Loans	200	Motor Vehicles	40
Sundry Creditors	300	(purchased on 1.10.09)	
Profit & Loss A/c		Raw materials at cost	920
Balance from previous B/S	Rs.32	Work-in-progress at cost	130
Profit for the year (After taxation)	Rs. <u>1,100</u>	Finished Goods at cost	180
		Book Debts	400
		Investment (meant for replacement of Plant and Machinery)	1,600
		Cash at Bank and Cash in hand	192

Financial Reporting

Discount on Debentures 10

Underwriting

Commission 16

7,6327,632

The resale value of Premises and Land is Rs.1,200 lacs and that of Plant and Machinery is Rs.2,400 lacs. Depreciation @ 20% is applicable to Motor Vehicles. Applicable depreciation on Premises and Land is 2%, and that on Plant and Machinery is 10%. Market value of the Investments is Rs.1,500 lacs. 10% of book debts is bad. In a similar company the market value of equity shares of the same denomination is Rs.25 per share and in such company dividend is consistently paid during last 5 years @ 20%. Contrary to this, Domestic Ltd. is having a marked upward or downward trend in the case of dividend payment.

Past 5 years' profits of the company were as under:

2004-05	Rs.67 lacs
2005-06	(-) Rs.1,305 lacs (loss)
2006-07	Rs.469 lacs
2007-08	Rs.546 lacs
2008-09	Rs.405 lacs

The unusual negative profitability of the company during 2005-06 was due to the lock out in the major manufacturing unit of the company which happened in the beginning of the second quarter of the year 2004-05 and continued till the last quarter of 2005-06.

Value the Goodwill of the Company on the basis of 4 years' purchase of the Super Profit. (Necessary assumption for adjustment of the Company's inconsistency in regard to the dividend payment may be made by the examinee).

Answer**1. Calculation of capital employed**

Present value of assets:	Rs. (in lacs)
Premises and land	1,200
Plant and machinery	2,400
Motor vehicles (book value less depreciation for ½ year)	36
Raw materials	920
Work-in-progress	130
Finished goods	180
Book debts (400 x 90%)	360
Investments	1,500
Cash at bank and in hand	<u>192</u>

Valuation

		6,918
Less: Liabilities:		
Provision for taxation	300	
5% Debentures	2,000	
Secured loans	200	
Sundry creditors	<u>300</u>	<u>2,800</u>
Total capital employed on 31.3.2010		<u>4,118</u>
2. Profit available for shareholders for the year 2009-10		
Profit for the year as per Balance Sheet		1,100
Less: Depreciation to be considered		
Premises and land	24*	
Plant & machinery	240*	
Motor vehicles	<u>4</u>	<u>268</u>
		832
Less: Bad debts		<u>40</u>
Profit for the year 2009-10		<u>792</u>
3. Average capital employed		
Total capital employed		4118
Less: $\frac{1}{2}$ of profit for the current year [Refer point 2]		<u>396</u>
Average capital employed		<u>3722</u>
		<i>Rs. (in lacs)</i>
4. Average profit to determine Future Maintainable Profits		
Profit for the year 2009-10	792	
Profit for the year 2008-09	405	
Profit for the year 2007-08	546	
Profit for the year 2006-07	<u>469</u>	
	2212 / 4	553
5. Calculation of General Expectation:		
Domestic Ltd. pays Rs.2 as dividend (20%) for each share of Rs.10.		
Market value of equity shares of the same denomination is Rs.25 which fetches dividend of 20%.		

* Depreciation on premises and land and plant and machinery have been provided on the basis of assumption that the same has not been provided for earlier.

Financial Reporting

Therefore, share of Rs.10 (Face value of shares of Domestic Ltd.) is expected to fetch $(20/25) \times 10 = 8\%$ return.

Since Domestic Ltd. is not having a stable record in payment of dividend, in its case the expectation may be assumed to be slightly higher, say 10%.

6. Calculation of super profit

Rs. (in lacs)

Future maintainable profit [See point 4]	553
Normal profit (10% of average capital employed as computed in point 3)	<u>372.2</u>
Super Profit	<u>180.8</u>

7. Valuation of Goodwill

Goodwill at 4 years' purchase of Super Profit	723.20
---	--------

Notes:

- (1) It is evident from the Balance Sheet that depreciation was not charged to Profit & Loss Account.
- (2) It is assumed that provision for taxation already made is sufficient.
- (3) While considering past profits for determining average profit, the years 2004-05 and 2005-06 have been left out, as during these years normal business was hampered.

Question 6

From the following particulars of three companies, ascertain the value of goodwill. Terms and conditions are as follows:

- (i) Assets are to be revalued.
- (ii) Goodwill is to be valued at four years' purchase of average super profits for three years. Such average is to be calculated after adjustment of depreciation at ten per cent on the amount of increase/decrease on revaluation of fixed assets. Income tax is to be ignored.
- (iii) Normal profit on capital employed is to be taken at 10 per cent, capital employed being considered on the basis of net revalued amounts of tangible assets.

The summarized Balance Sheets and relevant information are given below:

(Rs. in Lakhs)							
Liabilities	P Ltd.	Q Ltd.	R Ltd.	Assets	P Ltd.	Q Ltd.	R Ltd.
Equity shares of Rs.10 each	12.00	14.00	6.00	Goodwill	-	1.00	-
Reserves	2.00	1.00	2.00	Net tangible block	16.00	12.00	10.00
10 percent				Current assets	6.00	5.00	2.00

Valuation

debentures	4.00	-	2.00			
Trade and expenses creditors	4.00	3.00	2.00			
	22.00	18.00	12.00		22.00	18.00 12.00

	P Ltd.	Q Ltd.	R Ltd.
	Rs.	Rs.	Rs.
Revaluation of tangible block	20,00,000	10,00,000	12,00,000
Revaluation of current assets	7,00,000	2,80,000	1,60,000
Average annual profit for three years before charging debenture interest	3,60,000	2,88,000	1,56,000

Answer

Valuation of Goodwill

	P Ltd.	Q Ltd.	R Ltd.
	Rs.	Rs.	Rs.
Average annual profit after charging debenture interest	3,20,000	2,88,000	1,36,000
Less/Add : Depreciation on amount increased/decreased on revaluation	(-)40,000	+20,000	(-) 20,000
	2,80,000	3,08,000	1,16,000
Less: Normal profit at 10% on capital employed as calculated in working note	1,90,000	98,000	96,000
Super Profit	90,000	2,10,000	20,000
Goodwill valued at four years' purchase of super profits	3,60,000	8,40,000	80,000

Working Note:

Calculation of Capital Employed

	P Ltd.	Q Ltd.	R Ltd.
	Rs.	Rs.	Rs.
Tangible fixed assets	20,00,000	10,00,000	12,00,000
Current assets	7,00,000	2,80,000	1,60,000
	27,00,000	12,80,000	13,60,000
Less: Debentures and Creditors	8,00,000	3,00,000	4,00,000
	19,00,000	9,80,000	9,60,000

Financial Reporting

Valuation of Shares

Question 7

Write short Note on capital market information-P/E ratio, yield ratio and market value/book value of shares.

Answer

Capital market information-P/E ratio, yield ratio and market value/book value of shares: Frequently share prices data are punched with the accounting data to generate new set of information. These are (i) Price-Earning Ratio, (ii) Yield Ratio, (iii) Market Value/Book Value per share.

$$\text{Price - Earnings Ratio (P/E Ratio)} = \frac{\text{Average Share Price}}{\text{EPS}}$$

(Sometimes it is also calculated with reference to closing share price)

$$\text{P/E Ratio} = \frac{\text{Closing Share Price}}{\text{EPS}}$$

It indicates the pay back period to the investors or prospective investors. The P/E ratio can be interpreted on a comparison with the industry P/E. A low P/E in comparison to the Industry can indicate that there are prospects for growth in share price and hence could be an indicator to buy/hold the shares. A high P/E ratio in comparison to the Industry can be an indicator to sell the shares.

$$\text{Yield} = \frac{\text{Dividend}}{\text{Average Share Price}} \times 100$$

$$\text{or } \frac{\text{Dividend}}{\text{Closing Share Price}} \times 100$$

This ratio indicates return on investment; this may be on average investment or closing investment. Dividend (%) indicates return on paid up value of shares. But yield (%) is the indicator of true return in which share capital is taken at its market value.

$$\frac{\text{Market Value per share}}{\text{Book Value per share}} = \frac{\text{Average Share Price}}{\text{Net Worth/No. of Equity Shares}}$$

$$\text{or } \frac{\text{Closing Share Price}}{\text{Net Worth/No. of Equity Shares}}$$

This ratio indicates market response of the shareholders' investment. Undoubtedly, higher the ratio better is the shareholders' position in terms of return and capital gains.

Question 8

From the following data, compute the 'Net Assets' value of each category of equity shares of Smith Ltd.:

Shareholders funds

10,000 'A' Equity shares of Rs.100 each, fully paid

10,000 'B' Equity shares of Rs.100 each, Rs.80 paid

10,000 'C' Equity shares of Rs.100 each, Rs.50 paid

Retained Earnings Rs.9,00,000

Answer**(i) Computation of Net assets**

Worth of net assets is equal to shareholders' fund, i.e.

		Rs.
Paid up value of 'A' equity shares	10,000 x Rs.100	10,00,000
Paid up value of 'B' equity shares	10,000 x Rs. 80	8,00,000
Paid up value of 'C' equity shares	10,000 x Rs. 50	5,00,000
Retained earnings		<u>9,00,000</u>
Net assets		<u>32,00,000</u>

(ii) Net asset value of equity share of Rs.100 paid up

Notional calls of Rs. 20 and Rs.50 per share on 'B' and 'C' equity shares respectively will make all the 30,000 equity shares fully paid up at Rs. 100 each. In that case,

	Rs.
Net assets	32,00,000
Add: Notional calls (10,000 x Rs.20 + 10,000 x Rs.50)	<u>7,00,000</u>
	<u>39,00,000</u>

Value of each equity share of Rs.100 fully paid up = Rs. 39,00,000 / 30,000=Rs.130

(iii) Net asset values of each category of equity shares

	Rs.
Value of 'A' equity shares of Rs. 100 fully paid up	130
Value of 'B' equity shares of Rs. 100 each, out of which Rs. 80 paid up (130-20)	110
Value of 'C' Equity shares of Rs.100 each, out of which Rs. 50 paid up (130-50)	80

Financial Reporting

Alternatively value of an equity share may also be calculated as follows:

Total paid-up capital	Rs.
'A' equity shares (10,000XRrs.100)	10,00,000
'B' equity shares (10,000XRrs. 80)	8,00,000
'C' equity shares (10,000XRrs. 50)	<u>5,00,000</u>
	23,00,000
Retained earnings	<u>9,00,000</u>
Net assets value of all shares	<u>32,00,000</u>
Value per rupee of paid up capital = $\frac{\text{Net assets value of all shares}}{\text{Paid up capital}}$ =	$\frac{32,00,000}{23,00,000}$
	= Rs.1.391

Therefore,

Net assets value of Rs. 100 paid up share	Rs.1.391 x 100	Rs.139.10
Net assets value of Rs. 80 paid up share	Rs.1.391 x 80	Rs.111.28
Net assets value of Rs. 50 paid up share	Rs.1.391 x 50	Rs.69.55

Question 9

The Balance Sheet of RNR Limited as on 31.12.2009 is as follows :

Liabilities	(Rupees in Lakhs)	Assets	(Rupees in Lakhs)
1,00,000 equity shares of		Goodwill	5
Rs. 10 each fully paid	10	Fixed assets	15
1,00,000 equity shares of		Other tangible assets	5
Rs. 6 each, fully paid up	6	Intangible assets (market value)	3
Reserves and Surplus	4	Miscellaneous expenditure to	
Liabilities	<u>10</u>	the extent not written off	<u>2</u>
	<u>30</u>		<u>30</u>

Fixed assets are worth Rs. 24 lakhs. Other Tangible assets are revalued at Rs. 3 lakhs. The company is expected to settle the disputed bonus claim of Rs. 1 lakh not provided for in the accounts. Goodwill appearing in the Balance Sheet is purchased goodwill. It is considered reasonable to increase the value of goodwill by an amount equal to average of the book value and a valuation made at 3 years' purchase of average super-profit for the last 4 years.

After tax, profits and dividend rates were as follows:

Year	PAT (Rs. in Lakhs)	Dividend %
2006	3.0	11%
2007	3.5	12%
2008	4.0	13%
2009	4.1	14%

Normal expectation in the industry to which the company belongs is 10%.

Akbar holds 20,000 equity shares of Rs. 10 each fully paid and 10,000 equity shares of Rs. 6 each, fully paid up. He wants to sell away his holdings.

- (i) Determine the break-up value and market value of both kinds of shares.
- (ii) What should be the fair value of shares, if controlling interest is being sold?

Answer

$$(i) \text{ Break up value of Re. 1 of share capital} = \frac{\text{Rs. 28.98 lakhs}}{\text{Rs. 16.00 lakhs}} = \text{Rs. 1.81}$$

$$\text{Break up value of Rs. 10 paid up share} = 1.81 \times 10 = \text{Rs. 18.10}$$

$$\text{Break up value of Rs. 6 paid up share} = 1.81 \times 6 = \text{Rs. 10.86}$$

Market value of shares:

$$\text{Average dividend} = \left(\frac{11\% + 12\% + 13\% + 14\%}{4} \right) = 12.5\%$$

$$\text{Market value of Rs. 10 paid up share} = \frac{12.5\%}{10\%} \times 10 = \text{Rs. 12.50}$$

$$\text{Market value of Rs. 6 paid up share} = \frac{12.5\%}{10\%} \times 6 = \text{Rs. 7.50}$$

- (ii) Break up value of share will remain as before even if the controlling interest is being sold. But the market value of shares will be different as the controlling interest would enable the declaration of dividend upto the limit of disposable profit.

$$\frac{\text{Average Profit}^*}{\text{Paid up value of shares}} \times 100 = \frac{\text{Rs. 3.4 lakhs}}{\text{Rs. 16 lakhs}} \times 100 = 21.25\%$$

Financial Reporting

Market value of shares :

$$\text{For Rs. 10 paid up share} = \frac{21.25\%}{10\%} \times 10 = \text{Rs. 21.25}$$

$$\text{For Rs. 6 paid up share} = \frac{21.25\%}{10\%} \times 6 = \text{Rs. 12.75}$$

$$\text{Fair value of shares} = \frac{\text{Breakup value} + \text{Market value}}{2}$$

$$\text{Fair value of Rs. 10 paid up share} = \frac{18.10 + 21.25}{2} = \text{Rs. 19.68}$$

$$\text{Fair value of Rs. 6 paid up share} = \frac{10.86 + 12.75}{2} = \text{Rs. 11.81}$$

* (Transfer to reserves has been ignored)

Working Notes:

(Rs. in lakhs)

(a) Calculation of average capital employed

Fixed assets		24.00
Other tangible assets		3.00
Intangible assets		<u>3.00</u>
		30.00
Less: Liabilities	10	
Bonus	<u>1</u>	<u>11.00</u>
		19.00
Less: $\frac{1}{2}$ of profits [$\frac{1}{2}$ (4.1 – Bonus 1.0)]		<u>1.55</u>
Average capital employed		<u>17.45</u>

(b) Calculation of super profit

Average profit = $\frac{1}{4}$ (3 + 3.5 + 4 + 4.1 – Bonus 1.0)	
= $\frac{1}{4} \times 13.6$	3.400
Less: Normal profit = 10 % of Rs. 17.45 lakh	<u>1.745</u>
Super profit	<u>1.655</u>

(c) Calculation of goodwill

3 Years' purchase of average super-profit = $3 \times 1.655 = \text{Rs. 4.965 lakhs}$

Increase in value of goodwill	= $\frac{1}{2}$ (book value + 3 years' super profit)	
	= $\frac{1}{2}$ (5 + 4.965)	
	= Rs. 4.9825 lakhs	
Net assets as revalued including book value of goodwill		24.00
Add: Increase in goodwill (rounded-off)		<u>4.98</u>
Net assets available for shareholders		<u>28.98</u>

Note: In the above solution, tax effect of disputed bonus and corporate dividend tax has been ignored.

Question 10

The following is the Balance Sheet of N Ltd. as on 31st March, 2010:

Balance Sheet

Liabilities	Rs.	Assets	Rs.
4,00,000 Equity shares of Rs. 10 each fully paid	40,00,000	Goodwill	4,00,000
13.5% Redeemable preference shares of Rs. 100 each fully paid	20,00,000	Building	24,00,000
General Reserve	16,00,000	Machinery	22,00,000
Profit and Loss Account	3,20,000	Furniture	10,00,000
Bank Loan (Secured against fixed assets)	12,00,000	Vehicles	18,00,000
Bills Payable	6,00,000	Investments	16,00,000
Creditors	31,00,000	Stock	11,00,000
		Debtors	18,00,000
		Bank Balance	3,20,000
		Preliminary Expenses	<u>2,00,000</u>
	<u>1,28,20,000</u>		<u>1,28,20,000</u>

Further information:

- Return on capital employed is 20% in similar businesses.
- Fixed assets are worth 30% more than book value. Stock is overvalued by Rs. 1,00,000, Debtors are to be reduced by Rs. 20,000. Trade investments, which constitute 10% of the total investments are to be valued at 10% below cost.
- Trade investments were purchased on 1.4.2009. 50% of non-Trade Investments were purchased on 1.4.2008 and the rest on 1.4.2009. Non-Trade Investments yielded 15% return on cost.

Financial Reporting

- (iv) In 2007-2008 new machinery costing Rs. 2,00,000 was purchased, but wrongly charged to revenue. This amount should be adjusted taking depreciation at 10% on reducing value method.
- (v) In 2008-2009 furniture with a book value of Rs. 1,00,000 was sold for Rs. 60,000.
- (vi) For calculating goodwill two years purchase of super profits based on simple average profits of last four years are to be considered. Profits of last four years are as under:
 2006-2007 Rs. 16,00,000, 2007-2008 Rs. 18,00,000, 2008-2009 Rs. 21,00,000, 2009-2010 Rs. 22,00,000.
- (vii) Additional depreciation provision at the rate of 10% on the additional value of Plant and Machinery alone may be considered for arriving at average profit.

Find out the intrinsic value of the equity share. Income-tax and Dividend tax are not to be considered.

Answer

Calculation of intrinsic value of equity shares of N Ltd.

1. Calculation of Goodwill*(i) Capital employed*

<i>Fixed Assets</i>	<i>Rs.</i>	<i>Rs.</i>
Building	24,00,000	
Machinery (Rs. 22,00,000 + Rs. 1,45,800)	23,45,800	
Furniture	10,00,000	
Vehicles	<u>18,00,000</u>	
	75,45,800	
Add: 30% increase	<u>22,63,740</u>	
	98,09,540	
Trade investments (Rs.16,00,000 × 10% × 90%)	1,44,000	
Debtors (Rs. 18,00,000 – Rs. 20,000)	17,80,000	
Stock (Rs. 11,00,000 – Rs. 1,00,000)	10,00,000	
Bank balance	<u>3,20,000</u>	1,30,53,540
Less: Outside liabilities		
Bank Loan	12,00,000	
Bills payable	6,00,000	
Creditors	<u>31,00,000</u>	<u>49,00,000</u>
Capital employed		<u>81,53,540</u>

(ii) Future maintainable profit

Calculation of average profit

	2006-2007	2007-2008	2008-2009	2009-2010
	Rs.	Rs.	Rs.	Rs.
Profit given	16,00,000	18,00,000	21,00,000	22,00,000
Add: Capital expenditure of machinery charged to revenue		2,00,000		
Loss on sale of furniture			40,000	
	16,00,000	20,00,000	21,40,000	22,00,000
Less: Depreciation on machinery		20,000	18,000	16,200
Income from non-trade investments		1,08,000	2,16,000	2,16,000
Reduction in value of stock				1,00,000
Bad debts				20,000
Adjusted profit	<u>16,00,000</u>	<u>18,72,000</u>	<u>19,06,000</u>	<u>18,47,800</u>
				Rs.
Total adjusted profit for four years (2006-2007 to 2009-2010)				72,25,800
Average profit (Rs. 72,25,800/4)				18,06,450
Less: Depreciation at 10% on additional value of machinery (22,00,000 + 1,45,800) × 30/100 i.e. Rs. 7,03,740				<u>70,374</u>
Adjusted average profit				<u>17,36,076</u>

(iii) Normal Profit

20% on capital employed i.e. 20% on Rs. 81,53,540 Rs.16,30,708

(iv) Super profit

Expected profit – normal profit

Rs. 17,36,076 – Rs. 16,30,708 = Rs. 1,05,368

(v) Goodwill

2 years' purchase of super profit

Rs. 1,05,368 × 2 = Rs. 2,10,736

Financial Reporting

2. Net assets available to equity shareholders

	Rs.	Rs.
Goodwill as calculated in 1(v) above		2,10,736
Sundry fixed assets		98,09,540
Trade and Non-trade investments		15,84,000
Debtors		17,80,000
Stock		10,00,000
Bank balance		<u>3,20,000</u>
		1,47,04,276
Less: Outside liabilities		
Bank loan	12,00,000	
Bills payable	6,00,000	
Creditors	<u>31,00,000</u>	49,00,000
Preference share capital		<u>20,00,000</u>
Net assets for equity shareholders		<u>78,04,276</u>

3. Valuation of equity shares

$$\begin{aligned}
 \text{Value of equity share} &= \frac{\text{Net assets available to equity shareholders}}{\text{Number of equity shares}} \\
 &= \frac{\text{Rs. } 78,04,276}{4,00,000} \\
 &= \text{Rs. } 19.51
 \end{aligned}$$

Note:

1. Depreciation on the overall increased value of assets (worth 30% more than book value) has not been considered. Depreciation on the additional value of only plant and machinery has been considered taking depreciation at 10% on reducing value method while calculating average adjusted profit.
2. Loss on sale of furniture has been taken as non-recurring or extraordinary item.
3. It has been assumed that preference dividend has been paid till date.

Question 11

The Capital Structure of M/s XYZ Ltd., on 31st March, 2010 was as follows:

	Rs.
Equity Capital – 18,000 Shares of Rs. 100 each	18,00,000

Valuation

12% Preference Capital – 5,000 Shares of Rs. 100 each	5,00,000
12% Secured Debentures	5,00,000
Reserves	5,00,000
Profit earned before Interest and Taxes during the year	7,20,000
Tax Rate	40%

Generally the return on equity shares of this type of Industry is 15%.

Subject to:

- The profit after tax covers Fixed Interest and Fixed Dividends at least 4 times.
- The Debt Equity ratio is at least 2;
- Yield on shares is calculated at 60% of distributed profits and 10% of undistributed profits;

The Company has been paying regularly an Equity dividend of 15%.

The risk premium for Dividends is generally assumed at 1%.

Find out the value of Equity shares of the Company.

Answer

Calculation of profit after tax (PAT)	Rs.
Profit before interest & tax (PBIT)	7,20,000
Less: Debenture interest (Rs. 5,00,000 × 12/100)	<u>60,000</u>
Profit before tax (PBT)	6,60,000
Less: Tax @ 40%	<u>2,64,000</u>
Profit after tax (PAT)	3,96,000
Less: Preference dividend $\left(\text{Rs. } 5,00,000 \times \frac{12}{100} \right)$	60,000
Equity dividend $\left(\text{Rs. } 18,00,000 \times \frac{15}{100} \right)$	<u>2,70,000</u> <u>3,30,000</u>
Retained earnings (undistributed profit)	<u>66,000</u>

Calculation of Interest and Fixed Dividend Coverage

$$= \frac{\text{PAT} + \text{Debenture interest}}{\text{Debenture interest} + \text{Preference dividend}}$$

Financial Reporting

$$= \frac{\text{Rs. } 3,96,000 + 60,000}{\text{Rs. } 60,000 + 60,000}$$

$$= \frac{\text{Rs. } 4,56,000}{\text{Rs. } 1,20,000} = 3.8 \text{ times}$$

Calculation of Debt Equity Ratio

$$\text{Debt Equity Ratio} = \frac{\text{Debt (long term loans)}}{\text{Equity (shareholders' funds)}}$$

$$= \frac{\text{Debentures}}{\text{Preference share capital + Equity share capital + Reserves}}$$

$$= \frac{\text{Rs. } 5,00,000}{\text{Rs. } 5,00,000 + 18,00,000 + 5,00,000}$$

$$\text{Debt Equity Ratio} = \frac{\text{Rs. } 5,00,000}{\text{Rs. } 28,00,000} = .179$$

The ratio is less than the prescribed ratio.

Calculation of Yield on Equity Shares

Yield on equity shares is calculated at 60% of distributed profits and 10% of undistributed profits:

60% of distributed profits (60% of Rs. 2,70,000)	1,62,000
10% of undistributed profits (10% of Rs. 66,000)	<u>6,600</u>
	<u>1,68,600</u>

$$\text{Yields on equity shares} = \frac{\text{Yield on shares}}{\text{Equity share capital}} \times 100$$

$$= \frac{\text{Rs. } 1,68,600}{\text{Rs. } 18,00,000} \times 100$$

$$= 9.37\%$$

Calculation of Expected Yield on Equity Shares

Normal return expected	15%
Add: Risk premium for low interest and fixed dividend coverage (3.8 < 4)	1%*
Risk for debt equity ratio not required	<u>Nil**</u>
	<u>16%</u>

Value of an Equity Share

$$= \frac{\text{Actual yield}}{\text{Expected yield}} \times \text{Paid up value of a share}$$

$$= \frac{9.37}{16} \times 100 = \text{Rs. } 58.56$$

- * When interest and fixed dividend coverage is lower than the prescribed norm, the riskiness of equity investors is high. They should claim additional risk premium over and above the normal rate of return. Hence, the additional risk premium of 1% has been added.
- ** The debt equity ratio is lower than the prescribed ratio, that means outside funds (Debts) are lower as compared to shareholders' funds. Therefore, the risk is less for equity shareholders. Therefore, no risk premium is required to be added in this case.

Question 12

The following abridged Balance Sheet as at 31st March, 20110 pertains to Glorious Ltd.

Liabilities	Rs. in lakhs	Assets	Rs. in lakhs
Share Capital:		Goodwill, at cost	420
180 lakh Equity shares of Rs. 10 each, fully paid up	1,800	Other Fixed Assets	11,166
90 lakh Equity shares of Rs. 10 each, Rs. 8 paid up	720	Current Assets	2,910
150 lakh Equity shares of Rs. 5 each, fully paid-up	750	Loans and Advances	933
Reserves and Surplus	5,628	Miscellaneous Expenditure	171
Secured Loans	4,500		
Current Liabilities	1,242		
Provisions	<u>960</u>		
	<u>15,600</u>		<u>15,600</u>

You are required to calculate the following for each one of the three categories of equity shares appearing in the above mentioned Balance Sheet:

- Intrinsic value on the basis of book values of Assets and Liabilities including goodwill;
- Value per share on the basis of dividend yield.

Normal rate of dividend in the concerned industry is 15%, whereas Glorious Ltd. has been paying 20% dividend for the last four years and is expected to maintain it in the next few years; and

Financial Reporting

(iii) Value per share on the basis of EPS.

For the year ended 31st March, 2010 the company has earned Rs. 1,371 lakh as profit after tax, which can be considered to be normal for the company. Average EPS for a fully paid share of Rs. 10 of a Company in the same industry is Rs. 2.

Answer

(i) Intrinsic value on the basis of book values	Rs. in lakhs	Rs. in lakhs
Goodwill		420
Other Fixed Assets		11,166
Current Assets		2,910
Loans and Advances		<u>933</u>
		15,429
Less: Secured loans	4,500	
Current liabilities	1,242	
Provisions	<u>960</u>	<u>6,702</u>
		8,727
Add: Notional call on 90 lakhs equity shares @ Rs. 2 per share		<u>180</u>
		<u>8,907</u>

Equivalent number of equity shares of Rs. 10 each.

	Rs. in lakhs
Fully paid shares of Rs. 10 each	180
Partly-paid shares after notional call	90
Fully paid shares of Rs. 5 each, $\left[\frac{\text{Rs. 150 lakhs}}{\text{Rs. 10}} \times \text{Rs. 5} \right]$	<u>75</u>
	<u>345</u>

Value per equivalent share of Rs. 10 each = Rs. $\frac{8,907 \text{ lakhs}}{345 \text{ lakhs}}$ = Rs. 25.82

Hence, intrinsic values of each equity share are as follows:

Value of fully paid share of Rs. 10 = Rs. 25.82 per equity share.

Value of share of Rs. 10, Rs. 8 paid-up = Rs. 25.82 – Rs. 2 = Rs. 23.82 per equity share.

Value of fully paid share of Rs. 5 = $\frac{\text{Rs. 25.82}}{2}$ = Rs. 12.91 per equity share.

(ii) Valuation on dividend yield basis:

$$\text{Value of fully paid share of Rs. 10} = \frac{20}{15} \times \text{Rs. 10} = \text{Rs. 13.33}$$

$$\text{Value of share of Rs. 10, Rs. 8 paid-up} = \frac{20}{15} \times \text{Rs. 8} = \text{Rs. 10.67}$$

$$\text{Value of fully paid share of Rs. 5} = \frac{20}{15} \times 5 = \text{Rs. 6.67}$$

(iii) Valuation on the basis of EPS:

Profit after tax = Rs. 1,371 lakhs

Total share capital = Rs. (1,800 + 720 + 750) lakhs = Rs. 3,270 lakhs

$$\text{Earning per rupee of share capital} = \text{Rs. } \frac{1,371 \text{ lakhs}}{3,270 \text{ lakhs}} = \text{Re. 0.419}$$

$$\text{Earning per fully paid share of Rs. 10} = \text{Re. 0.419} \times 10 = \text{Rs. 4.19}$$

$$\text{Earning per share of Rs. 10 each, Rs. 8 paid-up} = \text{Re. 0.419} \times 8 = \text{Rs. 3.35}$$

$$\text{Earning per share of Rs. 5, fully paid-up} = \text{Re. 0.419} \times 5 = \text{Rs. 2.10}$$

$$\text{Value of fully paid share of Rs. 10} = \text{Rs. } \frac{4.19}{2} \times 10 = \text{Rs. 20.95}$$

$$\text{Value of share of Rs. 10, Rs. 8 paid-up} = \text{Rs. } \frac{3.35}{2} \times 10 = \text{Rs. 16.75}$$

$$\text{Value of fully paid share of Rs. 5} = \text{Rs. } \frac{2.10}{2} \times 10 = \text{Rs. 10.50}$$

Question 13

The directors of a public limited company are considering the acquisition of the entire share capital of an existing company X Ltd engaged in a line of business suited to them. The directors feel that acquisition of X will not create any further risk to their business interest.

The following is the Balance Sheet of X Ltd., as at 31st December, 2010:

Liabilities	Rs.	Assets	Rs.
Share Capital:		Fixed assets	6,00,000
4,000 equity shares of Rs.100 each		Current assets:	
fully paid-up	4,00,000	Stock	2,00,000
General reserve	3,00,000	Sundry debtors	3,40,000

Financial Reporting

Bank overdraft	2,40,000	Cash and bank balances	1,00,000
Sundry creditors	<u>3,00,000</u>		
	<u>12,40,000</u>		<u>12,40,000</u>

X's financial records for the past five years were as under:

	2010 Rs.	2009 Rs.	2008 Rs.	2007 Rs.	2006 Rs.
Profits	80,000	74,000	70,000	60,000	62,000
Extra ordinary item(s)	3,500	4,000	(6,000)	(8,000)	1,000
	83,500	78,000	64,000	52,000	61,000
Dividends	48,000	40,000	40,000	32,000	32,000
	35,500	38,000	24,000	20,000	29,000

Additional information:

(i) *There were no changes in the issued capital of X during this period.*

(ii) *The estimated values of X Ltd.'s assets on 31.12.2010 are:*

	Replacement cost Rs.	Realizable value Rs.
Fixed assets	8,00,000	5,40,000
Stock	3,00,000	3,20,000

(iii) *It is anticipated that 1% of the debtors may prove to be difficult to be realized.*

(iv) *The cost of capital to the acquiring company is 10%.*

(v) *The current return of an investment of the acquiring company is 10%. Quoted companies with similar businesses and activities as X have a P/E ratio approximating to 8, although these companies tend to be larger than X.*

Required:

Estimate the value of the total equity capital of X Ltd., on 31.12.2010 using each of the following bases:

- Balance sheet value*
- Replacement cost*
- Realizable value*
- P/E ratio model.*

Answer

		Rs.	Rs.
(a) Balance Sheet Value			
Capital		4,00,000	
Reserve		<u>3,00,000</u>	7,00,000
(b) Replacement cost value			
Capital		4,00,000	
Reserve		3,00,000	
Appreciation:			
Fixed assets	2,00,000		
Stock	<u>1,00,000</u>	<u>3,00,000</u>	10,00,000
(c) Realizable value			
Capital		4,00,000	
Reserve		3,00,000	
Appreciation in stock		1,20,000	
Depreciation in fixed assets		(60,000)	
Book debts (Bad)*		<u>(3,400)</u>	7,56,600
(d) P/E ratio model			

Comparable quoted companies have a P/E ratio of 8. X Ltd. is prima facie small company.

If a P/E ratio of 6 is adopted, the valuation will be $80,000 \times 6 = \text{Rs.} 4,80,000$

If a P/E ratio of 7 were to be adopted, the valuation will be $80,000 \times 7 = \text{Rs.} 5,60,000$

Question 14

P Limited is considering the acquisition of R Limited. The financial data at the time of acquisition being:

	<i>P Limited</i>	<i>R Limited</i>
<i>Net profit after tax (Rs. in lakhs)</i>	60	12
<i>Number of shares (lakhs)</i>	12	5

* It has been assumed that estimated bad debts would not be relevant for estimating values under bases (a) and (b).

Financial Reporting

Earning per share (Rs.)	5	2.40
Market price per share (Rs.)	150	48
Price earning ratio	30	20

It is expected that the net profit after tax of the two companies would continue to be Rs.72 lakhs even after the amalgamation.

Explain the effect on EPS of the merged company under each of the following situations:

(i) P Ltd. offers to pay Rs.60 per share to the shareholders of R Ltd.

(ii) P Ltd. offers to pay Rs.78 per share to the shareholders of R Ltd.

The amount in both cases is to be paid in the form of shares of P Ltd.

Answer

(i) In this case, P Ltd. offers to pay Rs.60 per share.

The share exchange ratio would be $\frac{60}{150} = 0.4$

It means, P Ltd. would give 0.4 shares for every one share of R Ltd. In other words, P Ltd. would give 2 shares for 5 shares of R Ltd.

The total number of shares to be issued by P Ltd. to R Ltd.

$$= 5,00,000 \times 0.4 = 2,00,000 \text{ shares}$$

or

$$5,00,000 \times \frac{2}{5} = 2,00,000 \text{ shares}$$

Total number of shares of P Ltd. after acquisition of R Ltd.

$$= 12,00,000 + 2,00,000 = 14,00,000 \text{ shares}$$

Calculation of E.P.S. of the amalgamated company

$$= \frac{\text{Total Net Profit after Interest and Tax}}{\text{Total Number of shares}}$$

$$= \frac{72,00,000}{14,00,000} = \text{Rs.5.14 per share}$$

After amalgamation, The EPS of P Ltd., will improve from Rs.5 to Rs.5.14 whereas EPS of former shareholders of R Ltd would reduce from present 2.40 per share to $5.14 \times 0.4 = \text{Rs.2.056}$ per share after merger.

- (ii) In this case, P Ltd. offers Rs.78 per share to the shareholders of R Ltd.

The Exchange Ratio would be $\frac{78}{150} = 0.52$ shares of P Ltd. for each share of R Ltd. In other words, P Ltd would give 52 shares for per 100 shares of R Ltd.

P Ltd would issue $5,00,000 \times 0.52 = 2,60,000$ shares to shareholders of R Ltd.

$$\text{E.P.S. of the Merged Company} = \frac{72,00,000}{12,00,000 + 2,60,000} = 4.93$$

After Merger, there is a dilution in the E.P.S., of P Ltd. from 5 to 4.93.

After Merger E.P.S. of former shareholders of R Ltd.

$$= 4.93 \times 0.52 = 2.56$$

There is a gain of Re. 0.16 in E.P.S. of merged company in comparison to E.P.S. of R Ltd. of Rs.2.40 before merger.

Comments:

Initial increase in and decrease in earnings per share are possible in both cases of Merger. Generally, the dilution in E.P.S. will occur wherever the Price Earnings ratio of acquired company calculated on the basis of price paid exceed the P/E ratio of acquired company and vice-versa.

In Situation (i) - The price offered by P Ltd. per share of R Ltd. is Rs.60 and E.P.S. of R Ltd. is 2.4, which would become the earnings of P Ltd. after merger.

Price Earning (P/E) Ratio of P Ltd. after merger = $\frac{60}{2.40} = 25$. It is lower than the P/E

Ratio of P Ltd. before merger i.e., 30, the E.P.S. of P Ltd. after merger increases to Rs.5.14.

In Situation (ii) - The price earnings (P/E) ratio offered for Merger is $\frac{78}{2.4} = 32.5$ which

is higher than P/E Ratio of P Ltd. before Merger. Hence, the E.P.S. of P Ltd after merger would get diluted.

Question 15

The following is the Balance Sheet (as at 31st December, 2009) of Sun Ltd.:

Liabilities		Assets	
		Rs.	Rs.
Share Capital:		Fixed Assets:	
80,000 Equity shares of Rs.10		8,00,000 Goodwill	1,00,000
each fully paid up			

Financial Reporting

50,000 Equity shares of Rs.10 each Rs.8 paid up	4,00,000	Plant and Machinery	8,00,000
36,000 Equity shares of Rs.5 each fully paid up	1,80,000	Land and Building	10,00,000
30,000 Equity shares of Rs.5 each Rs.4 paid-up	1,20,000	Furniture and Fixtures	1,00,000
3,000 10% Preference shares of Rs.100 each fully paid	3,00,000	Vehicles	2,00,000
Reserve and Surplus:		Investments	3,00,000
General reserve	1,40,000	Current Assets:	
Profit and Loss account	2,10,000	Stock	2,10,000
Secured Loan: 12% Debenture	2,00,000	Debtors	1,95,000
Unsecured Loan: 15% Term loan	1,50,000	Prepaid Expenses	40,000
Deposits	1,00,000	Advances	45,000
Current Liabilities:		Cash and Bank balance	2,00,000
Bank Loan	50,000	Preliminary Expenses	10,000
Creditors	1,50,000		
Outstanding expenses	20,000		
Provision for tax	2,00,000		
Proposed Dividend:			
Equity	1,50,000		
Preference	30,000		
	<u>32,00,000</u>		<u>32,00,000</u>

Additional Information:

- (1) In 2007 a new machinery costing Rs.50,000 was purchased, but wrongly charged to revenue (no rectification has yet been made for the same).
- (2) Stock is overvalued by Rs.10,000 in 2008. Debtors are to be reduced by Rs.5,000 in 2009, some old furniture (Book value Rs.10,000) was disposed of for Rs.6,000.
- (3) Fixed assets are worth 5 per cent more than their actual book value. Depreciation on appreciated value of fixed assets except machinery is not to be considered for valuation of goodwill.
- (4) Of the investment 20 per cent is trading and the balance is non-trading. All trade investments are to be valued at 20 per cent below cost. Trade investment were purchased on 1st January, 2009. 50 percent of the non-trade investments were

acquired on 1st January, 2008 and the rest on 1st January, 2007. A uniform rate of dividend of 10 percent is earned on all investments.

- (5) Expected increase in expenditure without commensurate increase in selling price is Rs.20,000.
- (6) Research and Development expenses anticipated in future Rs.30,000 per annum.
- (7) In a similar business a normal return on capital employed is 10%.
- (8) Profit (after tax) are as follows:
In 2007 – Rs.2,10,000, in 2008 – Rs.1,90,000 and in 2009 – Rs.2,00,000.
- (9) Current income tax rate is 50%, expected income tax rate will be 40%.

From the above, ascertain the ex-dividend and cum-dividend intrinsic value for different categories of Equity shares. For this purpose goodwill may be taken as 3 years purchase of super profits. Depreciation is charged on machinery @ 10% on reducing system.

Answer

Computation of Value of Shares

	Rs.
Value of Net Assets (As computed for Goodwill)	21,02,073
Value of Goodwill [Refer W.N.3]	11,406
Non-trade investments	<u>2,40,000</u>
	23,53,479
Less: Preference Share Capital	3,00,000
Proposed Dividend of Preference shares	30,000
Proposed Dividend of Equity shares	<u>1,50,000</u>
Net Assets available for Equity Shareholders	<u>18,73,479</u>

Computation of Number of Equivalent Equity Shares:

Equity shares	No. of Equivalent Shares
80,000 shares + 50,000 shares = 1,30,000 shares of Rs.10 each	$1,30,000 \times \frac{10}{10}$ 1,30,000
36,000 shares + 30,000 shares = 66,000 shares of Rs.5 each	$66,000 \times \frac{5}{10}$ <u>33,000</u>
Total Equivalent Equity Shares of Rs.10 each	<u>1,63,000</u>

Financial Reporting

Calculation of Ex-Dividend intrinsic value of different categories of Equity Shares of Sun Ltd.

Net Assets available to deemed fully paid-up Equity Shareholders

= Net Assets as computed above + Notional Cash from partly paid-up shares

= Rs.18,73,479 + (50,000 x 2 + 30,000x1)

= Rs.18,73,479 + 1,00,000 + 30,000 = Rs.20,03,479

Computation of Ex-Dividend value per Equity Share

(i) Value of Rs.10 fully paid Equity Share = $\frac{20,03,479}{1,63,000}$ = Rs.12.29 per share (approx.)

(ii) Value of Rs.8 paid-up Equity Share = 12.29 - 2 = Rs.10.29 per share (approx.)

(iii) Value of Rs.5 fully paid-up Equity Share = $12.29 \times \frac{5}{10}$ = Rs.6.15 per share (approx.)

(iv) Value of Rs.4 paid-up Equity Share = 6.15 - 1 = Rs.5.15 per share (approx.)

Calculation of Cum-Dividend intrinsic value of different categories of Equity Shares of Sun Ltd.

Value of Net Assets (including proposed dividend on equity shares) = Rs.18,73,479 + 1,50,000
= Rs.20,23,479

Net assets (including dividend) available to deemed fully paid-up Equity Shareholders

= Net Assets as computed above + Notional Cash from partly paid-up shares

= Rs.20,23,479 + (50,000 x 2 + 30,000x1)

= Rs.20,23,479 + 1,00,000 + 30,000 = Rs.21,53,479

Computation of Cum-Dividend value per share*

(i) Value of Rs.10 fully paid Equity Share = $\frac{21,53,479}{1,63,000}$ = Rs.13.21 per share (approx.)

(ii) Value of Rs.8 paid-up Equity Share = 13.21 - 2 = Rs.11.21 per share (approx.)

(iii) Value of Rs.5 fully paid-up Equity Share = $13.21 \times \frac{5}{10}$ = Rs.6.605 per share (approx.)

(iv) Value of Rs.4 paid-up Equity Share = 6.605 - 1 = Rs.5.605 per share (approx.)

* **Note:** Candidates can also arrive at the cum-dividend value of shares by calculating the percentage of proposed dividend of equity shares to paid-up capital and adding that percentage of paid-up value of each share to ex-dividend value of equity shares.

Working Notes:**1. Calculation of Average Capital Employed**

	Rs.
Fixed Assets:	
Plant and Machinery (including Rs.36,450 for a Machine charged in 2007)	8,36,450
Land and Building	10,00,000
Furniture & Fixtures (1,00,000-4,000)	96,000
Vehicles	<u>2,00,000</u>
	21,32,450
Add: Appreciation @ 5%	<u>1,06,623</u>
	22,39,073
Trade Investment $\left(3,00,000 \times \frac{20}{100} \right) \times \frac{80}{100}$	48,000
Current Assets:	
Stock	2,10,000
Debtors (1,95,000-5,000)	1,90,000
Prepaid Expenses	40,000
Advances	45,000
Cash & Bank Balance	<u>2,00,000</u>
	29,72,073
Less: Outside Liabilities:	
12% Debentures	2,00,000
15% Term Loan	1,50,000
Deposits	1,00,000
Bank Loan	50,000
Creditors	1,50,000
Outstanding Expenses	20,000
Provision for Tax	<u>2,00,000</u>
	<u>8,70,000</u>

Financial Reporting

Capital employed at the end of the year i.e. Net Assets 21,02,073

Less: $\frac{1}{2}$ of the current year's Accounting Profit after Tax:

Profit before Tax	3,80,950
Less: Tax 40%* of Rs.3,80,950	<u>1,52,380</u>
	<u>2,28,570</u>

50% of Rs.2,28,570 1,14,285

Average capital employed 19,87,788

2. Future Maintainable Profits

Statement of Average Profit

Particulars	2007 Rs.	2008 Rs.	2009 Rs.
Profit after Tax	2,10,000	1,90,000	2,00,000
Profit before Tax $\left(PAT \times \frac{1}{0.50} \right)$	4,20,000	3,80,000	4,00,000
Add: Capital expenditure charged to revenue	50,000	-	-
Less: Depreciation of the Machinery	(5,000)	(4,500)	(4,050)
Dividend on Non-Trade Investments	(12,000)	(24,000)	(24,000)
Over-valuation of closing stock	-	(10,000)	-
Add: Overvaluation of opening stock	-	-	10,000
Add: Loss on sale of furniture (Presumed to be extra ordinary items)	-	-	4,000
Less: Provision for debtors	<u> </u>	<u> </u>	<u>(5,000)</u>
	<u>4,53,000</u>	<u>3,41,500</u>	<u>3,80,950</u>
Total profit for the three years			11,75,450
Average Profit = $\frac{Rs.11,75,450}{3}$			3,91,817
Less: Depreciation @ 10% on increase in the value of machinery			

* Future tax rate has been considered.

$8,36,450 \times \frac{5}{100} \times \frac{10}{100} = \text{Rs.} 41,823 \times \frac{10}{100} \text{ i.e.,}$	4,182	
Expected increase in expenditure	20,000	
Annual R & D Expenses anticipated in future	<u>30,000</u>	<u>54,182</u>
Future Maintainable profit before tax		3,37,635
Less: Tax @ 40% of Rs.3,37,635		<u>1,35,054</u>
Future Maintainable Profit After Tax		<u>2,02,581</u>
3. Computation of Goodwill	Rs.	
Future Maintainable Profit After Tax	2,02,581	
Less: Normal Profit (10% of Rs.19,87,788)	<u>1,98,779</u>	
Super Profit	<u>3,802</u>	
Value of Goodwill = Super Profit x No. of years' purchase		
= Rs.3,802 x 3		11,406

Question 16

Following is the Balance Sheet of Rampal Limited as on 31st March, 2009:

Liabilities	Rs.	Assets	Rs.
1,00,000 equity shares of Rs.10 each	10,00,000	Goodwill	5,00,000
10,000, 12% preference shares of Rs.100 each	10,00,000	Buildings	15,00,000
General reserve	6,00,000	Plant	10,00,000
Profit and Loss account	4,00,000	Investment in 10% stock	4,80,000
15% debentures	10,00,000	Stock-in-trade	6,00,000
Creditors	8,00,000	Debtors	4,00,000
		Cash	1,00,000
		Preliminary expenses	2,20,000
	<u>48,00,000</u>		<u>48,00,000</u>

Additional information are given below:

- (a) Nominal value of investment is Rs.5,00,000 and its market value is Rs.5,20,000.
- (b) Following assets are revalued:

Financial Reporting

- | | | |
|-------|----------------|--------------|
| (i) | Building | Rs.32,00,000 |
| (ii) | Plant | Rs.18,00,000 |
| (iii) | Stock-in-trade | Rs.4,50,000 |
| (iv) | Debtors | Rs.3,60,000 |
- (c) Average profit before tax of the company is Rs.12,00,000 and 12.50% of the profit is transferred to general reserve, rate of taxation being 50%.
- (d) Normal dividend expected on equity shares is 8% while fair return on closing capital employed is 10%.
- (e) Goodwill may be valued at three year's purchase of super profits.
Ascertain the value of each equity share under fair value method.

Answer

1.	Capital Employed	Rs.	Rs.
	Assets:		
	Buildings		32,00,000
	Plant		18,00,000
	Stock		4,50,000
	Debtors		3,60,000
	Cash		1,00,000
			<u>59,10,000</u>
	Less: Liabilities:		
	Creditors	8,00,000	
	Debentures	<u>10,00,000</u>	18,00,000
	Capital Employed		<u>41,10,000</u>
2.	Actual Profit		
	Average Profit		12,00,000
	Less: Income from investment		50,000
			<u>11,50,000</u>
	Less: Income Tax @ 50%		<u>5,75,000</u>
	So, Actual Profit		<u>5,75,000</u>
3.	Profit for Equity Shareholders		
	Actual Profit		5,75,000
	Less: Transferred to reserve @ 12.50%		71,875
	Less: Preference Dividend		<u>1,20,000</u>
	Profit available to Equity Shareholders		<u>3,83,125</u>

4. **Normal Profit** = 10% of Capital Employed = Rs.41,10,000 ÷ 10 = Rs.4,11,000
5. **Super Profit** = Actual profit – Normal profit
= Rs.5,75,000 – 4,11,000 = Rs.1,64,000
6. **Goodwill** = Rs.1,64,000 × 3 = Rs.4,92,000
7. **Net Asset for equity shareholders** = Capital Employed + Goodwill + Investment
– Preference Capital
=Rs.(41,10,000+4,92,000+4,80,000- 10,00,000) = Rs.40,82,000/-
8. **Value Per Share (Intrinsic Value Method)** = Rs.40,82,000 ÷ 1,00,000 = Rs.40.82
9. **Yield Method** = $\frac{\text{Pr ofit for Equity Shareholder}}{\text{Equity Capital}} \times 100 = \frac{\text{Rs.3,83,125}}{10,00,000} \times 100 = 38.31\%$

Value per Share (Yield Method) = $\frac{\text{Expected Rate of Dividend}}{\text{Normal Rate of Dividend}} \times \text{Paid up value}$

 $= \frac{38.31}{8} \times 10 = \text{Rs.47.89}$
10. **Value of equity share under Fair Value Method**
(Intrinsic Value + Yield Value) divided by 2 = (40.82 + 47.89) divided by 2 =
Rs.44.36 (approx.)

Valuation of Business

Question 17

Timby Ltd. is in the business of making sports equipment. The Company operates from Thailand. To globalise its operations Timby has identified Fine Toys Ltd. an Indian Company, as a potential take over candidate. After due diligence of Fine Toys Ltd. the following information is available:

- (a) *Cash Flow Forecasts (Rs. in crore):*

Year	10	9	8	7	6	5	4	3	2	1
Fine Toys Ltd.	24	21	15	16	15	12	10	8	6	3
Timby Ltd.	108	70	55	60	52	44	32	30	20	16

- (b) *The net worth of Fine Toys Ltd. (in lakh Rs.) after considering certain adjustments suggested by the due diligence team reads as under:*

Tangible	750
Inventories	145
Receivables	75
	970

Financial Reporting

Less:

Creditors	165	
Bank Loans	250	(415)
Represented by equity shares of Rs. 1000 each		555

Talks for take over have crystalized on the following:

1. Timby Ltd. will not be able to use Machinery worth Rs.75 lakhs which will be disposed of by them subsequent to take over. The expected realization will be Rs.50 lakhs.
2. The inventories and receivables are agreed for takeover at values of Rs.100 and Rs.50 lakhs respectively which is the price they will realize on disposal.
3. The liabilities of Fine Toys Ltd. will be discharged in full on take over alongwith an employee settlement of Rs.90 lakhs for the employees who are not interested in continuing under the new management.
4. Timby Ltd. will invest a sum of Rs.150 lakhs for upgrading the Plant of Fine Toys Ltd. on takeover. A further sum of Rs.50 lakhs will also be incurred in the second year to revamp the machine shop floor of Fine Toys Ltd.
5. The Anticipated Cash Flows (in Rs. crore) post takeover are as follows:

Year	1	2	3	4	5	6	7	8	9	10
	18	24	36	44	60	80	96	100	140	200

You are required to advise the management the maximum price which they can pay per share of Fine Toys Ltd. if a discount factor of 20 per cent is considered appropriate.

Answer

Calculation of Maximum Price that can be quoted for take over of Fine Toys Ltd.

	Rs. in lakhs	Rs. in lakhs
Present (Discounted) value of incremental cash flows (Refer Working Note)		7,845.02
Add: Proceeds from disposal of fixed assets	50.00	
Proceeds from disposal of inventories	100.00	
Receipts from debtors	<u>50.00</u>	<u>200.00</u>
		8,045.02
Less: Settlement of creditors	165.00	
Bank Loans	250.00	

Valuation

Employee settlement	90.00	
Renovation of Plant	150.00	
Revamp of machine shop floor (Rs. 50 lakhs × 0.6944)*	<u>34.72</u>	<u>689.72</u>
Maximum value that can be offered		<u>7,355.30</u>
Maximum price per share of Fine Toys Ltd. (Rs.7,355.30 lakhs / 55,500shares) = Rs. 13,252.79		

Working Note:**Present Value of Incremental Cash Flows***(Rs. in lakhs)*

Year	Cash flow after takeover	Cash flows before takeover	Incremental Cash flows	Discount factor@20%	Discounted Cash flows
1	1,800	1600	200	0.8333	166.66
2	2,400	2000	400	0.6944	277.76
3	3,600	3000	600	0.5787	347.22
4	4,400	3200	1200	0.4823	578.76
5	6,000	4400	1600	0.4019	643.04
6	8,000	5200	2800	0.3349	937.72
7	9,600	6000	3600	0.2791	1,004.76
8	10,000	5500	4500	0.2326	1,046.70
9	14,000	7000	7000	0.1938	1,356.60
10	20,000	10800	9200	0.1615	<u>1,485.80</u>
					<u>7,845.02</u>

Question 18

The Balance Sheet of R Ltd. for the year ended on 31st March, 2006, 2007 and 2008 are as follows:

(Rs. in thousands)

Liabilities	31.3.2006	31.3.2007	31.3.2008
3,20,000 equity shares of Rs.10 each, fully paid	3,200	3,200	3,200
General reserve	2,400	2,800	3,200
Profit and Loss account	280	320	480
Creditors	1,200	1,600	2,000
	<u>7,080</u>	<u>7,920</u>	<u>8,800</u>

* Discount factor of year 2 @20% .

Financial Reporting**Assets**

Goodwill	2,000	1,600	1,200
Building and Machinery less, depreciation	2,800	3,200	3,200
Stock	2,000	2,400	2,800
Debtors	40	320	880
Bank balance	240	400	800
	<u>7,080</u>	<u>7,920</u>	<u>8,880</u>

Additional information:

(a) Actual valuations were as under

Building and machinery less, depreciation	3,600	4,000	4,400
Stock	2,400	2,800	3,200
Net profit (including opening balance after writing off depreciation, goodwill, tax provision and transferred to general reserve)	840	1,240	1,640

(b) Capital employed in the business at market value at the beginning of 2005-06 was Rs.73,20,000 which included the cost of goodwill. The normal annual return on average capital employed in the line of business engaged by R Ltd. is 12½% .

(c) The balance in the general reserve on 1st April, 2005 was Rs.20 lakhs.

(d) The goodwill shown on 31.3.2006 was purchased on 1.4.2005 for Rs.20 lakhs on which date the balance in the Profit and Loss account was Rs.2,40,000. Find out the average capital employed in each year.

(e) Goodwill is to be valued at 5 year's purchase of Super profit (Simple average method). Find out the total value of the business as on 31.3.2008.

Answer**Total value of business**

	Rs.
Total net Asset as on 31.3.2008	84,80,000
Less: Goodwill as per Balance Sheet	12,00,000
Add: Goodwill as calculated in Working Note 2	41,12,500
Value of Business	<u>113,92,500</u>

Working Notes:

1. Capital Employed at the end of each year

	31.3.2006 Rs.	31.3.2007 Rs.	31.3.2008 Rs.
Goodwill	20,00,000	16,00,000	12,00,000

Building and Machinery (Revaluation)	36,00,000	40,00,000	44,00,000
Stock (Revalued)	24,00,000	28,00,000	32,00,000
Debtors	40,000	3,20,000	8,80,000
Bank Balance	2,40,000	4,00,000	8,00,000
Total Assets	82,80,000	91,20,000	104,80,000
Less: Creditors	12,00,000	16,00,000	20,00,000
Closing Capital	70,80,000	75,20,000	84,80,000
Add: Opening Capital	73,20,000	70,80,000	75,20,000
Total	144,00,000	146,00,000	160,00,000
Average Capital	72,00,000	73,00,000	80,00,000

Since the goodwill has been purchased, it is taken as a part of Capital employed.

2. Valuation of Goodwill

(i) Future Maintainable Profit	31.3.2006	31.3.2007	31.3.2008
Net Profit as given	8,40,000	12,40,000	16,40,000
Less: Opening Balance	2,40,000	2,80,000	3,20,000
Adjustment for Valuation of Opening Stock	-	4,00,000	4,00,000
Add: Adjustment for Valuation of closing stock	4,00,000	4,00,000	4,00,000
Goodwill written off	-	4,00,000	4,00,000
Transferred to General Reserve	4,00,000	4,00,000	4,00,000
Future Maintainable Profit	14,00,000	17,60,000	21,20,000
Less: 12.50% Normal Return	9,00,000	9,12,500	10,00,000
(ii) Super Profit	5,00,000	8,47,500	11,20,000

(iii) **Average Super Profit** = Rs.(5,00,000 + 8,47,500+11,20,000) ÷ 3 = Rs.8,22,500

(iv) **Value of Goodwill** at five years' purchase= Rs.8,22,500 × 5 = Rs.41,12,500.

Financial Reporting

EXERCISES

Question 1

The Balance Sheets of X Ltd. are as follows:

	(Rs. in lakhs)	
	As at 31.3.2009	As at 31.3.2010
Liabilities		
Share Capital	1,000.0	1,000.0
General Reserve	800.0	850.0
Profit and Loss Account	120.0	175.0
Term Loans	370.0	330.0
Sundry Creditors	70.0	90.0
Provision for Tax	22.5	25.0
Proposed Dividend	<u>200.0</u>	<u>250.0</u>
	<u>2,582.5</u>	<u>2,720.0</u>
Assets		
Fixed Assets and Investments (Non-trade)	1,600.0	1,800.0
Stock	550.0	600.0
Debtors	340.0	220.0
Cash and Bank	<u>92.5</u>	<u>100.0</u>
	<u>2,582.5</u>	<u>2,720.0</u>

Other Information:

1. Current cost of fixed assets excluding non-trade investments on 31.3.2009 Rs. 2,200 lakhs and on 31.3.2010 Rs. 2,532.8 lakhs.
2. Current cost of stock on 31.3.2009 Rs. 670 lakhs and on 31.3.2010 Rs. 750 lakhs.
3. Non-trade investments in 10% government securities Rs. 490 lakhs.
4. Debtors include foreign exchange debtors amounting to \$ 70,000 recorded at the rate of \$ 1 = Rs. 17.50 but the closing exchange rate was \$ 1 = Rs. 21.50.
5. Creditors include foreign exchange creditors amounting to \$ 1,20,000 recorded at the rate of \$ 1 = Rs. 16.50 but the closing exchange rate was \$ 1 = Rs. 21.50.
6. Profit included Rs. 120 lakhs being government subsidy which is not likely to recur.
7. Rs. 247 lakhs being the last instalment of R and D cost were written off the profit and loss account. This expenditure is not likely to recur.
8. Tax rate during 2009-2010 was 50% effective future tax rate is estimated at 40%.
9. Normal rate of return is expected at 15%.

Based on the information furnished, Mr. Irail, a director contends that the company does not have any goodwill. Examine his contention.

[Answer: Capital employed as at 31.3.09 and 31.3.10 will be Rs. 2840 and Rs. 3,154.6 lakhs respectively; average capital employed Rs. 2,997.3 lakhs; Future maintainable profit Rs. 488.88 Lakhs; Goodwill Rs. 39.28 lakhs]

Question 2

Capital structure of Lot Ltd. as at 31.3.2010 as under:

	(Rs. in lakhs)
Equity share capital	10
10% preference share capital	5
15% debentures	8
Reserves	4

Lot Ltd. earns a profits of Rs. 5 lakhs annually on an average before deduction of interest on debentures and income tax which works out to 40%.

Normal return on equity shares of companies similarly placed is 12% provided:

- (a) Profit after tax covers fixed interest and fixed dividends at least 3 times.
- (b) Capital gearing ratio is .75.
- (c) Yield on share is calculated at 50% of profits distributed and at 5% on undistributed profits.

Lot Ltd. has been regularly paying equity dividend of 10%.

Compute the value per equity share of the company considering the paid up value of Rs. 100 per share.

[Answer: Profit for calculation of interest and fixed dividend coverage Rs. 3,48,000;

Calculation of interest and fixed dividend coverage:: $\frac{3,48,000}{1,70,000} = 2.05$ times ; **Capital**

gearing ratio: $\frac{13,00,000}{14,00,000} = 0.93$ (approximately); **Yield on equity shares**

$\frac{53,900}{10,00,000} \times 100 = 5.39\%$; **Expected yield of equity shares: 13.00; Value per equity**

share: $= \frac{5.39}{13.00} \times \text{Rs. } 100 = \text{Rs. } 41.46$]

Question 3

Write short notes on:

- (i) Difficulties in brand accounting
- (ii) Market value model of business valuation
- (iii) Cost approach of valuation

DEVELOPMENTS IN FINANCIAL REPORTING

BASIC CONCEPTS

VALUE ADDED STATEMENT

Value Added (VA) is the wealth; a reporting entity has been able to create through the collective effort of capital, management and employees. In economic terms, value added is the market price of the output of an enterprise less the price of the goods and services acquired by transfer from other firms. VA can provide a useful measure in gauging performance and activity of the reporting entity.

The conventional VA statement is divided into two parts – the first part shows how VA is arrived at and the second part shows the application of such VA.

Gross Value Added (GVA): GVA is arrived at by deducting from sales revenue the cost of all materials and services which were brought in from outside suppliers. Besides sales revenue, any direct income, investment income and extraordinary incomes or expenses are also included in calculation of GVA. Including these items the equation, we get

$$(\text{Sales revenue} + \text{Direct incomes}) - \text{Bought in cost of materials and services} + \text{Investment incomes} + \text{Extraordinary items} = \text{Retained profit} + \text{Depreciation} + \text{Wages} + \text{Interest} + \text{Tax} + \text{Dividend}$$

Net Value Added (NVA): NVA can be defined as GVA less depreciation.

The various advantages of the VA statement are:

- (a) Reporting on VA improves the attitude of employees towards their employing companies.
- (b) VA statement makes it easier for the company to introduce a productivity linked bonus scheme for employees based on VA.
- (c) VA based ratios (e.g. VA/Payroll, Taxation/VA, VA/Sales etc.) are useful diagnostic and predictive tools. Trends in VA ratios, comparisons with other companies and international comparisons may be useful. However, it may be noted that the VA ratios can be made more useful if the ratios are based on inflation adjusted VA data.
- (d) VA provides a very good measure of the size and importance of a company.
- (e) VA statement links a company's financial accounts to national income. A company's VA indicates the company's contribution to national income.

Financial Reporting

It is generally found that value addition is highest for service companies and lowest for a trading business.

ECONOMIC VALUE ADDED

EVA as a residual income measure of financial performance is simply the operating profit after tax less a charge for the capital, equity as well as debt, used in the business.

EVA helps to :

- Measure the financial performance.
- Take important managerial decisions.
- Equate managerial incentives with shareholder's interest.
- Improve financial & business literacy throughout the firm.

Cost of Capital

The term 'Cost of Capital' means the cost of long term funds of a company. It is the multiple of 'Capital Employed' and Weighted Average Rate of Cost of Debt Capital, Cost of Equity Capital and Cost of Preference Share Capital. This is why cost of capital is known as Weighted Average Cost of Capital (WACC). WACC is post tax. Capital Employed represents the total of Debt Capital, Equity Capital and Preference Share Capital.

Cost of Debt Capital

Cost of Debt Capital is the discount rate that equates the present value of after tax interest payment cash outflows to the current market value of the Debt Capital. Due to the tax-benefit on interest payment on debt capital, Cost of Debt is, generally, lower than the cost of Equity Capital,

Cost of Equity Capital

Cost of Equity Capital is the market expected rate of return. Equity capital and accumulated reserves and surpluses which are free to equity shareholders carry the same cost. Cost of Preference Capital is the discount rate that equates the present value of after tax interest payment cash outflows to the current market value of the Preference Share Capital.

Factors involved in calculating EVA:

$$\text{Cost of Debt } (K_d) = \frac{\text{Interest on Long Term Borrowings (1-Tax rate)}}{\text{Long Term Borrowings}} \times 100$$

$$\text{Cost of Preference Capital } (K_p) = \frac{\text{Preference Dividend}}{\text{Preference Share Capital}}$$

$$\text{Cost of Equity } (K_e) = \text{Risk free rate}(R_f) + \text{Beta} [\text{Market rate}(R_m) - \text{Risk free rate } (R_f)]$$

$$\text{Cost of Retained Earnings } (K_r)$$

Beta

Ungeared Beta = Industry Beta / [1 + (1–Tax Rate) (Industry Debt Equity Ratio)]

Gearred Beta = Ungeared Beta/[1 + (1 – tax rate) (Debt Equity Ratio)]

Equity Risk Premium = Market rate(R_m) – Risk free rate (R_f)

Market Rate of Return (R_m) =

Stock exchange index {at the end of the year – at the beginning of the year}

Stock exchange index at the beginning of the year.

Overall cost of capital =

$$K_d \times \frac{\text{Debt}}{\text{Total funds}} + K_p \times \frac{\text{PSC}}{\text{Total funds}} + K_e \times \frac{\text{Equity}}{\text{Total funds}}$$

Total Funds = Debt + Preference Capital + Equity Funds.

Capital Asset Pricing Model

Capital Asset Pricing Model (CAPM) is the most widely used method of calculating the Cost of Equity Capital. Under CAPM cost of Equity Capital is expressed as

Risk Free Rate + Specific Risk Premium = Risk Free Rate + Beta X Equity Risk Premium

= Risk Free Rate + Beta X (Market Rate - Risk Free Rate)

Specific Risk Premium is a multiple of Beta and Equity Risk Premium.

Beta

Beta is a relative measure of volatility that is determined by comparing the return on a share to the return on the stock market. In simple terms, the greater the volatility, the more risky the share and the higher the Beta. For the companies, which are not listed in stock exchanges, beta of the similar industry may be considered after transforming it to ungeared beta and then re-gearing it according to the debt equity ratio of the company. The formula for un-gearing and gearing beta is shown below.

Ungeared Beta = Industry Beta / [1 + (1–Tax Rate) (Industry Debt Equity Ratio)]

Gearred Beta = Ungeared Beta/[1 + (1 – tax rate) (Debt Equity Ratio)]

Financial Reporting

Equity Risk Premium

Equity Risk Premium is the excess return above the risk free rate that investors demand for holding risky securities. It is calculated as "Market rate of Return (MRR) minus Risk Free Rate". Market rate may be calculated from the movement of share market indices over a period of an economic cycle basing on moving average to smooth out abnormalities. Many of them do not calculate the MRR but on an ad-hoc basis they assume 8% to 12% as the equity risk premium.

MARKET VALUE ADDED

Market Value Added (MVA) is the difference between the current market value of a firm and the capital contributed by investors. If MVA is positive, the firm has added value. If it is negative the firm has destroyed value.

To find out whether management has created or destroyed value since its inception, the firm's MVA can be used:

$$\text{MVA} = \text{Market Value of Capital} - \text{Capital employed}$$

SHAREHOLDERS' VALUE ADDED

Shareholders' Value Added is a value-based performance measure of a company's worth to shareholders. The basic calculation is net operating profit after tax (NOPAT) minus the cost of capital from the issuance of debt and equity, based on the company's weighted average cost of capital (WACC).

HUMAN RESOURCE REPORTING

Human resource reporting is an attempt to identify, quantify and report investments made in human resources of an organisation that are not presently accounted for under conventional accounting practice. However "human resources" are not yet recognised as 'assets' in the balance sheet.

INFLATION ACCOUNTING

Inflation accounting is an accounting system that adjusts values for changes in purchasing power. It is an attempt to account for the price-level changes and adjust the financial statements accordingly. There are two ways in which the financial statements may be so adjusted:

- I. Historical cost based accounts may be restated in terms of current purchasing power of rupee. This method may be called "Accounting For Current Purchasing Power of Rupee" (ACPP).
- II. Historical cost based accounts may be restated in terms of current costs adjusting changes in the prices of specific assets. This method may be called "Current Cost Accounting" (CCA).

Current Purchasing Power Method

Under this method any established and approved general price index is used to convert the values of various items in the balance-sheet and the profit and loss account. In India, we may take a general price index like the Wholesale Price Index of the Reserve Bank of India which would show the changes in the value of the rupee in the past years.

In converting the figures in the basic historical cost accounts into those in the supplementary current purchasing power statement a distinction is drawn between:

- (a) monetary items; and
- (b) non-monetary items.

In converting from basic historical cost accounts to supplementary current purchasing power statements for any particular period:

- (a) monetary items in the balance sheet at the end of the period remain the same;
- (b) non-monetary items are increased in proportion to the inflation that has occurred since their acquisition or revaluation (and conversely, reduced in times of deflation)

In the conversion process, after increasing non-monetary items by the amount of inflation, it is necessary to apply the test of lower of cost (expressed in rupees of current purchasing power) and net realizable value to relevant current assets, e.g., stocks, and further to adjust the figures if necessary. Similarly, after restating fixed assets in terms of pounds of current purchasing power, the question of the value of the business needs to be reviewed in that context and provision made if necessary.

CURRENT COST ACCOUNTING

This system takes into account price changes relevant to the particular firm or industry rather than the economy as a whole. It seeks to arrive at a profit which can be safely distributed as dividend without impairing the operational capability of the firm. In addition to adjustments for depreciation and cost of sales, it deals with the working capital and also loans raised. The ambit is operation profit and operating capital employed.

Current cost accounting has the following important features:

- (a) Fixed assets are to be shown in the balance sheet at their value to the business and not at the lower of their original cost and realizable value.
- (b) Stocks are to be shown in the balance sheet at their value to the business and not at the lower of their original cost and realizable value.
- (c) Depreciation for the year is to be calculated on the current value of the relevant fixed assets.

Financial Reporting

- (d) The cost of stock consumed during the year is to be calculated on the value to the business of the stock at the date of consumption and not at the date of purchase.
- (e) The effects of the loss or gain from loans will be computed and set off against interest.

Realised holding Gain. It is the excess of the replacement cost of a non-monetary asset on the closing date over its historical cost. Such a gain is shown separately in the balance sheet as revaluation reserve and is not available for distribution as dividend but is utilised for increased replacement cost of the non-monetary asset.

Current Operating Profit. It is the excess of the sale proceeds of goods and services sold during a particular accounting period over the replacement cost of the goods or services sold on the dates the sales were effect.

For calculating current operating profit, following adjustments are to be made in the current cost accounting method:

- (a) Depreciation adjustment
- (b) Cost of sales adjustment (COSA)
- (c) Monetary working capital adjustment (MWCA)
- (d) Gearing adjustment.

Value Added, Economic Value Added, Market Value Added, Shareholders' Value Added

Question 1

What are the advantages of preparation of Value Added (VA) statements? Explain in brief.

Answer

Various advantages of preparation of Value Added (VA) Statements are as under:

1. Improves the attitude of employees -Reporting on VA improves the attitude of employees towards their employing companies. This is because the VA statement reflects a broader view of the company's objectives and responsibilities.
2. Productivity linked bonus -VA statement makes it easier for the company to introduce a productivity linked bonus scheme for employees based on VA. The employees may be given productivity bonus on the basis of VA / Payroll Ratio.
3. Ratio Analysis-VA based ratios (e.g. VA / Payroll, taxation / VA, VA / Sales etc.) are useful diagnostic and predictive tools. Trends in VA ratios, comparisons with other companies and international comparisons may be useful.

4. Reflect Corporate Significance-VA provides a very good measure of the size and importance of a company. To use sales figure or capital employed figures as a basis for company's rankings can cause distortion. This is because sales may be inflated by large bought-in expenses or a capital-intensive company with a few employees may appear to be more important than a highly skilled labour-intensive company.
5. Contribution to Economy-VA statement links a company's financial accounts to national income. A company's VA indicates the company's contribution to national income.
6. Strong Conceptual-VA statement is built on the basic conceptual foundations which are currently accepted in balance sheets and income statements. Concepts such as going concern, matching, consistency and substance over form are equally applicable to VA statement.

Question 2

Explain the concept of 'Economic value added' (EVA for short) and its uses.

Answer

Economic Value Added (EVA) for short, is primarily a benchmark to measure earnings efficiency. Though the term "Economic Profit" was very much there since the inception of "Economics", Stern Stewart & Co., of USA has got a registered Trade Mark for this by the name "EVA", an acronym for Economic Value Added. Its uses can be explained as:

- a) Measurement of financial performance -EVA as a residual income measure of financial performance, is simply the operating profit after tax less a charge for the capital, equity as well as debt, used in the business. EVA includes both profit and loss as well as balance sheet efficiency as well as the ROCE, or ROE.
- b) Impact on shareholders' wealth. -In addition, EVA is a management tool to focus managers on the impact of their decisions in increasing shareholders' wealth. These include both strategic decisions such as what investments to make, which businesses to exit, what financing structure is optimal; as well as operational decisions involving trade-offs between profit and asset efficiency such as whether to make in house or outsource, repair or replace a piece of equipment, whether to make short or long production runs etc.

Most importantly the real key to increasing shareholder wealth is to integrate the EVA framework in four key areas; to measure business performance; to guide managerial decision making; to align managerial incentives with shareholders' interests; and to improve the financial and business literacy throughout the organisation.

To better align managers interests with Shareholders – the EVA framework needs to be holistically applied in an integrated approach – simply measuring EVAs is not enough it must also become the basis of key management decisions as well as be linked to senior management's variable compensation.

Financial Reporting

Question 3

Write short note on Market value Added.

Answer

Market value added is the market value of capital employed in the firm less the book value of capital employed. Market value added is calculated by summing up the paid up value of equity and preference share capital, Retained earnings, long term and short term debts and subtracting this sum from the market value of equity and debt.

Market value added measures cumulatively the performance of corporate entity.

A High market value added means that the company has created substantial wealth for share holders. On the other hand negative MVA means that the value of management's actions and investments are less than the value of the capital contributed to the company by the capital market or that the wealth and value has been destroyed.

Question 4

From the following Profit and Loss Account of Kalyani Ltd., prepare a Gross Value Added Statement. Show also the reconciliation between Gross Value Added and Profit before Taxation.

Profit and Loss Account for the year ended 31st March, 2010

<i>Income</i>	<i>Notes</i>	<i>Amount</i>
		<i>(Rs. in lakhs) (Rs. in lakhs)</i>
Sales		206.42
Other Income		<u>10.20</u>
		216.62
<i>Expenditure</i>		
Production and Operational Expenses	1	166.57
Administration Expenses	2	6.12
Interest and Other Charges	3	8.00
Depreciation		<u>5.69</u>
Profit before Taxes		30.24
Provision for taxes		<u>3.00</u>
		27.24
Investment Allowance Reserve Written Back		0.46
Balance as per Last Balance Sheet		<u>1.35</u>
		<u>29.05</u>
Transferred to:		
General Reserve		24.30

Developments in Financial Reporting

Proposed Dividend	<u>3.00</u>	27.30
Surplus Carried to Balance Sheet		<u>1.75</u>
		<u>29.05</u>

Notes:

(1) Production and Operational Expenses	(Rs. in lakhs)
Increase in Stock	30.50
Consumption of Raw Materials	80.57
Consumption of Stores	5.30
Salaries, Wages, Bonus and Other Benefits	12.80
Cess and Local Taxes	3.20
Other Manufacturing Expenses	<u>34.20</u>
	<u>166.57</u>
(2) Administration expenses include inter-alia Audit fees of Rs. 1 lakh, Salaries and commission to directors Rs. 2.20 lakhs and Provision for doubtful debts Rs. 2.50 lakhs.	
(3) Interest and Other Charges:	(Rs. in lakhs)
On Fixed Loans from Financial Institutions	3.90
Debentures	1.80
On Working Capital Loans from Bank	<u>2.30</u>
	<u>8.00</u>

Answer

Kalyani Ltd.

Value Added Statement

for the year ended 31st March, 2010

	Rs. in lakhs	Rs. in lakhs	%
Sales		206.42	
Less: Cost of bought in material and services:			
Production and operational expenses	150.57		
Administration expenses	3.92		
Interest on working capital loans	<u>2.30</u>	<u>156.79</u>	
Value Added by manufacturing and trading activities		49.63	
Add: Other income		<u>10.20</u>	
Total Value Added		<u>59.83</u>	

Financial Reporting

Application of Value Added:

To Pay Employees:			
Salaries, Wages, Bonus and other benefits	12.80	21.39	
To Pay Directors:			
Salaries and Commission	2.20	3.68	
To Pay Government:			
Cess and Local Taxes	3.20		
Income Tax	<u>3.00</u>		
	6.20	10.36	
To Pay Providers of Capital:			
Interest on Debentures	1.80		
Interest on Fixed Loans	3.90		
Dividend	<u>3.00</u>		
	8.70	14.54	
To Provide for maintenance and Expansion of the company:			
Depreciation	5.69		
General Reserve (24.30 – 0.46)	23.84		
Retained profit (1.75 – 1.35)	<u>0.40</u>		
		<u>29.93</u>	<u>50.03</u>
		<u>59.83</u>	<u>100.00</u>

Reconciliation Between Total Value Added and Profit Before Taxation:

	(Rs. in lakhs)	(Rs. in lakhs)
Profit before tax		30.24
Add back:		
Depreciation	5.69	
Salaries, Wages, Bonus and other benefits	12.80	
Directors' Remuneration	2.20	
Cess and Local Taxes	3.20	
Interest on Debentures	1.80	
Interest on Fixed Loans	<u>3.90</u>	<u>29.59</u>
Total Value Added		<u>59.83</u>

Question 5

From the following Profit & Loss Account of Brightex Co. Ltd., prepare a gross value added statement for the year ended 31.12.2008:

Show also the reconciliation between gross value added and profit before taxation.

Profit and Loss Account for the year ended 31.12.2008

	Notes	(Rs.'000)	Rs.'000)
<i>Income:</i>			
Sales			6,240
Other Income			<u>55</u>
			6,295
<i>Expenditure:</i>			
Production and operational expenses	1	4,320	
Administration expenses (Factory)	2	180	
Interest & Other charges	3	624	
Depreciation		<u>16</u>	<u>5,140</u>
Profit before tax			1,155
Provision for tax			<u>55</u>
			1,100
Balance as per last Balance Sheet			<u>60</u>
			1,160
Transferred to fixed assets replacement reserve		400	
Dividend paid		<u>160</u>	
			<u>560</u>
Surplus carried to Balance Sheet			<u>600</u>

Notes:1. *Production & Operation expenses:*

Consumption of raw materials	3,210
Consumption of stores	40
Local tax	8
Salaries to administrative staff	620
Other manufacturing expenses	<u>442</u>
	<u>4,320</u>

Financial Reporting

2. *Administration expenses include salaries and commission to directors* 5
3. *Interest on other charges include:*
 - (a) *Interest on bank overdraft (Overdraft is of temporary nature)* 109
 - (b) *Fixed loan from I.C.I.C.I.* 51
 - (c) *Working capital loan from I.F.C.I.* 20
 - (d) *Excise duties amount to one-tenth of total value added by manufacturing and trading activities.*

Answer

Brightex Co. Ltd
Value Added Statement

For the year ended 31st December, 2008

	<i>Rs. in</i> <i>thousands</i>	<i>Rs. in</i> <i>thousands</i>	<i>%</i>
Sales		6,240	
Less: Cost of bought in material and services:			
Production and operational expenses			
(4,320 – 8 – 620)	3,692		
Administration expenses (180 – 5)	175		
Interest on bank overdraft	109		
Interest on working capital loan	20		
Excise duties (Refer to working note)	180		
Other/miscellaneous charges(444 – 180)	<u>264</u>	<u>4,440</u>	
Value added by manufacturing and trading activities		1,800	
Add: Other income		<u>55</u>	
Total Value Added		<u>1,855</u>	
Application of Value Added:			
To pay Employees :			
Salaries to Administrative staff		620	33.42
To pay Directors:			
Salaries and Commission		5	0.27

Developments in Financial Reporting

To Pay Government:

Local Tax	8		
Income Tax	<u>55</u>	63	3.40

To Pay Providers of Capital :

Interest on Fixed Loan	51		
Dividend	<u>160</u>	211	11.37

To provide For Maintenance and Expansion of the Company:

Depreciation	16		
Fixed Assets Replacement Reserve	400		
Retained Profit (600 - 60)	<u>540</u>	<u>956</u>	<u>51.54</u>
		<u>1,855</u>	<u>100.00</u>

Reconciliation between Total Value Added and Profit Before Taxation:

	<i>Rs. in thousands</i>	<i>Rs. in thousands</i>
Profit before Tax		1,155
<i>Add back:</i>		
Depreciation	16	
Salaries to Administrative Staff	620	
Director's Remuneration	5	
Interest on Fixed Loan	51	
Local Tax	<u>8</u>	<u>700</u>
Total Value Added		<u>1,855</u>

Working Note:

Calculation of Excise Duty

	<i>Rs. in thousands</i>
Interest and other charges	624
Less : Interest on bank overdraft	109
Interest on loan from ICICI	51
Interest on loan from IFCI	<u>20</u>
Excise duties and other/miscellaneous charges	<u>444</u>

Assuming that these miscellaneous charges have to be taken for arriving at Value Added

Financial Reporting

(In the first part of Value Added Statement), the excise duty will be computed as follows.

Let excise duty be x ; thus miscellaneous/ other charges = $444 - x$

Thus $x = 1/10 \times [6,240 - \{3692 + 175 + 109 + 20 + x + (444 - x)\}]$

$$= 1/10 \times [6240 - 4440] = 180$$

Other/ miscellaneous charges = $444 - 180 = 264$

The above solution is given accordingly.

However, if other/miscellaneous charges are taken as any type of application of Value Added.

(i.e, to be taken in the application part), then excise duty (x) will be computed as follows:

$$x = 1/10 \times [6240 - (3692 + 175 + 109 + 20 + x)]$$

$$x = 1/10 \times [2244 - x]$$

$$11x = 2244$$

$$x = 204$$

And thus total value added will be $2040 + 55$ (other income) = 2095

And accordingly, application part will be prepared, taking miscellaneous charges.

Rs('000) 240 [i.e, $444 - 204$] as the application of value added.

Question 6

On the basis of the following income statement pertaining to Brite Ltd., you are required to prepare:

- Gross value added statement; and
- Statement showing reconciliation of gross value added with Profit Before Taxation.

Profit and Loss Account of Brite Ltd. for the year ended 31st March, 2010

	Rs. in thousands	Rs. in thousands
Income		
Sales less returns		15,27,956
Dividends and interest		130
Miscellaneous income		<u>474</u>
	(A)	<u>15,28,560</u>

Developments in Financial Reporting

*Expenditure**Production and operational expenses:*

<i>Decreases in inventory of finished goods</i>	26,054	
<i>Consumption of raw materials</i>	7,40,821	
<i>Power and lighting</i>	1,20,030	
<i>Wages, salaries and bonus</i>	3,81,760	
<i>Staff welfare expenses</i>	26,240	
<i>Excise duty</i>	14,540	
<i>Other manufacturing expenses</i>	<u>32,565</u>	13,42,010

Administrative expenses:

<i>Directors' remuneration</i>	7,810	
<i>Other administrative expenses</i>	<u>32,640</u>	40,450

Interest on:

<i>9% Mortgage debentures</i>	14,400	
<i>Long-term loan from financial institution</i>	10,000	
<i>Bank overdraft</i>	<u>100</u>	24,500

<i>Depreciation on fixed assets</i>		<u>50,600</u>
-------------------------------------	--	---------------

(B)

14,57,560

<i>Profit before Taxation, (A) — (B)</i>		71,000
--	--	--------

<i>Provision for Income-tax @ 35.875%</i>		25,470
---	--	--------

<i>Profit after Taxation</i>		45,530
------------------------------	--	--------

<i>Balance of account as per last Balance Sheet</i>		<u>6,300</u>
---	--	--------------

51,830

Transferred to:

<i>General reserve 40% of Rs. 45,530</i>	18,212	
<i>Proposed dividend @ 22%</i>	22,000	
<i>Tax on distributed profits @ 12.81%</i>	<u>2,818</u>	43,030
<i>Surplus carried to Balance Sheet</i>		<u>8,800</u>

Financial Reporting

Answer

Brite Ltd.

Value Added Statement for the year ended 31st March, 2010

	<i>Rs. in thousands</i>	<i>Rs. in thousands</i>
Sales less returns		15,27,956
Less: Cost of bought in materials and services, as per working note	9,19,470	
Administrative expenses	32,640	
Interest on bank overdraft	<u>100</u>	<u>9,52,210</u>
Value added by manufacturing and trading activities		5,75,746
Add: Dividends and interest		130
Miscellaneous income		<u>474</u>
Total value added		<u>5,76,350</u>

Application of valued added

	<i>Rs. in thousands</i>	<i>Rs. in thousands</i>	<i>%</i>
To pay Employees:			
Wages, salaries and bonus	3,81,760		
Staff welfare expenses	<u>26,240</u>	4,08,000	70.79
To pay Directors:			
Directors' remuneration		7,810	1.36
To pay Government:			
Excise duty	14,540		
Income tax	25,470		
Tax on distributed profits	<u>2,818</u>	42,828	7.43
To pay providers of capital:			
Interest on 9% debentures	14,400		
Interest on long-term loan from financial institution	10,000		
Dividend to shareholders	<u>22,000</u>	46,400	8.05

Developments in Financial Reporting

To provide for maintenance and expansion of the company:

Depreciation on Fixed assets	50,600		
Transfer to General reserve	18,212		
Retained profit, Rs.(8,800-6,300)(in 000's)	<u>2,500</u>	<u>71,312</u>	<u>12.37</u>
		<u>5,76,350</u>	<u>100.00</u>

Statement showing reconciliation of Total value added with Profit before taxation

Rs. in thousands Rs. in thousands

Profit Before Taxation 71,000

Add back:

Wages, salaries and bonus	3,81,760	
Staff welfare expenses	26,240	
Excise duty	14,540	
Directors' remuneration	7,810	
Interest on 9% mortgage debentures	14,400	
Interest on long-term loan from financial institution	10,000	
Depreciation on fixed assets	<u>50,600</u>	<u>5,05,350</u>
Total Value Added		<u>5,76,350</u>

Working Note:

Calculation of cost of bought in materials and services:

Rs. in thousands

Decrease in inventory of finished goods	26,054
Consumption of raw materials	7,40,821
Power and lighting	1,20,030
Other manufacturing expenses	<u>32,565</u>
	<u>9,19,470</u>

Question 7

On the basis of the following Profit and Loss Account of Zed Limited and the supplementary information provided thereafter, prepare Gross Value Added Statement of the company for

Financial Reporting

the year ended 31st March, 2010. Also prepare another statement showing reconciliation of Gross Value Added with Profit before Taxation.

Profit and Loss Account of Zed Limited for the year ended 31st March, 2010.

	Amount (Rs. in lakhs)	Amount (Rs. in lakhs)
Income		
Sales		5,010
Other Income		<u>130</u>
		5,140
Expenditure		
Production and Operational Expenses	3,550	
Administrative Expenses	185	
Interest	235	
Depreciation	<u>370</u>	<u>4,340</u>
Profit before Taxation		800
Provision for Taxation		<u>280</u>
Profit after Taxation		520
Credit Balance as per last Balance Sheet		<u>40</u>
		<u>560</u>
Appropriations		
Transfer to General Reserve		100
Preference Dividend (Interim) paid		50
Proposed Preference Dividend (Final)		50
Proposed Equity Dividend		300
Balance carried to Balance Sheet		<u>60</u>
		<u>560</u>
Supplementary Information		
Production and Operational Expenses consist of:		
Raw Materials and Stores consumed		1,900

Developments in Financial Reporting

Wages, Salaries and Bonus	610
Local Taxes including Cess	220
Other Manufacturing Expenses	<u>820</u>
	<u>3,550</u>

Administrative Expenses consist of:

Salaries and Commission to Directors	60
Audit Fee	24
Provision for Bad and Doubtful Debts	20
Other Administrative Expenses	<u>81</u>
	<u>185</u>

Interest is on:

Loan from Bank for Working Capital	35
Debentures	<u>200</u>
	<u>235</u>

Answer

**Gross Value Added Statement of Zed Ltd.
for the year ended 31st March, 2010**

	<i>Rs. in lakhs</i>	<i>Rs. in lakhs</i>
Sales		5,010
Less: Cost of raw materials, stores and other services consumed	2,720	
Administrative expenses	125	
Interest on loan from bank for working capital	<u>35</u>	<u>2,880</u>
Value added by manufacturing and trading activities		2,130
Add: Other income		<u>130</u>
Total value added		<u>2,260</u>

Application of Value Added

	<i>Rs.in lakhs</i>	<i>Rs. in lakhs</i>	<i>%</i>
To pay employees			
Wages, salaries and bonus		610	26.99
To pay directors			
Salaries and commission to Directors		60	2.66

Financial Reporting

To	pay Government			
	Local taxes including cess	220		
	Income tax	<u>280</u>	500	22.12
To	pay providers of capital			
	Interest on debentures	200		
	Preference dividend	100		
	Equity dividend	<u>300</u>	600	26.55
To	provide for the maintenance and expansion of the company:			
	Depreciation	370		
	Transfer to general reserve	100		
	Retained profit Rs.(60 – 40) lakhs	<u>20</u>	<u>490</u>	<u>21.68</u>
			<u>2,260</u>	<u>100</u>

**Statement showing Reconciliation between
Gross Value Added with Profit before Taxation**

	<i>Rs. in lakhs</i>	<i>Rs. in lakhs</i>
Profit before taxation		800
<i>Add back:</i>		
Wages, salaries and bonus	610	
Salaries and commission to Directors	60	
Local taxes including cess	220	
Interest on debentures	200	
Depreciation	<u>370</u>	<u>1,460</u>
Gross Value Added		<u>2,260</u>

Question 8

Value Added Ltd. furnishes the following Profit and Loss A/c:

Profit and Loss A/c for the year ended 31st March, 2010

	<i>Notes</i>	<i>Rs.('000)</i>
<i>Income</i>		
<i>Turnover</i>	1	29,872
<i>Other Income</i>		<u>1,042</u>
		<u>30,914</u>

Developments in Financial Reporting

<i>Expenditure</i>		
<i>Operating expenses</i>	2	26,741
<i>Interest on 8% Debenture</i>		987
<i>Interest on Cash Credit</i>	3	151
<i>Excise duty</i>		<u>1,952</u>
		<u>29,831</u>
<i>Profit before depreciation</i>		1,083
<i>Less: Depreciation</i>		<u>342</u>
<i>Profit before tax</i>		741
<i>Provision for tax</i>	4	<u>376</u>
<i>Profit after tax</i>		365
<i>Less: Transfer to Fixed Assets Replacement Reserve</i>		<u>65</u>
		300
<i>Less: Dividend paid</i>		<u>125</u>
<i>Retained Profit</i>		<u>175</u>

Notes:

- (1) Turnover is based on invoice value and net of sales tax.
- (2) Salaries, wages and other employee benefits amounting to Rs.14,761 ('000) are included in operating expenses.
- (3) Cash Credit represents a temporary source of finance. It has not been considered as a part of capital.
- (4) Transfer of Rs.54 ('000) to the credit of deferred tax account is included in provision for tax.

Prepare value added statement for the year ended 31st March, 2010 and reconcile total value added with profit before taxation.

Answer

Value Added Ltd.

Value Added Statement for the year ended 31st March, 2010

	Rs.('000)	Rs.('000)	%
Turnover		29,872	
Less: Cost of bought in materials and services:			
Operating expenses (26,741 –14,761)	11,980		
Excise duty	1,952		

Financial Reporting

Interest on Cash Credit	<u>151</u>	<u>14,083</u>	
Value added by manufacturing and trading activities		15,789	
Add: Other income		<u>1,042</u>	
Total value added		<u>16,831</u>	
Application of value added:			
To Pay to employees:			
Salaries, wages and other employee benefits		14,761	87.70
To Pay to Government:			
Corporation tax (376 – 54)		322	1.91
To Pay to providers of capital:			
Interest on 8% Debentures	987		
Dividends	<u>125</u>	1,112	6.61
To Provide for maintenance and expansion of the company:			
Depreciation	342		
Fixed Assets Replacement Reserve	65		
Deferred Tax Account	54		
Retained Profit	<u>175</u>	<u>636</u>	<u>3.78</u>
		<u>16,831</u>	<u>100</u>

Note: Deferred tax account could alternatively be shown as an item 'To pay to government'.

Reconciliation between total value added and profit before taxation

	Rs.('000)	Rs.('000)
Profit before tax		741
Add back: Depreciation	342	
Wages, salaries and other benefits	14,761	
Debenture interest	<u>987</u>	<u>16,090</u>
Total Value Added		<u>16,831</u>

Question 9

From the following Profit and Loss account of New Mode Reporting Ltd., prepare a gross value added statement for the year ended 31st December, 2009. Show also the reconciliation between GVA and Profit before taxation:

Profit and Loss Account

	Rs.'000s	Rs.'000s
<i>Income</i>		
<i>Sales</i>	12,480	
<i>Other income</i>	<u>110</u>	12,590
<i>Expenditure</i>		
<i>Production and Operational expenditure</i>	8,640	
<i>Administrative expenses</i>	360	
<i>Interest and other charges</i>	1,248	
<i>Depreciation</i>	<u>32</u>	<u>10,280</u>
<i>Profit before tax</i>		2,310
<i>Less: Provision for tax</i>		<u>110</u>
<i>Profit after tax</i>		2,200
<i>Add: balance as per last Balance Sheet</i>		<u>120</u>
		2,320
<i>Less: Transfer to Fixed assets replacement Reserve</i>	800	
<i>Dividend paid</i>	<u>320</u>	<u>1,120</u>
<i>Surplus carried to Balance Sheet</i>		<u>1,200</u>

Additional information:

(i) *Production and Operational expenses consists of*

	Rs.
<i>Consumption of Raw materials</i>	64,20,000
<i>Consumption of Stores</i>	80,000
<i>Local tax</i>	16,000
<i>Salaries to Administrative staff</i>	12,40,000
<i>Other Manufacturing expenses</i>	8,84,000

Financial Reporting

- (ii) Administrative expenses include salaries and commission to directors – Rs.10,000
- (iii) Interest and other charges include-
- | | Rs. |
|--|----------|
| (a) Interest on bank overdraft
(overdraft is of temporary nature) | 2,18,000 |
| (b) Fixed loan from SIDBI | 1,02,000 |
| (c) Working capital loan from IFCI | 40,000 |
| (d) Excise duties | ? |
- (iv) Excise duties amount to one-tenth of total value added by manufacturing and trading activities.

Answer

(a) **New Mode Reporting Ltd.**

Value Added Statement

for the year ended 31st December, 2009

(Figures in Rs.'000)

Sales		12,480
Less: Cost of Materials and Services:		
Production and Operational Expenses (8,640–16-1,240)	7,384	
Administrative Expenses (360 – 10)	350	
Interest on Bank Overdraft	218	
Interest on Working Capital Loan	40	
Excise Duties (Refer to working note)	360	
Other/miscellaneous charges (888 – 360)	<u>528</u>	<u>8,880</u>
Value added by manufacturing and trading activities		3,600
Add: Other Income		<u>110</u>
Gross value added from operations		<u>3,710</u>

Application of Gross Value Added

	Rs. in '000	Rs.in'000	%
To Pay Employees:			
Salaries to Administrative Staff		1240	33.42

Developments in Financial Reporting

To	Pay Directors:			
	Salaries and Commission		10	0.27
To	Pay Government:			
	Local Taxes	16		
	Income Tax	<u>110</u>	126	3.40
To	Pay Providers of Capital:			
	Interest on Fixed Loan	102		
	Dividend	<u>320</u>	422	11.37
To	Provide for maintenance and expansion of the company:			
	depreciation	32		
	Fixed Assets Replacement Reserve	800		
	Retained Profit (1200 – 120)	<u>1080</u>	<u>1912</u>	<u>51.54</u>
			<u>3,710</u>	<u>100.00</u>

Reconciliation between Gross Value added and Profit Before Taxation

			<i>Rs.in'000</i>
Profit before Tax			2,310
Add Back:	Depreciation	32	
	Salaries to Administrative Staff	1,240	
	Directors' Salaries and Commission	10	
	Interest on Fixed Loan	102	
	Local Tax	<u>16</u>	<u>1,400</u>
Total value added			<u>3,710</u>

Working Note:

Calculation of excise duty	<i>Rs.'000</i>	<i>Rs.'000</i>
Interest and other charges		1,248
Less: Interest on bank overdraft	218	
Interest on SIDBI loan	102	
Interest on IFCI loan	<u>40</u>	<u>360</u>
Excise duty and other charges		<u>888</u>

Financial Reporting

Assuming that these other /miscellaneous charges will be deducted for arriving at the value added, the excise duty will be calculated as follows:-

Let Excise Duties be denoted by - E

Then, other charges = 888 - E

Excise duty are $\frac{1}{10}$ th of value added

Hence $E = \frac{1}{10} [12,480 - \{7,384 + 350 + 218 + 40 + E + (888 - E)\}]$

$= \frac{1}{10} [12,480 - 8,880]$

$= \frac{1}{10} \times 3,600 = 360$

Other/miscellaneous charge $888 - 360 = \text{Rs.}528$

The above solution has been given accordingly.

Alternatively, if other/miscellaneous charges are considered as application of value added (i.e., not deducted for deriving the value added), calculation of Excise Duties (E) will be as follows:

$E = \frac{1}{10} [12,480 - (7,384 + 350 + 218 + 40 + E)]$

$E = \frac{1}{10} \times (4,488 - E)$

$11E = 4,488$

$E = \text{Rs.}408$

And thus other/miscellaneous charges will be $\text{Rs.}888 - 408 = \text{Rs.}480$

Gross Value added in this case will be $\text{Rs. } 4,080 + 110 \text{ (Other income)} = \text{Rs.}4,190$

And accordingly, application part will be prepared after taking other/miscellaneous charges.

Question 10

Prepare a value added statement for the year ended on 31.3.2010 and reconciliation of total value added with profit before taxation, from the Profit and Loss Account of Futures Ltd. for the year ended on 31.3.2010:

	(Rs. in '000)
Income:	
Sales	24,400
Other Income	<u>508</u>
	<u>24,908</u>
Expenditure:	
Operating cost	21,250
Excise duty	1,110
Interest on Bank Overdraft	75
Interest on 9% Debenture	<u>1,200</u>
	<u>23,635</u>

Developments in Financial Reporting

	(Rs. in '000)
Profit before Depreciation	1,273
Depreciation	<u>405</u>
Profit before tax	868
Provision for tax	<u>320</u>
Profit after tax	548
Proposed Dividend	<u>48</u>
Retained Profit	<u>500</u>

The following additional Information are given :

- (i) Sales represents Net sales after adjusting Discounts, Returns and Sales tax.
- (ii) Operating cost includes Rs. 82,50,000 as wages, salaries and other benefits to Employees.
- (iii) Bank overdraft is temporary.

Answer**Value Added Statement of M/s Futures Ltd.**

		Rs. in 000
Sales		24,400
Less: Operating cost - Cost of bought in material & services (Rs. 21,250 – Rs. 8,250)	13,000	
Excise duty	1,110	
Interest on bank overdraft	<u>75</u>	<u>14,185</u>
Value added by trading and manufacturing activities		10,215
Add: Other income		<u>508</u>
Total value added		<u>10,723</u>

Application of value added

%

To pay Employees:

Wages, salaries and other benefits	8,250	76.94
To Pay Government : Corporate tax	320	2.98

To pay providers of capital:

Interest on 9% debentures	1,200	
Dividends	<u>48</u>	1,248 11.64

Financial Reporting

To Provide for maintenance and expansion of the company:

Depreciation	405		
Retained profit	<u>500</u>	<u>905</u>	<u>8.44</u>
		<u>10,723</u>	<u>100.00</u>
Reconciliation			
Profit before tax		868	
Depreciation		405	
Wages, salaries and other benefits		8,250	
Debenture interest		<u>1,200</u>	
		<u>10,723</u>	

Question 11

The following information is available of a concern; calculate E.V.A.:

<i>Debt capital 12%</i>	<i>Rs. 2,000 crores</i>
<i>Equity capital</i>	<i>Rs. 500 crores</i>
<i>Reserve and surplus</i>	<i>Rs. 7,500 crores</i>
<i>Capital employed</i>	<i>Rs. 10,000 crores</i>
<i>Risk-free rate</i>	<i>9%</i>
<i>Beta factor</i>	<i>1.05</i>
<i>Market rate of return</i>	<i>19%</i>
<i>Equity (market) risk premium</i>	<i>10%</i>
<i>Operating profit after tax</i>	<i>Rs.2,100 crores</i>
<i>Tax rate</i>	<i>30%</i>

Answer

E.V.A. = NOPAT – COCE

NOPAT = Net Operating Profit after Tax

COCE = Cost of Capital Employed

COCE = Weighted Average Cost Of Capital × Average Capital Employed

= WACC × Capital Employed

Debt Capital Rs.2,000 crores

Equity capital (500 + 7,500) = Rs.8,000 crores

Capital employed = 2,000+8,000 = Rs.10,000 crores

$$\text{Debt to capital employed} = \frac{2,000}{10,000} = 0.20$$

$$\text{Equity to Capital employed} = \frac{8,000}{10,000} = 0.80$$

Debt cost before Tax 12%

Less: Tax (30% of 12%) 3.6%

Debt cost after Tax 8.4%

According to Capital Asset Pricing Model (CAPM)

Cost of Equity Capital = Risk Free Rate + Beta × Equity Risk Premium

Or

$$= \text{Risk Free Rate} + \text{Beta} (\text{Market Rate} - \text{Risk Free Rate})$$

$$= 9 + 1.05 \times (19 - 9)$$

$$= 9 + 1.05 \times 10 = 19.5\%$$

WACC = Equity to CE × Cost of Equity capital + Debt to CE × Cost of debt

$$= 0.8 \times 19.5\% + 0.20 \times 8.40\%$$

$$= 15.60\% + 1.68\% = 17.28\%$$

COCE = WACC × Capital employed

$$= 17.28\% \times 10,000 \text{ crores} = 1728 \text{ crores}$$

E.V.A. = NOPAT – COCE

$$= \text{Rs. } 2,100 - \text{Rs. } 1,728 = \text{Rs. } 372 \text{ crores}$$

Question 12

Pilot Ltd. supplies the following information using which you are required to calculate the economic value added.

- Financial Leverage 1.4 times
- Capital (equity and debt)
 - Equity shares of 34,000 (number)
 - Rs.1,000 each
 - Accumulated profit Rs. 260 lakhs
 - 10 percent Debentures 80 lakhs (number)
 - of Rs.10 each
- Dividend expectations of equity shareholders 17.50%
- Prevailing Corporate Tax rate 30%

Financial Reporting

Answer

Computation of EVA*Rs. in lakhs*

Net profit after tax (Refer Working Note 1)	140
Add: Interest adjusted for tax effect ($800 \times 10\% \times .70$)	<u>56</u>
Return to Providers of Funds	196
Less: Cost of Capital (Refer Working Note 2)	<u>161</u>
Economic Value Added (EVA)	<u>35</u>

Working Notes:**1. Interest and Net Profit**

$$\text{Financial Leverage} = \frac{\text{Profit before Interest \& Taxes (PBIT)}}{\text{Profit before Tax (PBT)}}$$

Interest on Borrowings = Rs. 800,00,000 $\times$ 10% = Rs.80 lakhs

$$\text{Therefore, } 1.40 = \frac{\text{PBIT}}{\text{PBIT} - \text{Interest}}$$

$$1.40 = \frac{\text{PBIT}}{\text{PBIT} - 80}$$

$$1.40 (\text{PBIT} - 80) = \text{PBIT}$$

$$1.40 \text{ PBIT} - 112 = \text{PBIT}$$

$$1.40 (\text{PBIT} - \text{PBIT}) = 112$$

$$0.40 \text{ PBIT} = 112$$

$$\text{PBIT} = 112 / 0.40$$

$$\text{PBIT} = \text{Rs. 280 Lakhs}$$

$$\text{PBIT} = \text{Rs. 280 lakhs}$$

$$\text{PBT} = \text{PBIT} - \text{I} = 280 - 80 = \text{Rs. 200 lakhs}$$

$$\text{Tax (30\%)} = \text{Rs. 60 lakhs}$$

$$\text{Net profit after tax} = \text{Rs. 140 lakhs}$$

2. Cost of Capital*Rs.(in lakhs)*

Equity Shareholders' funds	600
10% Debenture holders' funds	<u>800</u>
Total	<u>1400</u>

Developments in Financial Reporting

$$\text{Weights assigned to Equity shareholders fund} = \frac{600}{1400} = 0.4286$$

$$\text{Weights assigned to Debenture holders} = \frac{800}{1400} = 0.5714$$

Source of Funds	Amount Rs.(in lakhs)	Weight	Cost %	WACC %
(1)	(2)	(3)	(4)	(5)=(3 × 4)%
Equity share holders' funds	600	0.4286	17.50	7.50
Debenture holders' funds	<u>800</u>	<u>0.5714</u>	<u>7.00*</u>	<u>4.00</u>
Total	<u>1400</u>	<u>1.0000</u>	<u>----</u>	<u>11.50</u>

Cost of Capital = Average Capital Employed × Weighted Average cost of Capital (WACC)

$$= \text{Rs.1400 lakhs} \times 11.50\% = \text{Rs.161 lakhs}$$

Human Resource Reporting

Question 13

Write short notes on:

- Jaggi and Lau model on valuation on group basis of Human Resources.
- Opportunity cost (HRA).
- Human Resource Accounting.

Answer

- (a) According to Jaggi and Lau Model, proper valuation of human resources is not possible unless the contributions of individuals as a group are taken into consideration. A group refers to homogeneous employees whether working in the same department or division of the organisation or not. An individual's expected service tenure in the organisation is difficult to predict but on a group basis it is relatively easy to estimate the percentage of people in a group likely to leave the organisation in future. This model attempted to calculate the present value of all existing employees in each rank. Such present value is measured with the help of the following steps:
- Ascertain the number of employees in each rank.
 - Estimate the probability that an employee will be in his rank within the organisation or terminated/promoted in the next period. This probability will be estimated for a specified time period.

* Rate of interest net of corporate tax of 30%.

Financial Reporting

- (iii) Ascertain the economic value of an employee in a specified rank during each time period.
- (iv) The present value of existing employees in each rank is obtained by multiplying the above three factors and applying an appropriate discount rate.

Jaggi and Lau simplified the process of measuring the value of human resources by considering a group of employees as valuation base. But in the process, they ignored the exceptional qualities of certain skilled employees. The performance of a group may be seriously affected in the event of exit of a single individual.

- (b) **Opportunity Cost:** It is one of the Economic value models used for measurement and valuation of Human assets. As per this model, opportunity cost is the value of an employee in his alternative use. This opportunity cost is used as a basis for estimating the value of Human resources. Opportunity cost value may be established by competitive bidding within the firm so that in effect, Managers must bid for any scarce employee. A Human asset will have a value only if it is a scarce resource, that is, when its employment in one division denies it to another division. This method excludes employees of the type of which can be readily hired from outside the firm. Also, it is in very rare cases that managers would like to bid for an employee.
- (c) Human Resource Accounting (HRA) is an attempt to identify, quantify and report investments made in human resources of an organization. Leading public sector units like OIL, BHEL, NTPC and SAIL etc. have started reporting human resources in their annual reports as additional information. Although human beings are considered as the prime mover for achieving productivity, and are placed above technology, equipment and money, the conventional accounting practice does not assign significance to the human resource. Human resources are not thus recognized as 'assets' in the Balance Sheet. While investments in human resources are not considered as assets and not amortised over the economic service life, the result is that the income and expenditure statement comprising current revenue and expenditure gives a distorted picture of the real affairs of the organization.

Accountants have been severely criticized by the Behavioural Scientists for their failure to value human resources, as this has come out as a handicap for effective management.

Human resource accounting provides scope for planning and decision making in relation to proper manpower planning. Also, such accounting can bring out the effect of various new rules, procedures and incentives relating to work force, and in turn, can act as an eye opener for modifications of existing statutes and laws.

Question 14

Briefly describe the method of valuation of human resources as suggested by Jaggi and Lau. Also point out the special merit and demerit of this method.

Answer

Jaggi and Lau suggested a model for valuation of human resources. According to them, proper valuation of human resources is not possible unless the contributions of individuals as a group are taken into consideration. A group refers to homogeneous employees whether working in the same department or division of the organization or not. An individual's expected service tenure in an organization is difficult to predict, but on a group basis, it is relatively easy to estimate the percentage of people in a group likely to leave the organization in future. This model attempts to calculate the present value of all existing employees in each rank. Such present value is measured with the help of the following steps:

- (i) Ascertain the number of employees in each rank.
- (ii) Estimate the probability that an employee will be in his rank within the organization on terminated/promoted in the next period. This probability will be estimated for a specified time-period.
- (iii) Ascertain the economic value of an employee in a specified rank during each time period.
- (iv) The present value of existing employees in each rank is obtained by multiplying the above three factors and applying an appropriate discount rate.

Jaggi and Lau tried to simplify the process of measuring the value of human resources by considering a group of employees as basis of valuation. But in the process they ignored the exceptional qualities of certain skilled employees. The performance of a group may be seriously affected in the event of exit of a single individual.

Merit

Jaggi and Lau model approached the valuation of human resources on the basis of grouping of employees. Under this method, calculations get simplified and the chances of errors get reduced.

Demerit

This model ignores individual skills of the employees. The varied skills of the employees is not recognized in the valuation process under Jaggi and Lau model.

Question 15

Briefly describe the progress made by India so far in the field of human resource accounting.

Financial Reporting

Answer

Human resource accounting can be defined as the process of identifying, measuring and communicating information about human resources in financial statements in order to facilitate effective management. Human resource accounting is a recent phenomenon in India. Leading public sector units like OIL, BHEL, NTPC, MMTC and SAIL etc. have started reporting Human Resources in their annual reports as additional information. The Indian Companies basically adopted the model of human resource valuation as advocated by Lev and Schwartz (1971). Indian Companies focused their attention on the present value of employee earning as a measure of their human capital. However the Indian Companies have suitably modified the Lev and Schwartz model to suit their individual circumstances.

Question 16

Give an account of the growing scope of human capital reporting.

Answer

Of late there is a growing trend of shift from the traditional focus on financial reporting of quantifiable resources (which can be measured in monetary terms) to a more comprehensive approach of reporting under which human resources are also considered as measurable assets. Having followed the methods of accounting of fixed assets, one can take into account the employee-related costs like cost of recruitment, training and orientation of employees, for the purpose of capitalization and then the appropriate portion thereof can be amortized each year over the estimated years of effect of such costs.

The relevance of human resource information lies in the fact that it concerns organizational changes in the firm's human resources. The ratio of human to non-human capital indicates the degree of labour intensity of an organization. Comparison of the specific values of human capital based on the organization's scales of wages and salaries with the general industry standards can be a good source of information to the management. There is no standard human capital reporting format as employment reporting is relatively a new form of reporting. Usually, the report inter alia contains data pertaining to employee numbers, employment and training policies, collective bargaining arrangements, industrial disputes, pension and pay arrangement and disabled employee numbers.

Human capital reporting provides scope for planning and decision-making in relation to proper manpower planning. Also, such reporting can bring out the effect of various rules, procedures and incentives relating to work force, and in turn, can act as an eye opener for modifications of existing statutes, laws and the like.

Question 17

A company has a capital base of Rs.1 crore and has earned profits to the tune of Rs.11 lakhs. The Return on Investment (ROI) of the particular industry to which the company

belongs is 12.5%. If the services of a particular executive are acquired by the company, it is expected that the profits will increase by Rs.2.5 lakhs over and above the target profit.

Determine the amount of maximum bid price for that particular executive and the maximum salary that could be offered to him.

Answer

Capital Base	=	Rs.1,00,00,000
Actual Profit	=	Rs. 11,00,000
Target Profit @ 12.5%	=	Rs. 12,50,000

Expected Profit on employing the particular executive

$$= \text{Rs.}12,50,000 + 2,50,000 = \text{Rs.}15,00,000$$

Additional Profit = Expected Profit – Actual Profit

$$= 15,00,000 - 11,00,000 = \text{Rs.}4,00,000$$

$$\text{Maximum bid price} = \frac{\text{Additional Profit}}{\text{Rate of Return on Investment}}$$

$$= \frac{4,00,000}{12.5} \times 100 = \text{Rs.}32,00,000$$

Maximum salary that can be offered = 12.5% of Rs.32,00,000 i.e., 4,00,000

Maximum salary can be offered to that particular executive upto the amount of additional profit i.e., Rs.4,00,000.

Question 18

From the following details, compute according to Lev and Schwartz (1971) model, the total value of human resources of the employee groups skilled and unskilled.

	Skilled	Unskilled
(i) Annual average earning of an employee till the retirement age	Rs.50,000	Rs.30,000
(ii) Age of retirement	65 years	62 years
(iii) Discount rate	15%	15%
(iv) No. of employees in the group	20	25
(v) Average age	62 years	60 years

Financial Reporting

Answer

According to Lev and Schwartz, the value of human capital embodied in a person of age t is the present value of his remaining future earnings from employment. Their valuation model for a discrete income stream is given by the following formula:

$$V = \sum_{t=\tau}^t \frac{I(t)}{(1+r)^{t-\tau}}$$

Where,

V = the human capital value of a person t years old.

$I(t)$ = the person's annual earnings up to retirement.

r = a discount rate specific to the person.

t = retirement age.

Value of skilled employees:

$$= \frac{50,000}{(1+0.15)^{(65-62)}} + \frac{50,000}{(1+0.15)^{(65-63)}} + \frac{50,000}{(1+0.15)^{(65-64)}}$$

Rs. 32,875.81 + Rs. 37,807.18 + Rs.43,478.26 = Rs.1, 14,161.25

Total value of skilled employees is Rs.1, 14,161.25 $\times$ 20 = Rs.22,83,225.

Value of unskilled employees

$$= \frac{30,000}{(1+0.15)^{(62-60)}} + \frac{30,000}{(1+0.15)^{(62-61)}}$$

$$= \frac{30,000}{(1+0.15)^2} + \frac{30,000}{(1+0.15)}$$

= 22,684.31 + 26,086.96 = 48,771.27

Total value of the unskilled employees = Rs. 48,771.27 $\times$ 25 = Rs.12,19,282

$\therefore$ Total value of human resources (skilled and unskilled) = Rs.22,83,225 + Rs.12,19,282
= Rs.35,02,507.

Inflation Accounting

Question 19

P Ltd. started its business on 01.04.2007, It issued one lac Equity Shares of Rs. 10 each at par and 30,000, 9% Debentures of Rs. 50 each, both were fully subscribed. It purchased Plant and Machinery for worth Rs. 15 Lac and goods for trading worth Rs. 12 lac @ Rs. 100 per unit. Estimated life of plant and machinery was 10 years with no scrap value. Goods

were sold at Profit of 40% on selling price. Collection from Debtors outstanding as on 31.3.2008 amounted to Rs. 5 lac. Goods sold were replaced at a cost of Rs. 120 per unit, the number of units being the same. Trade Creditors outstanding as on 31.3.2008 were Rs. 3 lac. The replaced goods were entirely in stock on 31.3.2008, replacement cost of goods was considered to be Rs. 140 per unit. Replacement cost of machine was Rs. 20 lac as on 31.3.2008. Draft Profit and Loss Account and Replacement reserve on replacement cost basis.

Answer**M/s P Ltd.****Profit & Loss Account as on 31.03.2008**

	Rs.
Sales	20,00,000
Less: Cost of sales (Refer W.N. 1)	<u>14,40,000</u>
Gross Profit	5,60,000
Less: Depreciation (Refer W.N. 2)	<u>1,75,000</u>
Profit before Interest	3,85,000
Less: Debenture Interest (Refer W.N. 3)	<u>1,35,000</u>
Profit after charging depreciation and interest	<u>2,50,000</u>

Replacement Reserve

	Realised Gain Rs.	Unrealised Gain Rs.
Stock:		
Sold (Rs. 14,40,000 – Rs. 12,00,000)	2,40,000	
Unsold goods 12,000 x (Rs. 140 – Rs. 120)		2,40,000
Plant & Machinery Depreciation (Rs. 1,75,000 – Rs.1,50,000)	25,000	
Book value of asset		
[(Rs.20,00,000- Rs.2,00,000) less (Rs.15,00,000-Rs.1,50,000)]	<u>2,65,000</u>	<u>4,50,000</u>
	<u>2,65,000</u>	<u>6,90,000</u>

Replacement Reserve = Rs. 2,65,000 +Rs. 6,90,000 = Rs. 9,55,000

Working Notes:**1. Sales and Cost of sales**

Sale Price @ 40% profit on Selling Price = Rs. 12,00,000 x (100/60) = Rs. 20,00,000

Cost of Sales = 12,000 x Rs. 120 = Rs. 14,40,000

Financial Reporting

2. Depreciation under replacement cost basis

Under replacement cost basis, depreciation is calculated (on average basis) which can be shown as follows:

$$\frac{15,00,000 + 20,00,000}{2} = 10\% \text{ of Rs. } 17,50,000 = \text{Rs. } 1,75,000$$

3. Debenture Interest

$$30,000 \times \text{Rs. } 50 \times 9\% = \text{Rs. } 1,35,000$$

Question 20

Rajkumar Ltd. is adopting historical cost system. From the following details furnished, prepare current cost Profit and Loss account for the year ended on 31.3.2009:

Statement of Profit and Loss:	(Rs.)
Sales	24,00,000
Cost of sales:	
Opening stock	1,80,000
Purchases	15,60,000
Less: closing stock	<u>2,40,000</u>
	15,00,000
Gross Profit	9,00,000
Operating expenses	3,60,000
Depreciation	1,20,000
Interest on loan	1,80,000
Provision for tax	<u>90,000</u>
Net profit	1,50,000
Dividend (proposed)	<u>30,000</u>
Retained profit	<u>1,20,000</u>

The chief finance officer of Rajkumar Ltd. furnished the additional information as below:

(a) Gearing adjustment for the year	Rs.20,232
(b) Cost of sales adjustment for the year	Rs.37,998
(c) Depreciation adjustment for the year	Rs.18,000
(d) Monetary working capital adjustment for the year	Rs.13,500

Answer**(a) Current Cost Profit and Loss Account of Raj Kumar Ltd. For the year ended 31.3.2009**

	Rs.	Rs.
Trading profit before interest and tax under historical cost system		
Gross profit less (Operating expenditure + Depreciation)		
Rs. 9,00,000 less (Rs. 3,60,000 + Rs.1,20,000)		4,20,000
Less: Current cost adjustments		
Depreciation adjustment	18,000	
Cost of sales adjustment	37,998	
Monetary working capital adjustment	<u>13,500</u>	<u>69,498</u>
Current cost operating profit		3,50,502
Less: Interest on loan	1,80,000	
Gearing adjustment	<u>20,232</u>	<u>1,59,768</u>
Current cost profit before tax		1,90,734
Less: Provision for tax		<u>90,000</u>
Current cost profit after tax		1,00,734
Less: Dividend		<u>30,000</u>
Retained current cost profit for the year		<u>70,734</u>

Question 21

When general price index was 100, Standard Ltd. purchased fixed assets of Rs. 2 crore and it had also permanent working capital of Rs.80 lakhs. The entire amount required for purchase of fixed assets and permanent working capital was financed by way of 12 % redeemable share capital. Standard Ltd. wants to maintain its physical capital.

On 31.03.09, the company had reserves of Rs. 3.50 crores. The general price index on that was 200. The written down value of fixed assets was Rs. 20 lakhs and they were sold for 3 crores. The proceeds were utilized for redemption of shares. On the same day (31.03.09), the company purchased new factory for Rs. 20 crores. The ratio of permanent working capital to cost of assets to be maintained at 0.4 : 1.

The company raised the additional funds required for the purpose by issue of equity shares.

(A) Calculate the amount of equity capital raised.

(B) Show the Balance Sheet as on 01.04.09.

Financial Reporting

Answer

Amount of equity capital raised	<i>Rs. in crores</i>
Amount required for purchase of new factory	20.00
Permanent working capital requirement at 40%	<u>8.00</u>
	28.00
Less: Existing working capital (W.N. 3)	<u>6.30</u>
Fresh equity capital raised	<u>21.70</u>

Balance Sheet of Standard Ltd. as on 1st April, 2009

(Rs. in crores)

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Share Capital	21.70	Fixed Assets	20.00
Reserves and Surplus (Bal. figure)	<u>6.30</u>	Working Capital	<u>8.00</u>
	<u>28.00</u>		<u>28.00</u>

Working Notes:

(Rs. in crores)

1. Preference share capital on 31st March, 2009

Fixed assets	2.00
Working capital	<u>0.80</u>
Financed by 12% Redeemable preference share capital	<u>2.80</u>

To maintain physical capital, the company needs to evaluate the financial capital on 31st March, 2009 which is required to maintain the existing operating capability of the physical assets. On the basis of price index data available, it can be worked out as follows:

$$\text{Rs. 2.80 crore} \times \frac{200}{100} = \text{Rs. 5.60 crores}$$

2. Working capital on 31st March, 2009

(before sale of fixed assets and redemption of preference shares)

Preference share capital	2.80
Reserves	<u>3.50</u>
	6.30
Less: Written down value of fixed assets	<u>0.20</u>
Working capital	<u>6.10</u>

As the physical capital on the basis of price index is Rs. 5.6 crores which is less than the actual working capital on 31st March, 09, therefore, physical capital is maintained.

3. **Working capital as on 31st March, 2009**

(after sale of fixed assets and redemption of preference shares)

Working capital before sale of fixed assets and redemption	6.10
Add: Sale proceeds of fixed assets	<u>3.00</u>
	9.10
Less: Redemption of preference shares	<u>2.80</u>
Working capital available after sale of fixed assets and redemption of pref. shares	<u>6.30</u>

Financial Reporting

EXERCISES**Question 1**

From the following Profit and Loss Account of X Limited, prepare Gross Value Added Statement and show the reconciliation between Gross Value Added and Profit before taxation:

Profit and Loss Account for the year ended 31st March, 2010

Income	(Rs. in lakhs)	(Rs. in lakhs)
Sales		800
Other Income		<u>50</u>
		850
Expenditure		
Production and Operational Expenses	600	
Administrative Expenses	30	
Interest and Other Charges	30	
Depreciation	<u>20</u>	<u>680</u>
Profit before taxes		170
Provision for taxes		<u>30</u>
		140
Balance as per last Balance Sheet		<u>10</u>
		<u>150</u>
Transferred to:		
General Reserve		80
Proposed Dividend		20
Surplus carried to Balance Sheet		<u>50</u>
		<u>150</u>
Break-up of some of the Expenditure is as follows:		
Production and Operational Expenses:		
Consumption of Raw Materials and Stores		320
Salaries, Wages and Bonus		60
Cess and Local Taxes		20
Other Manufacturing Expenses		<u>200</u>
		<u>600</u>

Developments in Financial Reporting

Administrative Expenses:

Audit Fee	6
Salaries and Commission to Directors	8
Provision for Doubtful Debts	6
Other Expenses	<u>10</u>
	<u>30</u>

Interest and other Charges:

On Working Capital Loans from Bank	10
On Fixed Loans from ICICI	15
On Debentures	<u>5</u>
	<u>30</u>

[Answer: Total Value Added Rs. 298 lakhs; Reconciliation between Gross Value Added and Profit before Taxation- (Rs. in lakhs) Profit before tax 170+ Depreciation 20 + Salaries, Wages and Bonus 60+ Directors' Remuneration+ 8 Cess and Local Taxes 20 + Interest on Debentures 5 + Interest on Fixed Loans 15]

Question 2

The following is the Profit and Loss Account of Galaxy Ltd. for the year ended 31.03.2010. Prepare a Gross Value Added Statement of Galaxy Ltd. and show also the reconciliation between Gross Value Added and Profit before taxation.

Profit and Loss Account for the year ended 31.03.2010

	Notes	Amount
		(Rs. in lakhs)
Income:		
Sales	—	890
Other Income	—	<u>55</u>
		945
Expenditure:		
Production and operational expenses	(a)	641 —
Administration expenses (Factory)	(b)	33 —
Interest	(c)	29 —
Depreciation		<u>17</u> <u>720</u>

Financial Reporting

Profit before taxes	—	225
Provision for taxes (d)	—	<u>30</u>
Profit after tax	—	195
Balance as per last Balance Sheet	—	<u>10</u>
		<u>205</u>
Transferred to General Reserve		45
Dividend paid		<u>95</u>
		140
Surplus carried to Balance Sheet		<u>65</u>
		<u>205</u>

Notes:

- (a) Production and Operational expenses Rs. in lakhs
- | | |
|--|------------|
| Consumption of raw materials | 293 |
| Consumption of stores | 59 |
| Salaries, Wages, Gratuities etc. (Admn.) | 82 |
| Cess and Local taxes | 98 |
| Other manufacturing expenses | <u>109</u> |
| | <u>641</u> |
- (b) Administration expenses include salaries, commission to Directors Rs.9.00 lakhs
Provision for doubtful debts Rs. 6.30 lakhs.
- Rs. in lakhs
- (c) Interest on loan from ICICI Bank for working capital 9
- | | |
|---|-----------|
| Interest on loan from ICICI Bank for fixed loan | 10 |
| Interest on loan from IFCI for fixed loan | 8 |
| Interest on Debentures | <u>2</u> |
| | <u>29</u> |
- (d) The charges for taxation include a transfer of Rs. 3.00 lakhs to the credit of Deferred Tax Account.
- (e) Cess and Local taxes include Excise Duty, which is equal to 10% of cost of bought-in material.

[Answer: Total value added 396 lakhs; Excise Duty = 549 – 494 = Rs. 55 lakhs]

Question 3

What is economic value added and how is it calculated? Discuss.

Question 4

From the following information of Vinod Ltd., compute the economic value added:

(i)	Share capital	Rs.2,000 lakhs
(ii)	Reserve and surplus	Rs.4,000 lakhs
(iii)	Long-term debt	Rs.400 lakhs
(iv)	Tax rate	30%
(v)	Risk free rate	9%
(vi)	Market rate of return	16%
(vii)	Interest	Rs.40 lakhs
(viii)	Beta factor	1.05
(ix)	Profit before interest and tax	Rs.2,000 lakhs

[Answer: Economic Value Added Rs. 390.72 lakhs; Cost of Equity = 16.35%; Cost of Debt = $\frac{28}{400} \times 100 = 7\%$; Weighted Average Cost of Capital $\frac{1,009}{6,400} = 15.77\%$ (approx.);

Capital Employed Rs. 6,400 lakhs; Net Operating Profit after Tax Rs. 1,372 Lakhs]

Question 5

Why Human Resources Asset is not recognized in the Balance sheet?

Question 6

The following figures have been extracted from the accounts of Tame Ltd.

	31.3.09	31.03.10
	Rs.	Rs.
Trade receivables	1,800	3,000
Trade payable	1,000	1,200

The accounting year is 2009–10. The index number for receivables and payable at the beginning and year were 150 and 180 respectively. The average index for the year was 165.

Compute Monetary Working Capital Adjustment (MWCA) and show current cost adjustments.

[Answer: Closing MWC at average price = Rs.1,800 × (165/180) = Rs.1,650; Opening MWC at average price = Rs.800 × (165/150) = Rs.880; MWCA = Rs.230 (Increase in value of MWC due to price rise)]