

CHAPTER 1

Issue of Shares

(Including alteration of share capital and buy-back of shares)

Sole proprietorship and partnership forms of business organisations could not meet the growing demands of a very big business, because of their limitations such as limited capital, limited managerial ability, unlimited liability and other drawbacks. Therefore, a Company form of business organisation came into existence to do away with the defects of sole proprietorship and partnership forms of business organisations.

A Company is a voluntary association of persons formed through the process of law, for the purpose of carrying on some business.

Definitions :

Lord Justice Lindley defines a Company as follows, "It is an association of persons who contribute money or money's worth to a common stock and employ it for some common purpose."

"A Company is an artificial person created by law, having separate entity with a perpetual succession and a common seal". — Prof. Haney

Characteristics of a Company :

Following are the essential characteristics of a Company :

(1) **Separate Legal Entity** : A Company is a legal person and its entity is quite distinct and separate from its members. It can purchase and sell the properties in its own name, can open bank account in its own name and can enter into contracts. Since a Company has a legal personality distinct from that of its members, a creditor of such a Company can sue only the Company for his debts and not any of its members.

(2) **Perpetual Existence** : The existence of a Company is not affected by the retirement, death, lunacy or insolvency of its members. Shareholders may come and Shareholders may go but the Company goes on for ever, unless wound up according to Companies Act.

(3) **Limited Liability** : The liability of the shareholder of a Company is limited to the unpaid value of his shares. For example, if the face value of a share in a Company is Rs. 10 and a shareholder has already paid Rs. 8 per share, he can be called upon to pay not more than Rs. 2 per share.

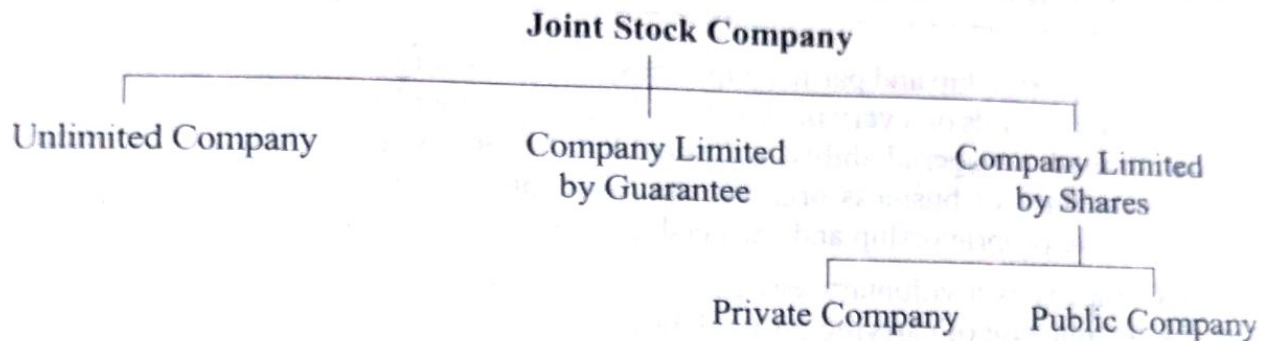
(4) **Common Seal** : Since the Company has no physical existence, it must act through its agents, called directors. All documents prepared by the directors must bear the seal of the Company. The common seal acts as the official signature of the Company.

(5) **Transferability of Shares** : The Capital of the Company is divided into parts, called shares. These shares are freely transferable subject to certain conditions.

(6) **Separation of Management from Ownership** : Shareholders are the true owners of a Company, but usually, the number of shareholders is quite large, and as such it is neither possible nor desirable for each member to take part in the day-to-day management of the Company. Therefore, the Company is managed by a 'Board of Directors' elected by the shareholders.

Kinds of a Company

Companies registered under the Companies Act, 1956, may be classified as below :



Unlimited Company : Unlimited Company is a company where there is no limit on the liability of its members. It means, when a company suffers loss and the company's property is not sufficient to pay off its debts, the private property of its members will be used to meet the claims of creditors. As the risk involved in such companies is too high, these are not found in India even though permitted by the Companies Act.

Company Limited by Guarantee : In case of such a company, the liability of the members is limited to the extent of the guarantee given by them in the event of the winding up of the company. The liability of its member will arise only in the event of winding up of the company.

Company Limited by Shares : In case of such a company the liability of the members is strictly limited to the extent of the nominal value of shares held by each of them. If a member has already paid the full amount of the shares, he will not be liable to pay any amount. If a member has partly paid shares, he can be forced to pay the remaining amount during the existence of the company as well as during the winding up. Such companies may be sub-divided into private and public companies :

Private Company :

A private company is one which has a minimum paid-up share capital of Rs. 1,00,000 or such higher paid-up capital as may be prescribed by Companies Act, and by its Articles of Association

- (i) restricts the right to transfer its shares;
- (ii) limits the number of its members to fifty (exclusive of past and present employees);
- (iii) prohibits any invitation to the public to subscribe for any shares in, or debentures of the company; and
- (iv) prohibits any invitation or acceptance of deposits from persons other than its members, directors or their relatives.

The name of every private company must end with the words 'Private Limited'.

Public Company :

A public company means a company which is not a private company and has a minimum paid-up share capital of Rs. 5,00,000 or such higher paid-up share capital as may be prescribed by the Companies Act.

DISTINCTION BETWEEN PRIVATE COMPANY AND PUBLIC COMPANY

Basis of Distinction		Private Company	Public Company
1.	Number of members	Minimum number of members is 2, and the maximum, exclusive of past and present employees, is 50.	Minimum number of members is 7 and there is no limit to maximum number.
2.	Paid-up Capital	It should have minimum paid-up capital as prescribed by the Companies Act, which is Rs. 1,00,000 at present.	It should also have minimum paid-up capital as prescribed by the Companies Act, which is Rs. 5,00,000 at present.
3.	Invitation to the public	It cannot invite the public to subscribe to its shares.	It can invite the public to subscribe to its shares.
4.	Transfer of Shares	There is restriction on the transfer of its shares.	There is no restriction on the transfer of its shares.
5.	Preparation of Articles	Preparation of Articles is mandatory for all private companies.	Preparation of Articles is not mandatory. In case the Articles are not registered, the provisions of Table A given in Companies Act shall apply.
6.	Commencement of Business	It can commence its business as soon as certificate of incorporation is received.	In addition to 'Certificate of incorporation' it must also obtain "Certificate of Commencement of Business".
7.	Number of Directors	It must have at least two directors.	It must have at least three directors.
8.	Statutory Meeting	It is not required to hold the statutory meeting.	It is required to hold statutory meeting within 6 months of its getting the Certificate of Commencement of Business.
9.	Accepting Deposits	It cannot accept deposits from the public.	It can accept deposits from the public.
10.	Use of word 'Limited'	It is compulsory to use the words 'Private Limited' at the end of its name.	Only the word 'Limited' is used at the end of its name.

In this chapter, problems relating to issue of shares have been discussed in detail. But before solving the practical questions relating to issue of shares, it is necessary to understand the meaning of share, types of shares and the method of their issue.

Shares :

Meaning of Shares : Total Capital of the Company is divided into units of small denominations. Each such unit is called 'share'. For example, if the total capital of the Company is Rs. 10,00,000 divided into 1,00,000 units of Rs. 10 each, each unit of

Rs. 10 will be called a share (of Rs. 10 each). Thus in the above case the Company has 1,00,000 shares of Rs. 10 each. Shares must be numbered so that they may be identified.

Nature of Shares : The shares of a Company are movable property, transferable in the manner provided by the Articles of Association of the Company. Shares of a Company are treated as goods under the Sales of Goods Act, 1930. These can be bought, sold, hypothecated and bequeathed.

Types of Shares : Under the Companies Act, 1956, a Company may issue two types of shares :

(1) Preference Shares

(2) Equity Shares

(1) **Preference Shares :** Preference Shares are those which carry the following two rights :

(i) They have a right to receive dividend at a fixed rate before any dividend is paid on the equity shares.

(ii) When the company is wound up, they have a right to the return of capital before that of equity shares.

In addition to the above, the preference shares may carry some more rights such as the right to participate in excess profits when a specified dividend has been paid on the equity shares or the right to receive a premium at the time of redemption.

Types of Preference Shares :

(i) **Cumulative Preference Shares :** Cumulative preference shares are those preference shares, the holders of which are entitled to recover the arrears of preference dividend, before any dividend is paid on equity shares. This means that if in any year, the profits of the company are insufficient to pay dividend on these shares, the dividend keeps on accumulating until it is fully paid. For example, if dividend has not been paid for the years ending 31st March 2005 and 2006 on 7% cumulative preference shares and the company wants to distribute dividend on equity shares for the year ending 31st March 2007, a total of 21% dividend (for the years ending 31st March 2005, 2006 and 2007) will have to be first paid on preference shares before the payment of any dividend to equity shares. The arrears of dividend on these shares are shown in the balance sheet as a contingent liability. In India, a preference share is always cumulative unless specifically mentioned otherwise. In case, the dividend on these shares remains in arrears for an aggregate period of not less than two years, holders of such shares will be entitled to take part and vote on every resolution in the general meeting of shareholders.

(ii) **Non-cumulative Preference Shares :** The holders of such shares get a fixed amount of dividend out of the profits of each year. If no dividend is declared in any year due to any reason, such shareholders get nothing, nor can they claim unpaid dividend of any year in any subsequent year. In case, the dividend on these shares remains in arrears for a period of not less than two years immediately preceding the meeting or for any three years during a period of six years ending with the expiry of financial year, holders of such shares will be entitled to take part and vote on every resolution at any meeting of the shareholders.

(iii) **Participating Preference Shares :** Such shares, in addition to the fixed preference dividend, carry a right to participate in the surplus profits, if any, after

OF SHARES

Rs. 10 will be called a share (of Rs. 10 each). Thus in the above case the Company has 1,00,000 shares of Rs. 10 each. Shares must be numbered so that they may be identified.

Nature of Shares : The shares of a Company are movable property, transferable in the manner provided by the Articles of Association of the Company. Shares of a Company are treated as goods under the Sales of Goods Act, 1930. These can be bought, sold, hypothecated and bequeathed.

Types of Shares : Under the Companies Act, 1956, a Company may issue two types of shares :

(1) Preference Shares

(2) Equity Shares

(1) Preference Shares : Preference Shares are those which carry the following two rights :

(i) They have a right to receive dividend at a fixed rate before any dividend is paid on the equity shares.

(ii) When the company is wound up, they have a right to the return of capital before that of equity shares.

In addition to the above, the preference shares may carry some more rights such as the right to participate in excess profits when a specified dividend has been paid on the equity shares or the right to receive a premium at the time of redemption.

Types of Preference Shares :

(i) **Cumulative Preference Shares :** Cumulative preference shares are those preference shares, the holders of which are entitled to recover the arrears of preference dividend, before any dividend is paid on equity shares. This means that if in any year, the profits of the company are insufficient to pay dividend on these shares, the dividend keeps on accumulating until it is fully paid. For example, if dividend has not been paid for the years ending 31st March 2005 and 2006 on 7% cumulative preference shares and the company wants to distribute dividend on equity shares for the year ending 31st March 2007, a total of 21% dividend (for the years ending 31st March 2005, 2006 and 2007) will have to be first paid on preference shares before the payment of any dividend to equity shares. The arrears of dividend on these shares are shown in the balance sheet as a contingent liability. In India, a preference share is always cumulative unless specifically mentioned otherwise. In case, the dividend on these shares remains in arrears for an aggregate period of not less than two years, holders of such shares will be entitled to take part and vote on every resolution in the general meeting of shareholders.

(ii) **Non-cumulative Preference Shares :** The holders of such shares get a fixed amount of dividend out of the profits of each year. If no dividend is declared in any year due to any reason, such shareholders get nothing, nor can they claim unpaid dividend of any year in any subsequent year. In case, the dividend on these shares remains in arrears for a period of not less than two years immediately preceding the meeting or for any three years during a period of six years ending with the expiry of financial year, holders of such shares will be entitled to take part and vote on every resolution at any meeting of the shareholders.

(iii) **Participating Preference Shares :** Such shares, in addition to the fixed preference dividend, carry a right to participate in the surplus profits, if any, after

dividend at a stipulated rate has been paid to equity shareholders. Similarly, in the event of winding up, if after paying back both the preference and equity shareholders, there is still some surplus left, such shareholders are entitled to receive a pre-determined proportion of surplus.

(iv) **Non-participating Preference Shares** : Such shares get only a fixed rate of dividend every year and do not carry a right to participate in the surplus profits or in any surplus on winding up. Unless expressly provided, the preference shares are usually non-participating.

(v) **Redeemable Preference Shares** : Such shares are those which will be repaid by the Company within a stipulated period in accordance with the terms of issue and the fulfilment of certain conditions laid down in Section 80 of the Companies Act.

(vi) **Irredeemable Preference Shares** : Irredeemable preference shares are those, the capital of which cannot be refunded before winding up. According to Section 80 (5A), no company limited by shares, shall issue any preference share, which is irredeemable or is redeemable after the expiry of 20 years from the date of its issue.

(vii) **Convertible Preference Shares** : Holders of these shares have a right to get their preference shares converted into equity shares at their option according to the terms of issue.

(viii) **Non-Convertible Preference Shares** : When the holders of preference shares have not been conferred the right of getting their preference shares converted into equity shares, such shares are called non-convertible preference shares.

(2) **Equity Shares** : Equity shares are those shares which are paid dividends only when profits are left after the preference shareholders have been paid fixed rate of dividends. In other words, there will be no fixed rate of dividend on the equity shares. If in a particular year, there are no profits or insufficient profits, the equity shares will receive nothing. If the Company earns more profits, they get a higher rate of dividend. As regards return of capital, equity share capital is returned only when preference share capital is returned in full. Equity shareholders have voting rights and control the affairs of the Company.

DISTINCTION BETWEEN PREFERENCE SHARES AND EQUITY SHARES

Serial No.	Basis of Distinction	Preference Shares	Equity Shares
1.	Rate of Dividend	Preference Shares are paid dividend at a fixed rate.	The rate of dividend on equity shares is not fixed. It may vary from year to year depending upon the availability of profits.
2.	Arrears of dividend	If dividend is not paid on these shares in any year, the arrears of dividend may accumulate.	In case of equity shares, dividend cannot accumulate.
3.	Preferential right as to the payment of dividend	They have a right to receive dividend before any dividend is paid on equity shares.	Payment of dividend on equity shares is made after the payment of preference dividend.

	payment of capital	They have a right to return of capital in the case of winding up, before any capital is returned to equity shareholders.	Equity share capital is paid only when preference share capital is paid out fully.
5.	Voting rights	Preference Shareholders do not have any voting rights.	Equity Shareholders enjoy voting rights.
6.	Right to participate in management	They do not have a right to participate in management of the Company.	They have full right to participate in management of the Company.

SHARE CAPITAL

Meaning : Share Capital means the Capital raised by a Company by the issue of shares. Many individuals and institutions contribute varying sums to the Company's capital yet there is no separate Capital Account for each of these individuals or institutions. There is one Consolidated Capital Account called the Share Capital Account.

Kinds of Share Capital : The various terms used in connection with the Share Capital of a company are the following :

(1) **Authorised, Registered or Nominal Capital :** Authorised Capital refers to that amount which is stated in the Memorandum of Association. This is the maximum Capital for which a Company is authorised to issue shares during its lifetime.

(2) **Issued Capital :** Issued Capital is that part of Authorised Capital which is actually offered to the public for subscription. The remaining part of the Authorised Capital is known as the 'Unissued Capital' which can be issued later on.

(3) **Subscribed Capital :** Subscribed Capital is that part of Issued Capital which has been actually subscribed for by the public. If, say, 3,00,000 shares of Rs. 10 each are offered to the public and the public applies for 2,80,000 shares, the Subscribed Capital will be Rs. 28,00,000.

(4) **Called-up Capital :** Only a part of the face value of a share may be called by the directors from the shareholders. For example, if the directors call at the rate of Rs. 6 per share on 2,80,000 shares of Rs. 10 each, Rs. 16,80,000 will be the called up Capital. The remaining amount of Rs. 4 per share will be uncalled Capital.

(5) **Paid-up Capital :** It is that portion of called up capital which has been actually received from the shareholders. Usually the called-up Capital and the paid-up Capital are the same except that some shareholders may not have paid the amount of calls. Any unpaid amount is called 'Calls in arrear'. If a shareholder holding 500 shares has not paid Rs. 3 per share, Rs. 1,500 will be calls in arrear. Paid up Capital will be called up Capital less the amount of calls in arrear.

(6) **Reserve Capital :** According to section 99 of the Companies Act, a Company may, by a special resolution, determine that a portion of its uncalled Capital shall not be called up, except in the event of winding up of the Company. In such a case, that portion of the subscribed Capital becomes Reserve Capital. It is available only for the creditors on the winding up of the company.

Presentation of Share Capital in Company's Balance Sheet

As per Schedule VI of Companies Act, 1956, Share Capital is to be disclosed in a Company's Balance Sheet in the following manner :

BALANCE SHEET OF as at

LIABILITIES		Rs.	Rs.
Share Capital			
Authorised Capital :			
..... Equity Shares of Rs. each			
..... Preference Shares of Rs. each			
Issued Capital :			
..... Equity Shares of Rs. each			
..... Preference Shares of Rs. each			
Subscribed Capital :			
..... Equity Shares of Rs. each			
..... Preference Shares of Rs. each			
(Of the above shares..... Shares are allotted as fully paid-up pursuant to a contract without payments being received in cash)			
Called-up Capital :			
..... Shares of Rs. each, Rs. per share Called-up			
Paid-up Capital :			
Called-up Capital			
Less :	Calls in Arrears :		
	(i) By directors	Rs.	
	(ii) By others	Rs.	
Add :	Forfeited shares		
Calls in Advance			

Example : Tata Rubber Ltd. was formed with a nominal Share Capital of Rs. 50,00,000 divided into 5,00,000 shares of Rs. 10 each. The Company offers 3,00,000 shares to the public payable Rs. 3 per share on Application, Rs. 3 per share on Allotment and the balance on First and Final Call. Applications were received for 2,80,000 shares. All money payable on allotment was duly received, except on 500 shares held by X. First and Final Call was not made by the Company.

How would you show the relevant items in the Balance Sheet of Tata Rubber Ltd.?

SOLUTION : BALANCE SHEET OF TATA RUBBER LTD. as on

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Share Capital :		Fixed Assets :	
Authorised Capital :			
5,00,000 shares of Rs. 10 each	50,00,000		
Issued Capital :		Current Assets :	
3,00,000 shares of Rs. 10 each	30,00,000	Cash at Bank	16,78,500
Subscribed Capital :			
2,80,000 shares of Rs. 10 each	28,00,000		
Called-up Capital :			
2,80,000 shares of Rs. 10 each			
Rs. 6 per share Called-up	16,80,000		

Paid-up Capital :			
2,80,000 shares of Rs. 10 each			
Rs. 6 per share Called-up 16,80,000			
Less : Calls in Arrears			
(500 Shares × Rs. 3)	1,500	16,78,500	
		16,78,500	
			16,78,500

Capital Reserves : Capital reserves are those reserves which are created out of Capital profits. Capital profits are those profits which are not earned in the normal course of the business. These reserves cannot be utilised for the distribution of dividends. Following are the items that give rise to Capital profits and hence Capital reserves :

- (I) Profit on sale of fixed assets.
- (II) Profit on revaluation of fixed assets.
- (III) Premium on issue of shares and debentures.
- (IV) Profit on redemption of debentures.
- (V) Profit earned by a company prior to its incorporation.
- (VI) Profit on forfeiture and re-issue of shares.

Capital Reserves are shown on the liabilities side of the Balance Sheet under the head "Reserves and Surplus."

DISTINCTION BETWEEN RESERVE CAPITAL AND CAPITAL RESERVES

	Basis of Distinction	Reserve Capital	Capital Reserve
1.	Meaning and Creation	It refers to that portion of uncalled share capital which shall not be called up, except in the event of winding up. (Section 99)	Capital Reserve is that reserve which is created out of Capital profits such as profit on sale of fixed assets, profit on revaluation of fixed assets, premium on issue of shares and debentures, profit on redemption of debentures etc. These profits are not earned in the normal course of business.
2.	Necessity	It is not necessary to create Reserve Capital.	It is necessary to create Capital Reserve, in case of Capital profits.
3.	Special Resolution	A special resolution is required for its creation.	No special resolution is required for the creation of Capital Reserves.
4.	Realised or not realised	It refers to the amount which has not been received.	It refers to the amount which has already been received.
5.	Disclosure in Balance Sheet	It is not shown in the Company's balance sheet.	It is shown as the first item under the head, 'Reserves and Surplus' on the liabilities side of the balance sheet.
6.	Time when it can be used	It can be used only at the time of winding up of the Company.	It can be used to write off Capital losses or to declare a share bonus any time during the life of the Company.

Issue of Shares

Shares may be issued in any of the following ways :

- (i) For Cash : By Private Placement of shares

- (ii) For Cash : By Public Subscription of shares
- (iii) For Consideration other than Cash.

(i) Private Placement of Shares

Sometimes the promoters of a public company are confident of raising capital through private sources and contacts. In such a case the Company does not invite the public to subscribe for its shares, but make private placement of shares to promoters, their friends, relatives, shareholders of group companies, Mutual Funds, Non-Resident Indians (NRIs), financial institutions like Life Insurance Corporation of India (LIC), Unit Trust of India (UTI), Industrial Credit and Investment Corporation of India (ICICI) etc. When the shares are not offered to the public, the Company need not issue a prospectus. Instead of issuing a prospectus, the promoters are required to prepare a draft prospectus known as a 'Statement in Lieu of Prospectus' and must file it with the Registrar at least 3 days before the first allotment of either shares or debentures. The Statement in Lieu of Prospectus shall be signed by every person who is named therein as a director or proposed director of the Company or by his agent authorised in writing.

In case of private placement of shares, the allottees will not sell their shares for a minimum period of three years from the date of allotment. This period is known as 'lock-in-period'.

Sweat Equity Shares :

Sweat equity shares means equity shares issued by the Company to its employees or directors at a discount or for consideration other than cash for providing know-how or making available intellectual property rights. According to Section 79A of the Companies Act, a Company may issue sweat equity shares of a class of shares already issued, if the following conditions are fulfilled, namely :

- (i) the issue of sweat equity shares is authorised by a special resolution passed by the Company in general meeting;
- (ii) the resolution specifies the number of shares, current market price, the consideration, if any, and the class or classes of directors or employees to whom such equity shares are proposed to be issued;
- (iii) not less than one year has elapsed since the date on which the Company was entitled to commence business;
- (iv) the sweat equity shares of a Company whose equity shares are listed on recognised stock exchange, are issued in accordance with the regulations made by the SEBI in this behalf.
- (v) such shares cannot be resold by their holders within a period of three years, called lock-in period.

It is to be noted that a company may issue sweat equity shares at a price lower than the nominal value of equity share. In such a case, provisions of section 79 relating to issue of shares at discount shall have to be followed.

The entries for issue of sweat equity shares are the same as for issue of other equity shares.

• Employees Stock Option Plan (ESOP) :

The scheme of employees stock option was introduced by the Companies (Amendment) Act, 2000 through section 2 (15A). Employees stock option means the

option (right and not an obligation) given to the whole-time directors, officers and employees right to purchase or subscribe at a future date, the securities offered by the Company at a pre-determined price, which usually is lower than the market price. This is a voluntary scheme on the part of the Company to give its employees a sense of belonging. Shares allotted under this scheme shall be locked in for a minimum period of one year from the date of allotment. In other words, shares issued under ESOP cannot be disposed off within 1 year from the date of allotment.

Objectives or Importance of ESOP :

- (i) Its main objective is to inspire the employees to have a higher participation in the company.
- (ii) Its another objective is to create long-term wealth in the hands of the employees.
- (iii) Also, ESOP is a means to attract, retain and motivate the good and efficient employees for the company.

(ii) Public Subscription of Shares

Following steps are to be taken by a Public Company for the issue of shares to public:

- (1) To Issue Prospectus.
- (2) To Receive Applications.
- (3) To Make Allotments.
- (4) To Make Calls.

(1) **To Issue Prospectus :** Prospectus is an invitation to the public to purchase its shares. It describes the profitability and soundness of the business of the Company to attract the investing public. It contains the following informations :

Name and address of the registered office of the Company, Names and addresses of the directors, Objects of the Company, risks involved in the issue, Consent from SEBI (Securities and Exchange Board of India), Authorised and Issued Capital of the company and the number of shares now offered for subscription, terms of present issue, dates of opening and closing of the issue etc.

(2) **To Receive Applications :** After reading the prospectus the public applies for shares in the Company on a prescribed form. Each application must accompany the application money which is mentioned in the prospectus, but it should not be less than 25% of the issue price of each share. With a view to reducing the pressure on the market, the minimum number of shares for which application is to be made has been fixed at 200 shares of Rs. 10 each. Where, however, the issue is at a premium or comprises of debentures, whether convertible or non-convertible, the amount in respect of each instrument shall not be less than Rs. 2,000.

The amount of share application money must be deposited by the public in a Scheduled Bank. The name of the Company's Scheduled Bank is also mentioned in the prospectus. The Company cannot withdraw this amount from the bank till the certificate of commencement of business has been obtained by it.

(3) **To Make Allotment of Shares :** After the last date fixed for receipt of application money expires, the Bank sends all applications to the Company. The

directors of the Company cannot proceed to allot shares unless **Minimum Subscription** has been received by the Company.

Minimum Subscription : Minimum Subscription means the amount which, in the opinion of the Directors, is the minimum to be raised by the issue of shares so as to provide for the following requirements :

- (i) For the payment of purchase price of any property purchased or agreed to be purchased;
- (ii) For the payment of preliminary expenses, including underwriting commission and brokerage on issue of shares;
- (iii) For the repayment of any moneys borrowed by the Company for the above purposes;
- (iv) For Working Capital; and
- (v) For any other expenditure required for the usual conduct of business operations.

According to Companies Act minimum subscription has been fixed at 90% of the issued amount. The company has to get minimum subscription within 120 days from the date of the issue of the prospectus. If the company fails to receive the minimum subscription within the said period, the company cannot proceed for the allotment of shares and the entire application money must be returned within 130 days of the date of issue of the prospectus. If there is a delay in refund of such amount by more than 8 days after the company becomes liable to pay the amount, the Company shall be liable to repay it with interest at the rate of 15% per annum for the delayed period.

Each allottee will be issued share certificates for eligible number of shares in tradeable lots, e.g., in case of shares of face value of Rs. 10 each, the tradable lot is 100 shares.

In case of oversubscription of shares, the allotment shall be on a proportionate basis according to the number of shares applied for. If the proportionate allotment works out to less than 100 shares per applicant, the allotment shall be made as follows :

- (i) Each successful applicant shall be allotted a number of 100 shares, and
- (ii) The successful applicants shall be determined by drawal of lots.

For example, if a company issues a prospectus inviting applications for 1,00,000 shares and if applications are received for 15,00,000 shares, the issue has been over subscribed by 15 times. In such a case, an applicant in the category of 500 shares is entitled to the proportionate allotment of $\frac{500}{15} = 33$ shares. However, since the actual entitlement would be rounded off to 100 shares, successful applicants out of the total applicants in this category shall be determined by drawal of lots in such a manner that every third applicant is allotted 100 shares.

As a result of over subscription, some applications may be rejected in full. Others may be partially accepted and still others may be accepted in full. Those who are allotted shares are sent 'Letters of Allotment' indicating the number of shares allotted and the amount now due on allotment. Those who are not allotted shares are sent 'Letters of Regret' alongwith a cheque for the refund of application money. The whole

process of allotment of shares must be completed within 120 days of the issue of prospectus.

(4) To Make Calls : The amounts paid on application and allotment are not calls but subsequent instalments, as and when demanded, are calls. A Company may demand the whole amount of a share on application in one instalment. If the whole of the amount of share is not paid on application and allotment, the unpaid amount may be called by the directors in one or more instalments. Each instalment is named as First Call, Second Call etc. Calls must be made strictly in accordance with the provisions of the Articles of Association. In the absence of the Articles of Association, the provisions of Table A of the Companies Act will apply. These provisions are :

1. Where the total issue size exceeds Rs. 250 crores, the amount to be called up either on application, or on allotment, or on any one call shall not exceed 25% of the total quantum of the issue. It therefore follows that for issues of upto 250 crores, the Company is permitted to call up entire issue price on application itself.
2. All amount on shares should be fully called up within a period of 12 months from the date of allotment. However, this guideline do not apply to issues of Rs. 500 crores or above.
3. There must be an interval of atleast one month between the making of two calls.
4. Atleast fourteen days notice must be given to the shareholders to pay the amount of call.
5. Calls must be made on a uniform basis on all the shares within the same class of shares.

A Call letter must specify the amount of the call, mode of remitting money, address to which call money is required to be sent and the last date for sending the money.

Preliminary Expenses

Expenses incurred on the formation of a Company are termed as 'Preliminary Expenses'. These include the following :

- I. Expenses incurred on the preparation and printing of various documents needed for the registration of a Company.
- II. Stamp duty and registration fees on these documents.
- III. Duty payable on Authorised Capital.
- IV. Expenses incurred on the preparation, printing and issue of prospectus.
- V. Underwriting Commission.
- VI. Cost of preliminary books and the Common Seal.
- VII. In case the Company has been formed to purchase a running business, the fees charged by Accountant or Valuer valuing the assets and liabilities of that business.

Preliminary expenses may be written off against Securities Premium Account. Otherwise, these may be written off from Profit & Loss Account gradually over some period. The unwritten portion of preliminary expenses is shown on the assets side of the balance sheet under the heading 'Miscellaneous Expenditure'.

Book Building

Nowadays a lot of companies are using the book building process for marketing a public offer of equity shares. Book building is a common practice in most developed countries but it is of recent origin for the Indian Capital Market.

Under book building process the issue price of a share is determined by the demand and supply forces in the capital market. Herein, bids are invited from investors who place their bids at different prices. The issue price is determined by the issuing company on the basis of bids received and the careful evaluation of demand and various level of prices. The issue price is fixed after bid closing date. Once the price is fixed, the applicants who have applied at that price or a higher price are allotted shares at that fixed price.

The prospectus does not mention the issue price because the price is fixed after the bid closing date. However, Companies can now mention the floor price i.e., minimum price below which bids will not be accepted.

As per SEBI Guidelines 2000, shares may be issued under book building process in any of the following two manners :

- (i) 100% of the net offer to public through book building process, or
- (ii) 75% of the net offer through book building and 25% at the price determined through book building.

Steps in Book Building Process :

The steps which are usually followed in the book building process are as follows :

- (i) The issuer company appoints a lead manager known as "Book Runner".
- (ii) A draft prospectus is prepared in consultation with the book runner, which does not mention the issue price but includes other particulars such as size of the issue, past history of the company and floor price or price band, i.e., a range within which bids would be accepted. The band cannot exceed 20% of the floor price.
- (iii) The draft prospectus is filed with SEBI.
- (iv) Bid period is determined and the awareness campaign is conducted by book runner through advertisements and road shows etc.
- (v) An underwriter is appointed to underwrite the issue to the extent of net offer to the public.
- (vi) Copies of the draft prospectus are circulated by the Book Runner to the institutional investors like UTI, LIC, GIC, etc.
- (vii) Book Runner maintains a record book to record the bid price and the quantity of shares applied by various investors.
- (viii) After closure of the bid period, the book runner and the issuing company determine the issue price on the basis of which shares are allocated by the Book Runner.
- (ix) Once the price is determined, the applicants who have applied at that price or a higher price are allotted shares at the fixed price only.

Advantages of Book Building :

- (i) Issue price of the shares is realistic and fair because it is determined by the demand and supply forces and not by issuing company alone.
- (ii) It helps in fast and assured collection of funds.
- (iii) It helps in considerable saving in issue expenses.
- (iv) There is no risk of failure of the issue because the company can withdraw from the market if there is not enough demand for its securities.

Limitations of Book Building :

- (i) It is suitable for mega issues only.
- (ii) Issuing company must be reputed and well known to the investors.

Entries on Issue of Shares**Entries on Receiving Applications :**

(1) As discussed earlier, the amount received on applications has to be kept in a scheduled bank, till the Company receives the Certificate of Commencement of business. Normally, the applicants deposit the application money directly in the bank. Bank itself sends the application forms to the office of the Company. The following entry is made by the Company on receiving the applications :

Bank A/c

Dr.

To Share Application A/c

(Application money received on shares at the rate of Rs. per share)

(2) Application money is a part of the share capital of the Company, and as such, when the directors allot the shares, the share application money is transferred to Share Capital Account. For this the following journal entry is passed :

I. Share Application A/c

Dr.

To Share Capital A/c

(Application money on allotted shares transferred to Share Capital A/c)

II. Sometimes, the directors do not allot any shares to some of the applicants. The application money of such applicants is returned to them. The entry will be :

Share Application A/c

Dr.

To Bank A/c

(Application money returned on un-allotted shares)

Entries on Allotment :

(3) Those applicants who are allotted shares are sent letters of allotment in which the number of shares allotted and the amount due on allotment is mentioned. As soon as the allotment letters are issued, the allotment money becomes due and becomes a part of Share Capital. The entry required is :

Share Allotment A/c

Dr.

To Share Capital A/c

(Amount due on allotment on shares at the rate of Rs. per share)

(4) On receipt of Allotment Money :

Bank A/c

Dr.

To Share Allotment A/c

(Amount received on allotment on shares at the rate of Rs. per share)

Entries on First Call :

(5) When Shareholders are informed to pay the First Call :

Share First Call A/c

Dr.

To Share Capital A/c

(First call due on shares at the rate of Rs. per share)

(6) On receipt of First Call Money :

Bank A/c

Dr.

To Share First Call A/c

(First Call money received on shares at the rate of Rs. per share)

Entries on Second Call :

(7) When shareholders are informed to pay the Second Call :

Share Second Call A/c

Dr.

To Share Capital A/c

(Second Call due on shares at the rate of Rs. per share)

(8) On receipt of Second Call Money :

Bank A/c

Dr.

To Share Second Call A/c

(Second Call money received on shares at the rate of Rs. per share)

Similarly, entries for other calls may be prepared.

(iii) Issue of Shares for Consideration other than Cash

It is not necessary to issue the shares only for cash. A Company may issue fully paid shares for consideration other than cash, in the following circumstances :

(1) Issue of Shares to Promoters :

Promoters of a Company may be issued shares in the Company for the services rendered by them. The entry will be :

Incorporation Costs or Formation Exp. A/c

Dr.

To Share Capital A/c

(Shares issued to Promoters)

(2) Issue of Shares for Purchase of Assets :

Sometimes, a Company purchases some assets and instead of making the payment to the vendors in the form of Cash, it issues fully paid shares to the vendors. Following journal entries are made for this purpose :

I. When assets are purchased from the vendors :

Sundry Assets A/c

Dr.

To Vendor's A/c

II. When shares are issued to vendors :

Vendor's A/c

Dr.

To Share Capital A/c

CHAPTER 2

Redemption of Preference Shares

(Redemption of preference shares means return of share money to the shareholders.)
With effect from 1st March 1997 a Company cannot issue ~~irredeemable preference~~ shares which can be redeemed beyond a period of 20 years. It means that a Company can issue only redeemable preference shares if it is authorised by the Articles of the Company. Companies Act lays down certain conditions under Section 80 which must be fulfilled to make the redemption valid. These are stated as under :—

1. **Fully Paid** :— No preference shares can be redeemed unless they are fully paid. It has been made compulsory, under Section 80 A, that partly paid preference shares be always made fully paid up before redemption takes place.
2. **Out of profits or new issue** :— Such shares can be redeemed either (i) out of the profits of the Company which would otherwise be available for dividend or (ii) out of the proceeds of fresh issue of shares made for the purpose of redemption. Both sources can be used simultaneously, i.e., a part of the amount needed for redemption may be collected out of the proceeds of a fresh issue of shares and the balance by using the profits that would otherwise be available for distribution of dividends.
3. **Capital Redemption Reserve** :— Where shares are redeemed out of profits otherwise available for dividend, a sum equal to the nominal amount of the shares redeemed must be transferred to a reserve account styled as 'Capital Redemption Reserve Account'. This provision is made with a view to prevent the profits from being used for any other purpose such as declaration of dividends, redemption of debentures, etc. However, Capital Redemption Reserve can be utilised for the issue of fully paid bonus shares to the shareholders of the Company.

The following table gives the profits which are available for dividend and which are not available for dividend :—

<i>Profits available for dividend (Transfer to Capital Redemption Reserve A/c is allowed from these profits)</i>	<i>Profits not available for dividend (Transfer to Capital Redemption Reserve A/c is not allowed from these profits)</i>
1. General Reserve	1. Securities Premium Account
2. Reserve Fund	2. Capital Reserve
3. Dividend Equalisation Fund	3. Share Forfeiture Account
4. Insurance Fund	4. Profit Prior to Incorporation

5. Workmen's Compensation Fund
6. Workmen's Accident Fund
7. Voluntary Debenture Redemption Fund
8. Profit and Loss Account

5. Development Rebate Reserve

4. The redemption of preference shares by a Company shall not be taken as reducing the amount of its authorised share capital. Hence, the shares so redeemed shall remain part of the authorised capital in the balance sheet and the Company shall have the power to issue upto the nominal amount of the shares redeemed.
5. If new shares are issued for the purpose of redemption of preference shares, it will not be treated as increase of capital. Redeemable preference shares must be redeemed within one month of the issue of new shares.
6. If the shares are redeemed at premium then it is desirable to provide such premium first out of the 'Securities Premium Account' and the balance out of the profits of the Company.
7. After the redemption of preference shares the Company must send the information in this regard to the registrar of Companies within 30 days.
8. Redeemable Preference Shares cannot be redeemed by issuing debentures.

The Intention of Section 80 :— The intention of imposing the legal restrictions under Section 80 is to protect the interests of creditors of the Company by keeping the share capital intact even after the redemption of redeemable preference shares. When preference shares are redeemed out of proceeds of a fresh issue of shares, the security available to the creditors in the form of assets prior to redemption remains intact. On the contrary, if the redemption is allowed from borrowings, although it results in an increase in the available assets, it also results in an increase in the liabilities and therefore does not safeguard the interests of the creditors.

In case of redemption out of divisible profits, Capital Redemption Reserve Account takes the place of Redeemable Preference Share Capital Account in the balance sheet. There is no depletion of the Company's assets after the redemption since Capital Redemption Reserve Account is created by retaining permanently the profits which may otherwise be utilised for paying dividend to shareholders at any time.

The purpose of disallowing the redemption of partly paid preference shares is also to protect the interests of creditors because in case of winding up, if the amount otherwise available is insufficient to make full payment to the creditors, the liquidator will call upon the preference shareholders to pay the uncalled amount and he will utilise this amount to meet the creditors claim. If redemption of partly paid preference shares is allowed, it would mean the replacement of only the paid-up value of such shares and hence the uncalled amount will never be available to the creditors.

Accounting Entries on the Redemption of Preference Shares

- Step 1. When preference shares are being redeemed out of the proceeds of new issue of shares, any of the following entries will be passed for the issue of new shares :—

REDEMPTION OF PREFERENCE SHARES

2.3

(a) When new shares are issued at par :—

Bank A/c	
To Share Application and Allotment A/c*	Dr.
Share Application and Allotment A/c	
To Share Capital A/c	Dr.

(b) When new shares are issued at premium :—

Bank A/c	
To Share Application and Allotment A/c	Dr.
Share Application and Allotment A/c	
To Share Capital A/c	Dr.
To Securities Premium A/c	

(c) When new shares are issued at discount :—

Bank A/c	
To Share Application and Allotment A/c	Dr.
Share Application and Allotment A/c	
Share Discount A/c	Dr.
To Share Capital A/c	Dr.

Step 2. In case the preference shares are redeemable at premium, the premium on redemption should be set off first against the 'Securities Premium Account' and then the balance, if any, should be provided for either out of the profits of the Company or any reserve :—

Securities Premium A/c	Dr.
Or	

Profit & Loss A/c and all Revenue Reserves Dr.

 To Premium on Redemption A/c

(Provision of premium payable on redemption)

Step 3. Compare the amount of preference shares redeemed (without premium) with the proceeds of fresh issue of shares (without premium but after discount). Thus the word 'proceeds of fresh issue' does not include the amount of premium if shares are issued at premium but stands for the net amount received if shares are issued at discount. If the proceeds of fresh issue is less than the amount of shares redeemed, the amount equal to the difference must be transferred to 'Capital Redemption Reserve Account'. Journal entry is :—

Profit & Loss Appropriation A/c	Dr.
General Reserve or any other Reserve	Dr.

(Profits available for dividend)

 To Capital Redemption Reserve A/c

Step 4. For the total amount due to preference shareholders on redemption :—

Redeemable Preference Share Capital A/c	Dr.
Premium on Redemption A/c	Dr.

 To Redeemable Preference Shareholder's A/c

*It should be noted that in case the full amount is received in one lump sum it will be credited to Share Application & Allotment A/c.

CHAPTER 3

Acquisition of Business

Sometimes a Company buys the existing business of a sole trader or that of a partnership firm. A Company may also purchase the business of another Company which is called 'Amalgamation' and which is discussed separately.

Seller of the business is called 'Vendor' and purchaser as 'Purchasing Company' and the purchase price is called 'Purchase Consideration'.

Assets taken over by the Purchasing Company : Purchasing Company may take over all the assets of the Company or may not take over some of them. In the absence of a contract to the contrary, it is assumed that purchasing Company has taken over all the assets of the Vendor including cash and bank balances but fictitious assets and miscellaneous expenses such as preliminary expenses, discount on issue of shares and debentures, underwriting commission and debit balance of Profit and Loss Account are not taken over by the purchasing Company.

Liabilities taken over by the Purchasing Company : In the absence of a contract to the contrary, it is assumed that purchasing company has taken over all the external liabilities of the Vendor. Internal liabilities such as Capital, Capital Reserve, General Reserve, Undistributed Profits etc., are not taken over by the Purchasing Company.

Calculation of Purchase Consideration :

Mostly purchase consideration is already stated in the question in the form of a lump sum amount. Sometimes, it is calculated by adding various forms of payment i.e., payment in cash, shares and debentures.

If purchase consideration is not given in the question, it will be equal to the net assets, including goodwill, acquired :

$$\text{Net Assets} = \text{Agreed Value of Assets taken Over} (-) \text{Agreed Value of External Liabilities taken over.}$$

If the purchase consideration agreed between the Purchasing Company and Vendor is more than the net assets, the difference will be amount paid for 'Goodwill'. Thus

$$\text{Purchase Price} - \text{Net Assets} = \text{Goodwill}$$

On the contrary, if the purchase consideration agreed between the Purchasing Company and Vendor is less than the net assets, the purchasing company makes a capital profit and the same should be credited to 'Capital Reserve Account'. Thus

$$\text{Net Assets} - \text{Purchase Price} = \text{Capital Reserve}$$

For example, a Company pays Rs. 5,00,000 for a business which has assets amounting to Rs. 4,80,000 and which owes Rs. 30,000 to sundry creditors. The net assets will be Rs. 4,50,000 (i.e., Rs. 4,80,000 - Rs. 30,000) and goodwill will be Rs. 50,000 (i.e., Rs. 5,00,000 - Rs. 4,50,000).

If purchase price is Rs. 4,40,000, Rs. 10,000 (i.e., Rs. 4,50,000 – Rs. 4,40,000) will be the amount of capital reserve.

Accounting Records in the Books of Purchasing Company

Following entries are made in the books of Purchasing Company :

1. For recording purchase of business :

Business Purchase A/c

Dr.

To Vendor's A/c

(Purchase price payable to Vendor)

2. For recording Assets and Liabilities taken over by the Purchasing Company :

- (A) If purchase price is equal to net assets

Sundry Assets A/c

Dr.

(At agreed value of assets purchased)

To Sundry Liabilities A/c (At agreed value of liabilities taken over)

To Business Purchase A/c

(Assets and Liabilities taken over)

- (B) If purchase price is more than net assets

Sundry Assets A/c

Dr.

Goodwill A/c (being, the balancing figure)

To Sundry Liabilities A/c

To Business Purchase A/c

(Assets and Liabilities taken over)

- (C) If purchase price is less than net assets :

Sundry Assets A/c

Dr.

To Sundry Liabilities A/c

To Business Purchase A/c

To Capital Reserve A/c (being, the balancing figure)

(Assets and Liabilities taken over)

3. If interest is due at the purchase price :

Interest A/c

Dr.

To Vendors A/c

(Interest due to Vendors)

4. For payment of purchase price to the Vendor :

Vendor's A/c

Dr.

To Bank A/c

To Share Capital A/c (If shares are issued)

To Debentures A/c (If debentures are issued)

(Payment made to Vendors)

ILLUSTRATION 1.

CHAPTER 4

Profit or Loss Prior to Incorporation and Subsequent to Incorporation

Sometimes a new Company may take over a running business from a certain date, whereas it may receive its certificate of incorporation at a later date. For example, a Company incorporated on 1st April, 1997 may purchase a running business as from 1st January, 1997. Usually the business is purchased from vendor from the date of last balance sheet so that assets and liabilities are taken over at the figures given in the Balance Sheet.

The new company would be entitled to all profits earned from the date of purchase to the date of incorporation. Thus if a new Company named *X Ltd.* purchases the business of *Y Ltd.* on 1st Jan., 1997 but gets its certificate of incorporation on 1st April, 1997, the *X Ltd.* would be entitled to the profits made between 1st January to 31st March. Such profit is called profit prior to incorporation. Although *X Ltd.* is entitled to such profit, it cannot be taken as revenue profits earned by *X Ltd.* because these are the profits earned even before the Company came into existence. Such profit is not available for distribution as dividend to its shareholders. It is deemed to be capital profit and is transferred to capital reserve. It is, therefore, essential for the Purchasing Company to ascertain the amount of such profit separately. The profit prior to incorporation may be used for the following :—

1. In writing off goodwill,
2. In writing off a capital loss, if any
3. The balance of pre-incorporation profit is transferred to Capital Reserve Account.

If there is a loss during pre incorporation period, such loss is in the nature of a capital loss and must be debited to Goodwill Account.

In the case of a public limited company, it must also obtain a certificate of commencement of business in addition to the certificate of incorporation. As such, in some questions, the date of certificate of commencement of business is also given, in addition to the date of certificate of incorporation. It should be noted carefully that it is the date of incorporation and not the date of commencement of business which is taken into consideration for the calculation of profit or loss prior to incorporation.

Calculation of Profit or Loss Prior to Incorporation

In order to calculate the profit or loss prior to incorporation, the following steps may be taken :—

(1) Calculation of Gross Profit, Time Ratio and Sales Ratio :—

- (i) **Calculation of Gross Profit :—** Prepare one 'Trading Account' for the whole period i.e., from the date of purchase of business to the date of final accounts. The date of incorporation does not affect the calculation of gross profit.
- (ii) **Calculation of Time Ratio :—** It is calculated by considering the period falling from the date of purchase to the date of incorporation and the period falling from the date of incorporation to the date of preparing final accounts. For example, if X Co. is formed to purchase a running business as from 1 January, 1997 and receives its certificate of incorporation on 31st March, 1997 and if it prepares its final accounts on 31st December, 1997, then the pre-incorporation period is 3 months (i.e., from 1st January to 31st March) and the post-incorporation period is 9 months (i.e., from 1st April to 31st Dec.). As such, the time ratio is 3 : 9 or 1 : 3.
- (iii) **Calculation of Sales Ratio :—** It is calculated by comparing the sales of pre-incorporation period to that of sales of post-incorporation period. If, in the above example, the sales from 1st Jan., 1997 to 31st March, 1997 are Rs. 1,00,000 and the sales from 1st April, 1997 to 31st Dec., 1997 are Rs. 7,00,000, the sales ratio is 1 : 7.

(2) Now a Profit & Loss Account is prepared for calculating the net profits for pre- and post-incorporation periods separately. This is done by allocating the various items into the pre- and post incorporation period on the following basis :—

- (i) Gross profit should be allocated between the two periods on the basis of **sales ratio**. This is done because the gross profit is connected with sales.
- (ii) Such expenses which are directly related to sales (or which fluctuate with sales) should be allocated on the basis of **sales ratio**. Such expenses include selling expenses, advertisement, commission, discount, bad-debts, carriage outward, packing and distribution expenses etc.
- (iii) Such expenses which are of fixed nature or which are incurred on the basis of time should be allocated on the basis of **time ratio**. These include rent, salaries, insurance, interest, electricity charges, postage, office expenses, audit fees etc.
- (iv) There are certain expenses which are incurred exclusively after the incorporation of the Company such as director fees, remuneration of the managing director, preliminary expenses or formation expenses, interest on debentures etc. These expenses are not divided but charged wholly to the **post-incorporation period**.

(3) Lastly, from the gross profit of prior period, expenses of prior period are deducted to find out the net profit prior to incorporation and from the gross profit of the subsequent period, expenses of the subsequent period are deducted to find out the net profit of the subsequent period.

Profit prior to incorporation is capital profit and hence transferred to capital reserve whereas the profit after incorporation will be treated as revenue profit and will be available for dividends etc.

UNIT – II

CHAPTER 5

Issue of Debentures

Meaning of Debenture :

In addition to raising of Capital by issue of shares, a Company requiring funds on long term basis, may borrow money by issue of debentures. A debenture issued by a Company is usually in the form of a Certificate, given under the seal of the Company. Thus a debenture is a written acknowledgement of a debt taken by the Company as these are issued under the seal of the Company.

A Debenture Certificate contains the terms of the repayment of the principal sum at a specified date and the terms of payment of interest at a fixed per cent.

According to section 2(12) of the Companies Act, "Debenture includes debenture stock, bonds and any other securities of a Company, whether constituting a charge on the assets of the Company or not."

Characteristics or features of debentures :

1. A debenture is issued by a Company in the form of a Certificate, which is a written acknowledgement of debt taken by the Company.
2. A debenture is issued under the seal of the company.
3. It contains a contract for the repayment of principal sum at a specified date.
4. Usually the debentures are issued with a specified rate of interest, which is called 'Coupon Rate'. A debentureholder receives interest on his debentures at this specified rate, as mentioned in the certificate. Payment of interest is made, normally after every six months, whether the Company makes a profit or not.
5. A debenture is generally secured by a charge on the assets of the Company. This means that if the Company is unable to repay the debentures as per the terms of issue, the debentureholders can move the Court and realise their money by getting the assets of Company sold.
6. Funds raised by the issue of debentures are of long term nature and usually the debentures are repaid after a long period, such as seven years, ten years or twelve years. As such, the loan raised by the issue of debentures is also called as 'Loan Capital'.

Bond : It is very much similar to that of debenture. Traditionally, bonds had been issued by the government, but now a days these are also being issued by various semi-government and non-government organisations. Main distinction between debenture and bond is with respect to the rate of interest. Debentures are issued with a fixed rate of interest whereas bonds can be issued without predetermined rate of interest as in the case of **deep discount bonds** or **zero coupon bonds**. A deep discount bond or zero coupon bond is one which is issued without prefixed rate of interest and its issue

price is heavily discounted. The difference between issue price and the redemption price represents the total interest to be spread over the duration of the bond. A proportionate amount of total interest is charged to Profit and Loss Account every year over the lifetime of bond.

Types or Kinds of Debentures :

A Company may issue the following types of debentures :

1. **Secured or Mortgage Debentures** : These debentures are those which are secured either on particular assets of the Company called fixed charge or on all assets of the Company in general, called a floating charge. Fixed charge denies the Company from dealing with mortgaged assets, whereas the floating charge does not prevent the Company from using the assets. If the Company is unable to repay the debentures on the due date, the debentureholders can realise their money from the assets mortgaged with them. First mortgage debentures are those that have a first claim on the assets charged and second mortgage debentures are those having a second claim on the assets charged. In India, debentures have necessarily to be secured.

2. **Unsecured or Naked Debentures** : These debentures are those which are not given any security. The holders of such debentures are treated as unsecured creditors at the time of liquidation of the Company. Such debentures are not very common these days, so much so that, unless otherwise stated, a debenture is presumed to be secured.

3. **Registered Debentures** : Names and addresses of the holders of such debentures are recorded in a register of the Company called, "Register of Debentureholders". Such debentures are not freely transferable. The Transfer of such debentures requires the execution of a proper transfer deed. Principal amount and interest on such a debenture is paid to the person whose name appears in the Company's register.

4. **Bearer Debentures** : Names and addresses of the holders of such debentures are not recorded in the Company and these debentures are transferable by mere delivery. Payment of principal and interest is made to the bearer of such debentures. Coupons are attached with these debentures and the interest is paid to such persons who produce the coupons in the specified bank.

5. **Redeemable Debentures** : Redeemable debentures are those debentures which will be repaid by the Company either in lump sum at the end of a specified period or by instalments during the lifetime of the Company. Most of the debentures are generally of this type.

6. **Irredeemable or Perpetual Debentures** : Irredeemable debentures are those debentures which are not repayable by the Company during its life time. These debentures are repayable only at the time of liquidation of the Company.

7. **Convertible Debentures** : Convertible debentures are those debentures which are convertible into equity shares or other securities at a stated rate of exchange either at the option of debentureholders or at the option of the company after a specified period. When only a part of the amount of debenture is convertible into shares, such debentures are called 'Partly Convertible Debentures'. When the full amount of debenture is convertible into shares, such debentures are called 'Fully Convertible Debentures'. SEBI Guidelines require that where the conversion is to be made at or after 18 months from the date of allotment but before 36 months, any conversion in part or whole shall be optional on the part of the debentureholders. Convertible debentures

are very popular these days, as they provide liquidity, safety, capital appreciation and assured return to the investors.

Distinction Between a Share and a Debenture

S N	Basis of Distinction	Share	Debenture
1.	Capital vs Loan	A share is a part of the Capital of the Company, therefore, the shareholders are the owners of the Company.	A debenture is a part of the loan and as such, the debentureholders are the creditors of the Company.
2.	Dividend vs Interest	A shareholder gets dividend from the Company.	A debentureholder gets interest from the Company.
3.	Fluctuating or Fixed rate of dividend or interest	Dividend is paid only when there are profits. The rate of dividend may fluctuate from year to year depending upon the profits and decision of the directors.	The rate of interest is fixed and it must be paid irrespective of the Company making a profit or incurring a loss.
4.	Voluntary or compulsory redemption	It is at the option of the Company to return the amount of shares by buying back its own shares.	The amount of debentures must be returned according to the terms of the issue.
5.	Priority of repayment of principal in case of winding up	In the case of winding up, the payment of share capital is made after the repayment of debentures.	In the case of winding up, the payment of debentures is made before the payment of share capital.
6.	Unsecured or Secured	A share is always unsecured. Hence, they bear more risk.	Debentures are usually secured on the assets of the Company. Hence, they bear little risk.
7.	Restriction on issue at discount	Section 79 imposes certain restrictions on the issue of shares at discount.	There are no restrictions on the issue of debentures at discount.
8.	Voting rights	Share confers on its holder the right to participate in and vote at Company's meetings.	A holder of debenture neither possesses any voting right in the Company's meetings nor can he participate in the meeting.

Issue of Debentures

The procedure for the issue of debentures is very much similar to that of the issue of shares. A prospectus is issued in which terms and conditions of the issue of debentures are given. Applications on the prescribed form are deposited with the Company's bankers alongwith application money. Full amount of debentures may be called by the Company on application itself or the amount may be called in instalments, as in the case of shares. If the amount of debenture is called in instalments, some amount may be called on application, some amount on allotment and the balance may be called in one or more calls.

Just like shares, debentures may also be issued either at par, or at a premium or at a discount. However, there are no restrictions on the issue of debentures at discount, whereas shares can be issued at discount only after observing certain legal formalities. The rate of discount is also to be decided by the directors.

Journal entries on issue of debentures are also the same as in the case of issue of shares. The only difference is that 'Debenture A/c' will be opened in place of 'Share

Capital A/c. It is usual to prefix the rate of interest to the debentures. Thus, if the rate of interest is 12%, the name given will be "12% Debentures".

Following entries will be passed on the issue of debentures (assuming that the debentures carry 12% interest)

1. On receipt of application money : Dr.
 Bank A/c
 To 12% Debenture Application A/c
 (Application money received)

2. On Transfer of application money to Debenture Account : Dr.
 12% Debenture Application A/c
 To 12% Debentures A/c
 (Application money transferred)

3. On refund of money on totally rejected applications : Dr.
 12% Debenture Application A/c
 To Bank A/c
 (Application money returned on rejected applications)

4. On the transfer of surplus application money on partially accepted applications : Dr.
 12% Debenture Application A/c
 To 12% Debenture Allotment A/c
 (Transfer of excess application money to allotment A/c)

5. On making allotment money due : Dr.
 12% Debenture Allotment A/c
 To 12% Debentures A/c
 (Allotment money due)

6. On receipt of allotment money : Dr.
 Bank A/c
 To 12% Debenture Allotment A/c
 (Allotment money received)

7. On making the call money due : Dr.
 12% Debenture First Call A/c
 To 12% Debentures A/c
 (First Call money due)

8. On receipt of call money : Dr.
 Bank A/c
 To 12% Debenture First Call A/c
 (First Call money received)

If there are more than one call, separate entries for each call will be passed, like above.

Issue of Debentures at Premium

CHAPTER 6

Redemption of Debentures

Meaning of Redemption of Debentures :

(Redemption of debentures means repayment of the amount of debentures to debentureholders.) In other words, redemption refers to discharge of liability on account of debentures by repaying the due amount of debentures. The terms and conditions of redemption are stated in the prospectus inviting applications for the issue of debentures. The terms of redemption are also clearly stated in the debenture certificate. Hence, the redemption is made according to the terms of issue either in one lump-sum at the expiry of the specified period or by means of annual instalments or by conversion into shares or by purchasing them in the open market before the expiry of the specified period.

Sources of Finance for the Redemption of Debentures

Amount required for the redemption of debentures may be managed by a Company from the following sources :

- (1) Redemption from the proceeds of fresh issue of shares and debentures.
- (2) Redemption of Debentures out of Capital.
- (3) Redemption of Debentures out of Profits.

(1) Redemption from the proceeds of fresh issue of shares and debentures :

When a Company is in need of additional funds for the redemption of debentures, it may decide to issue new equity shares, preference shares or debentures. The proceeds of the fresh issue of share capital and debentures are utilised for redeeming the old debentures. In such type of redemption, the financial position of the Company is not adversely affected.

(2) **Redemption of Debentures out of Capital :** When no profits are set aside for redemption of debentures it is called redemption out of Capital. In such a case no profits are transferred to Debenture Redemption Reserve.

In view of Section 117C of the Companies Act and the Securities and Exchange Board of India (SEBI) guidelines requiring creation of Debenture Redemption Reserve equivalent to at least 50% of the amount of debentures issued before redemption commences, it is not possible to redeem debentures purely out of capital.

(3) **Redemption of Debentures out of Profits :** Redemption out of profits means that an amount equal to debentures redeemed is transferred from Profit and Loss Appropriation Account to a newly opened account named 'Debenture Redemption Reserve Account'. According to guidelines issued by Securities and Exchange Board of India (SEBI) it is obligatory for all Companies issuing debentures to create a 'Debenture Redemption Reserve' upto atleast 50% of the amount of debentures issued

before the commencement of redemption of debentures. It is called redemption out of profits because the transfer of profit to Debenture Redemption Reserve (DRR) reduces the amount of profit available for dividend. It means that the profit set aside for DRR is not available for payment as dividend but would be utilised to redeem the debentures. Thus existing liquid resources of the Company are not affected by redemption in this manner.

SEBI Guidelines for redemption of debentures :

- (i) Every company shall create 'Debenture Redemption Reserve' for debentures redeemable after a period of more than 18 months from the date of issue.
- (ii) The creation of Debenture Redemption Reserve (*i.e.*, DRR) is obligatory only for non-convertible debentures and non-convertible portion of partly convertible debentures.
- (iii) A company shall create DRR equivalent to at least 50% of the amount of debentures issued **before starting the redemption of debentures.**
- (iv) Withdrawal from the DRR is permissible only after 10% of the debentures have been redeemed.

Hence, a Company cannot redeem its debentures purely out of capital. Atleast 50% of debentures issued must be redeemed out of profits by creating a 'Debenture Redemption Reserve' and the balance of debentures issued may be redeemed out of profits or out of capital.

Exceptions to the creation of Debenture Redemption Reserve :

Following are the exceptions to the above rule :

- (i) Creation of Debenture Redemption Reserve is not required for issue of debentures with a maturity period of 18 months or less.
- (ii) Infrastructure Companies (*i.e.*, Companies wholly engaged in developing, maintaining and operating infrastructure facilities) are exempted from creating Debenture Redemption Reserve.

Clarifications regarding DRR :

The Department of Company Affairs, Government of India, vide their Circular No. 9/2002, dated 18-04-2002 has issued the following clarifications regarding creation of Debenture Redemption Reserve (DRR) :

- (a) No DRR is required for debentures issued by All India Financial Institutions, by RBI and Banking Companies for both public as well as privately placed debentures.
- (b) No DRR is required for privately placed debentures.
- (c) Section 117 (C) will apply to all debentures pending to be redeemed and, therefore, DRR will also be created for debentures issued prior to 31-12-2000 and pending redemption.
- (d) Section 117 (C) will apply to non-convertible portion of debentures issued whether they are fully or partly paid.

Methods of Redemption of Debentures

63

Following are the methods of redemption of debentures :

- | | | | |
|--|--|------------------------------|---|
| 1. Lump-sum payment at the end of fixed period | 2. Redemption of Debentures in instalments (By draw of lots) | 3. By conversion into shares | 4. By the purchase of own debentures in the open market |
|--|--|------------------------------|---|

(1) Lump-sum payment at the end of fixed period : Under this method, the Company redeems whole of its debentures in one lump-sum at the expiry of a specified period, i.e., at maturity date of the debentures or earlier at the option of the company. Such redemption may be made at par or at premium, according to the terms of issue.

As mentioned earlier it is necessary to transfer an amount equal to 50% of the face value of debentures issued from P & L Appropriation A/c to a newly opened account called "Debenture Redemption Reserve A/c" before the commencement of redemption of debentures. The effect of such a transfer is that it reduces the balance of profits, which ultimately reduces the amount available for dividends. The amount thus saved because of non-payment of dividends is utilized for the payment of debentures. Such redemption is called redemption out of profits because it reduces the amount of profits available for dividends. Such redemption does not affect the financial position of the Company adversely.

When all the debentures are redeemed, the Debenture Redemption Reserve A/c is closed by transferring it to General Reserve A/c.

The journal entries in this method are as follows :

(i) On transfer of profits from P & L Appropriation A/c :

Profit & Loss Appropriation A/c

Dr.

To Debenture Redemption Reserve A/c

(ii) On redemption of debentures :

(a) Debentures A/c

Dr.

To Debentureholders A/c

(b) Debentureholders A/c

Dr.

To Bank A/c

(iii) When all the debentures are redeemed :

Debenture Redemption Reserve A/c

Dr.

To General Reserve A/c

CHAPTER 7

Underwriting

Meaning of Underwriting

In case of issue of shares, if within 120 days from the date of opening of the issue the Company does not receive a minimum subscription of 90% of the issued amount, the Company cannot proceed to allot shares and the entire application money must be returned to the applicants. In view of this, most of the public companies enter into underwriting arrangements.

Underwriting is an agreement entered into before the issue is brought before the public that if the shares or debentures are not taken up by the public in full, underwriters will have to take up and pay for such part of the shares or debentures as the public has not applied for. The persons or institutions who or which guarantee or undertake the issue are known as underwriters. For the guarantee or the service rendered by them, they charge an agreed commission known as '**Underwriting Commission**'. The commission is calculated at a specified rate usually on the issue price of the shares or debentures underwritten. It should be noted that even if the public subscribes for all the shares or debentures offered and the underwriters are not required to take up any share, commission will be payable on the whole of the shares or debentures underwritten. For example, X agrees to underwrite 20,000 shares of a Company at 5% commission. If the public applies for 15,000 shares X will be required to take up the remaining 5,000 shares and he will be entitled to commission on 20,000 shares. Again, if the public applies in full, he will still be entitled to commission on 20,000 shares.

It is not necessary that the whole issue is underwritten by one underwriter alone because the financial position of the underwriter may not be as sound as to take the risk of subscribing the whole issue in the worst circumstances of no subscription by the public. As such, in case of large issues, underwriting agreements are entered into with two or more underwriters, each agreeing to a specified amount.

Underwriting of each issue was mandatory previously but according to the revised guidelines issued by Securities and Exchange Board of India (SEBI) on 10.10.1994, Companies have been given the option to decide whether the issue is to be underwritten or not. This is done to reduce the cost of issue.

Advantages and Objects of Underwriting

- (1) **Certainty of collecting the Capital** : As a result of underwriting the full subscription of the entire issue is ensured because in the event of the public not taking up the whole of them, the balance will be issued to underwriters.

- (2) **Fulfilment of Minimum Subscription Requirement :** The requirement of minimum subscription of 90% of the issue amount is automatically fulfilled.
- (3) **Greater Confidence of the Public :** A Company whose issue is fully underwritten, commands greater confidence in the public because public feels that had the Company been unsound, underwriters would have never agreed to underwrite the issue.
- (4) **Increase in the Goodwill of the Company :** Underwriting increases the goodwill of the Company. Usually, underwriters underwrite the issues of only those Companies which are having efficient management, sound financial health and whose future is bright. This is so because they know that if the shares are not subscribed for by the public, they will have to take them up and hence the ultimate burden will fall upon them.

Underwriting Commission

Section 76 of the Companies Act, 1956 lays down certain provisions regarding the underwriting commission. These are as follows :

- (1) The payment of commission is possible only when it is permitted by its Articles.
- (2) The rate of commission must not exceed :
 - (i) In the case of shares, 5% of the price at which the shares are issued or the rate provided in the Articles, whichever is less, and
 - (ii) In the case of debentures, $2\frac{1}{2}\%$ of the price at which the debentures are issued or the rate provided in the Articles, whichever is less.

However, pursuant to the Guidelines issued by Department of Economic Affairs, Ministry of Finance, the following rates of underwriting Commission are in force :

- | | |
|--|------|
| (A) On Equity Shares | 2.5% |
| (B) On Preference Shares and Debentures | |
| (i) For Issue amounts of upto Rs. 5 Lakh | 1.5% |
| (ii) For Issue amounts in excess of Rs. 5 Lakh | 1 % |
- (3) The amount or rate per cent of the commission paid or agreed to be paid must be disclosed in the prospectus and in case no prospectus is issued, in the statement in lieu of prospectus.
 - (4) The number of shares or debentures which each underwriter has agreed to underwrite for commission must also be disclosed in the prospectus or the statement in lieu of prospectus, as the case may be.
 - (5) Commission cannot be paid on shares and debentures which are not offered to the public for subscription.

If default is made in complying with the provisions of section 76, the Company and every officer of the Company who is in default, shall be punishable with fine which may extend to Rs. 500.

Underwriting Commission is a loss of capital nature and hence is shown on the Assets side of the balance sheet under the heading "Miscellaneous Expenditure". The account represents a fictitious asset and may be written off from reserves or securities

premium account. It may also be gradually written off by transfer to Profit & Loss Account.

Brokerage : Brokerage is paid to a broker on the shares subscribed through him. Brokerage is distinguished from underwriting commission and it may be paid in addition to the underwriting commission. A broker is under no obligation to take up any shares that may remain unsold. Brokerage is fixed at 1.5% whether the issue is underwritten or not. All expenses incurred by the broker for canvassing of public issues will be borne by the broker himself.

Entries Relating to Underwriting

In the Books of Company	In the Books of Underwriters
1. In case the whole of shares or debentures are not taken up by the public, the remaining are allotted to underwriters as follows : Underwriters A/c Dr. To Share Capital A/c To Debentures A/c (The balance of Shares and Debentures allotted to Underwriters)	1. In case the whole of shares or debentures are not taken up by the public, the remaining are purchased from the Co. as follows : Shares A/c Dr. Debentures A/c Dr. To Company A/c (The balance of Shares and Debentures taken)
2. On making the commission payable to underwriters : Underwriting Commission A/c Dr. To Underwriters A/c (Underwriting Commission due)	On making the commission receivable from the Company : Company A/c Dr. To Underwriting Commission A/c (Underwriting Commission due from Co.)
3. On payment of commission in the form of shares and debentures : Underwriters A/c Dr. To Share Capital A/c To Debentures A/c (Payment of commission to Underwriters)	3. On receipt of commission in the form of shares and debentures : Shares A/c Dr. Debentures A/c Dr. To Company A/c (Amount of Commission received)
4. On receipt of balance amount due from underwriters : Bank A/c Dr. To Underwriters A/c (Amount received from Underwriters)	4. On payment of balance amount due to the Company : Company A/c Dr. To Bank A/c (Payment made to Company)

CHAPTER 8

Final Accounts of Companies

Two basic financial statements are included in the 'Final Accounts' of a Company :

1. Profit and Loss Account, and
2. Balance Sheet

Under Section 210 of the Companies Act it has been made compulsory for Companies to prepare their final accounts and present the same before the shareholders for their approval, at every Annual General Meeting of the Company. The auditor's report and director's report must be attached to the final statements of the Company.

Section 211 of the Companies Act states that the balance sheet and profit and loss account of a Company shall give a true and fair view of the state of affairs of the Company and shall be in the prescribed form given in Schedule VI. The prescribed form for the preparation of balance sheet has been given in Part I of Schedule VI.

No standard form has been prescribed by Companies Act for the preparation of profit and loss account of a Company. However, in Part II of Schedule VI it has been laid down as to what it shall contain and disclose.

According to Schedule VI a Balance Sheet should be shown first and a profit and loss account shall be annexed to it. But for the sake of convenience, a profit & loss account will be discussed first and the balance sheet afterwards.

In view of the amendment in the Income-tax Act, 1961, the Profit and Loss Account must be prepared for the year ended 31st March and a Balance Sheet as on 31st March each year.

Profit & Loss Account of a Company :— In case of a Company, it is not essential to split the Profit & Loss Account into three sections (*i.e.*, Trading Account, Profit & loss Account and Profit & Loss Appropriation Account). Only one account (called Profit & Loss Account) may be prepared which may cover the items of Trading Account and P & L Appropriation A/c. However, the splitting of the Profit & Loss A/c into three sections is not forbidden by the Companies Act. In fact, it is desirable to split the Profit & Loss A/c into three sections so that gross profit, net profit and surplus carried to the Balance Sheet may be readily known.

However, in case of a Company, instead of the heading of Trading and Profit & Loss Account, the heading is only Profit & Loss Account. Items relating to Trading Account are shown in its first part and the items relating to Profit & Loss Account appear in its second part.

Profit and Loss Account of a Company should be made out in such a manner that it depicts a true and fair picture of the result of the working of the Company for the financial year. As such, all items relating to the income and expenditure of the

Company should be shown in full detail under the most convenient heads. In the case of a Company it is essential to show the figures of the previous year on both sides of the account in order to facilitate a comparative study.

Given below is the ideal form of Profit & Loss Account of a Company, prepared according to schedule VI Part II :—

PROFIT & LOSS ACCOUNT
for the year ending on

Figures for the previous year	Expenditure	Figures for the current year	Figures for the previous year	Income	Figures for the current year
Rs.		Rs.	Rs.		Rs.
	To Opening Stock :			By Sales	
	1. Raw Materials			Less : Sales Returns	
	2. Work-in-progress			By Closing Stock :	
	3. Finished goods			1. Raw Materials	
	To Purchases			2. Work-in-progress	
	Less : Purchase Returns			3. Finished goods	
	To Manufacturing Expenses :			By Gross loss (if any) c/d	
	1. Wages				
	2. Fuel and Power				
	3. Royalty				
	4. Excise duty				
	5. Other direct expenses, such as : Carriage/Carriage Inwards, Freight, Custom duty etc.				
	To Gross Profit (if any) c/d				
	To Gross Loss (if any) b/d			By Gross Profit (if any) b/d	
	To Employee's Remuneration & Benefits :			By Income from Investments	
	1. Salaries, Bonus etc.			By Profit on Sale of Investments	
	2. Contribution to Provident Fund, Pension fund etc.			By Interest received	
	3. Staff welfare expenses			By Miscellaneous receipts, such as :	
	To Selling & Distribution Expenses :			1. Transfer Fee	
	1. Advertising, Godown rent etc.			2. Rent Received	
	2. Commission, brokerage & Discount allowed			3. Dividend Received	
	To Office Expenses :			By Net Loss (if any)	
	1. Rent			c/d to P & L Appropriation A/c	
	2. Rates and Taxes				
	3. Insurance				

GENERAL ACCOUNTS OF COMPANIES

- | | | | |
|---|--|--|--|
| 4 Printing, Postage & Stationery | | | |
| 5 Repairs | | | |
| 6 Miscellaneous expenses | | | |
| To Interest | | | |
| 1 Interest on Debentures | | | |
| 2 Other Interest | | | |
| To Loss on Sale of Investments | | | |
| To Director's Fees | | | |
| To Auditor's Fees | | | |
| To Managerial remuneration | | | |
| To Political Donations | | | |
| To Provision for specific liabilities : | | | |
| 1. For Depreciation | | | |
| 2. For Bad & Doubtful Debts | | | |
| 3. For Taxation | | | |
| To Net Profit (if any) c/d to P & L Appropriation A/c | | | |

It will be necessary to prepare a Profit & Loss Appropriation Account just after the Profit & Loss Account. But as Profit & Loss Appropriation Account will be discussed later in this chapter only a format of the same is given below :—

PROFIT & LOSS APPROPRIATION ACCOUNT for the year ending

- | | | | |
|---|--|--|--|
| To Last year's loss b/d (if any) | | | |
| To Current year's Loss b/d (if any) | | | |
| To Transfer to Reserves : | | | |
| 1. Transfer to General Reserve | | | |
| 2. Transfer to Development Rebate Reserve | | | |
| 3. Transfer to Dividend Equalisation reserve | | | |
| 4. Transfer to Debenture Redemption Fund etc. | | | |
| To Adjustments relating to past years, such as, arrears of Depreciation | | | |
| To Preference Dividend | | | |
| To Interim Dividend on equity shares | | | |
| To Proposed Dividend on equity shares | | | |
| To Balance of Profit (if any) carried to Balance Sheet | | | |

- | | | | |
|---|--|--|--|
| By Last year's Profit b/d (if any) | | | |
| By Current year's Profit b/d (if any) | | | |
| By Transfer from Reserves (if any) | | | |
| By Adjustments relating to past years, such as saving in provision for Taxation in previous years | | | |
| By Balance of Loss (if any) Carried to Balance Sheet | | | |

The Form of Balance Sheet as given in Part I of Schedule VI is given below :—

SCHEDULE VI PART I
FORM OF BALANCE SHEET
BALANCE SHEET OF CO. LTD.
as on

Figures for the previous year	Liabilities	Figures for the current year	Figures for the previous year	Assets	Figures for the current year
Rs.		Rs.	Rs.		Rs.
	(1) Share Capital : Authorised shares of Rs.....each Issued shares of Rs.....each Subscribed shares of Rs.....each Rs..... per share called up Less: Calls in arrears Add: Forfeited shares A/c Calls in Advance A/c (2) Reserves & Surplus : 1. Capital Reserve 2. Capital Redemption Reserve 3. Securities Premium 4. Other Reserves Less: Debit balance of P & L Appropriation A/c (if any) 5. Surplus i.e., Credit Balance of P & L A/c (after providing for Proposed Dividend, Bonus or Reserves) 6. Proposed additions to reserves 7. Sinking Fund (3) Secured Loans : 1. Debentures 2. Loans and advances from Banks 3. Loans and advances from subsidiaries 4. Other Loans and Advances 5. Interest accrued and due on secured loans (4) Unsecured Loans : 1. Fixed Deposits 2. Loans and advances from subsidiaries 3. Short-Term Loans and Advances 4. Other Loans and Advances 5. Interest accrued and due on unsecured loans			(1) Fixed Assets : 1. Goodwill 2. Land 3. Buildings 4. Leaseholds 5. Railway Sidings 6. Plant & Machinery 7. Furniture & Fittings 8. Development of Property 9. Patents, Trade Marks and Designs 10. Live Stocks 11. Vehicles etc. (2) Investments : (Showing nature of investment and mode of Valuation, for example, Cost or Market Value) 1. Govt. or Trust Securities 2. Shares, debentures or bonds 3. Investment in Immovable Properties 4. Investment in the Capital of partnership firms. (3) Current Assets, Loans & Advances : (A) Current Assets : 1. Interest accrued on Investments 2. Stores and Spare parts 3. Loose Tools 4. Stock-in-trade 5. Work in progress 6. Sundry Debtors : (a) Debts outstanding for a period exceeding 6 months (b) Other debts Less: Provision 7. (a) Cash balance on hand (b) Bank balances : (i) With Scheduled Banks (ii) With Others (B) Loans and Advances : 8. (a) Advances and loans to	

ACCOUNTS OF A COMPANY

- (3) **Current Liabilities and Provisions :**
- (A) **Current Liabilities :**
1. Acceptances (B/P)
 2. Sundry Creditors
 3. Amount due to Subsidiary Companies
 4. Advance Payments and Unexpired Discounts (for which the value has still to be given)
 5. Unclaimed Dividends
 6. Other Liabilities, if any
 7. Interest accrued but not due on loans
- (B) **Provisions :**
8. Provision for Taxation
 9. Proposed Dividends
 10. Provision for Contingencies
 11. Provision for Provident Fund
 12. Provision for insurance, pension and similar staff benefit schemes.
 13. Other Provisions
- (6) **Contingent Liabilities** (by way of foot-notes only) e.g. :
1. Claims against the company not acknowledged as debts.
 2. Uncalled liability on partly paid shares.
 3. Arrears of fixed cumulative dividends.
 4. Estimated amount of contracts remaining to be executed on Capital account and not provided for.
 5. Other moneys for which the Company is contingently liable.

- subsidiaries
- (b) Advances and loans to partnership firms in which the Company or any of its subsidiaries is a partner.
9. Bills of Exchanges (B/R)
 10. Advances recoverable in cash or in kind (e.g. Rates, Taxes, Insurance etc. prepaid)
 11. Balances with customs, Port Trusts, and excise authorities etc.
- (4) **Miscellaneous Expenditure :**
1. Preliminary Expenses
 2. Expenses, including commission or Brokerage on underwriting of issue of Shares or Debentures.
 3. Discount allowed on the issue of Shares or Debentures.
 4. Interest paid out of capital during construction period.
 5. Development expenditure not adjusted.
 6. Other sums (specifying nature)
- (5) **Profit and Loss Account**
(Loss)
Dr. balance of P & L A/c
(if any)
(This is shown only when its debit balance could not be written off out of other reserves.)

Details of each of the above items is given in a separate schedule. The schedule contains all the information regarding that particular item.

Explanation of Different Items of Balance Sheet

Items appearing on the Liabilities side :

1. **Share Capital :** Authorised Capital, Issued Capital, Subscribed Capital, Called-up Capital and Paid-up Capital should be shown separately under this head. If the Company has issued preference shares also, they should also be shown separately under this head. If there are calls-in-arrears, they should be shown as a deduction from called-up Capital. If some shares have been forfeited, the amount of 'forfeited share

account' should be shown by adding to the paid-up capital. 'Calls-in-advance account' is also shown under this head separately.

2. **Reserves and Surplus** : Following reserves are shown under this head :

- I. Capital Reserve
- II. Capital Redemption Reserve
- III. Securities Premium
- IV. **Other Reserves** : If there is a debit balance of profit and loss account, it shall be shown as a deduction from such uncommitted reserves.
- V. **Surplus** : It denotes the credit balance left in profit and loss appropriation account after providing for proposed allocations namely, dividend, bonus or reserves.
- VI. Proposed additions to reserves.
- VII. **Sinking Fund** : If reserves are invested in outside securities and such securities are earmarked (set aside) for the particular purpose indicated by the reserve, the reserve will be named as 'Reserve Fund'.

3. **Secured Loans** : Where loans have been taken on the security of some assets of the Company, such loans are called '**Secured Loans**'. Debentures are usually secured loans and therefore shown under this head. Interest accrued and due on Secured Loans should also be shown under this head separately. Interest accrued but not due should not be shown under this head, but should be shown under the head 'Current Liabilities'.

For example, if a Company pays interest on its debentures half yearly on 30th June and 31st December, and assuming that the Company prepares its accounts on 31st March, 2004, and if the interest due on these debentures upto 31st December, 2003 remains unpaid on 31st March, 2004 it will be called '**Interest accrued and due**' and will be shown under the head 'Secured Loans'. Interest on the above debentures from 1st January, 2004 to 31st March, 2004 will be termed as 'Interest accrued but not due' and will be shown under the head 'Current Liabilities'.

4. **Unsecured Loans** : Where loans have not been taken on the security of any asset of the Company, such loans are called 'Unsecured Loans'. Short-term loans and long-term loans should be shown separately. Short-term loans include those which are due for repayment not later than one year as at the date of the balance sheet. Interest accrued and due on Unsecured Loans should also be shown under this head.

5. **Current Liabilities and Provisions** : Under this head, 'Current Liabilities' are shown separately in Part A and Provisions are shown separately in Part B. Current Liabilities include Bills Payable, Sundry Creditors, Advance Payments, Unclaimed Dividends etc.

Provisions are shown in part B and they include Provision for Taxation, Proposed Dividends, Provident Fund, Provision for insurance and pension schemes etc.

There is a distinction between a liability and a provision. If an amount is payable in future and the figure is exact, it is a liability. For instance, if the salary for the month of March totalling Rs. 50,000 is outstanding on 31st March, such amount of outstanding salary is a definite liability. If the amount of a liability is not certain, it will be a provision such as provision for taxation etc.

There is distinction between 'Reserves' and 'Provisions'. Reserves mean accumulated profits and it is created to strengthen the financial position of the company and to meet unforeseen (unknown) liabilities and losses.

'Provision' is an amount provided for any known liability whose amount as yet is uncertain. Provision is made to meet a specific liability of which the amount cannot be determined with substantial accuracy.

Contingent Liabilities : Contingent Liabilities are liabilities which have not arisen, but may arise upon the happening of a certain event. In other words, the liability itself is uncertain. It may or may not involve the payment of money. The amount of contingent liabilities is never shown in the amount column of the liabilities side. These are always stated in the form of a foot-note on the liabilities side.

Following are the usual types of Contingent liabilities :

- I. **Claims against the Company not acknowledged as debts or disputed claims:** For example, if some party has filed a suit against the firm for damages, the amount will be payable if decreed by the court, otherwise not. The amount payable will also be decided by the Court.
- II. **Uncalled liability on partly-paid shares :** If the Company holds partly-paid shares of other Companies as investment, the uncalled amount on these shares is a contingent liability, as it will have to be paid when called.
- III. **Arrears of Dividends on Cumulative Preference Shares.**
- IV. **Estimated amount of contracts remaining to be executed on Capital account and not provided for.**
- V. **Other moneys for which the Company is contingently liable.**
- VI. **Bills discounted but not matured :** If the Company has discounted some bills receivable from the bank, the primary liability will be that of the acceptor. The Company will be liable if the acceptor does not pay.
- VII. **Guarantee for Loan :** If the Company has stood surety for some loan, it may become liable to pay the amount of loan if the principal debtor fails to meet his obligation.

Explanation of the items appearing on Assets Side :

1. **Fixed Assets :** Assets which are acquired for permanent use in the business and are not meant for resale are called fixed assets. Such assets are purchased once and last for many years such as Goodwill, Land, Buildings, Leaseholds, Railway Sidings, Plant and Machinery, Furniture, Development of Property, Patents, Live Stock, Vehicles etc.

In the case of fixed assets, original cost of each asset, additions made during the year, cost of the asset sold during the year and the total depreciation provided on each asset upto the end of the year are to be stated separately.

If all such details cannot be conveniently included in the balance sheet itself, a separate schedule containing all such details will be annexed to the balance sheet and it will form part of the balance sheet.

2. **Investments :** These should be classified as under :

- I. Investment in Government or trust securities.
- II. Investment in Shares, debentures or bonds.

III. Investment in immovable properties.

IV. Investment in the capital of partnership firms.

Investments should further be divided into two parts :

1. Quoted, and II. Unquoted. In the case of quoted investments, market price must be disclosed.

3. **Current Assets, Loans and Advances** : These should be divided into two parts :

A. Current Assets

B. Loans and Advances

4. **Miscellaneous Expenditure** : That amount of Miscellaneous Expenditure which is written off this year is shown on the debit side of profit and loss account and the unwritten off portion is shown in the balance sheet under this head.

5. **Debit balance of Profit and Loss Account** : If there is net loss in a Company and other reserves (or general reserve) is given, net loss must be deducted from such 'other reserves'. But if other reserve is not given, this net loss will be shown under this head.

Some necessary Adjustments for preparation of Final Accounts of Companies :—

(1) **Interest on Debentures** :— It is necessary to calculate the full year's interest on Debentures, even if nothing is mentioned in the adjustments about the debenture interest. The full year's debenture interest must be compared with the debenture interest appearing in the Trial Balance and the difference, if any, should be treated as outstanding interest. The amount of outstanding interest should be shown on the debit side of P & L A/c and also on the liabilities side along with Debentures.

(2) **Cost of Issue of Debentures or Discount on Issue of Debentures** :— Cost of issue, commission or discount on the issue of debentures appears on the assets side of balance sheet under the heading 'Miscellaneous Expenditure'. This expense should be written off as early as possible and in any case not later than the date of redemption of debentures. The amount written off is shown on the debit side of Profit & Loss Account and the unwritten off portion is shown on the Assets side under the heading 'Miscellaneous Expenditure'.

(3) **Interest on Sinking Fund Investments** :— First of all, it must be written on the credit side of Profit & Loss Account because the law requires all incomes to be shown there. But this is opposed to the general accounting practice that if the interest is received on the investments made out of a particular fund, such an interest must be added to that fund. As such, the effect of this departure from accounting practice is nullified by once again recording the amount of such an interest on the debit side of Profit and Loss Appropriation Account and adding to the Sinking Fund on the liabilities side of the balance sheet.

(4) **Doubtful Debts** :— Sometimes it is given in the adjustments that the Debtors appearing in the Trial Balance include some debts which are doubtful. No adjustment should be made for such doubtful debts unless it is clearly stated to make a provision in respect thereof.

Also, sometimes the Debtors for more than six months old are given in the adjustments. It requires no adjustment except that the Debtors shown in the balance sheet will be split into Debtors for more than six months old and others.

For example, Total Debtors are Rs. 30,000, out of which Rs. 4,000 are more than six months old. It will be shown on the Assets side as follows :—

Debtors for more than six months old
Other Debtors

Rs.	Rs.
4,000	
26,000	30,000

(5) **Proposed Dividend** :— 'Dividend' is that portion of the profits of the company which is allocated to the shareholders of the company. 'Proposed Dividend' is generally given under adjustments. This is recorded on the debit side of Profit & Loss Appropriation Account and on the liability side of balance sheet under the heading 'Current Liabilities and Provisions' under Part B 'Provisions'.

Some Special Items Related to Trial Balance

1. **Depreciation** :— If it is appearing on the debit side of the Trial Balance, it will be shown only on the debit side of P & L A/c. On the contrary, if it appears on the credit side of the Trial Balance, it will be deducted only from the concerned assets on the assets side of the balance sheet.
2. **Outstanding Expenses** :— Sometimes, these are appearing inside the Trial Balance on the credit side. In such a case, these will be recorded only on the liabilities side under the heading 'Current Liabilities'.
3. **Prepaid Expenses** :— Sometimes, these are appearing inside the Trial Balance on the debit side. In such a case, these will be recorded only on assets side under the heading, 'Current Assets, Loans and Advances' under Part B 'Loans and Advances'.
4. **Closing Stock** :— It may also be given inside the Trial Balance on the debit side. Hence, will be shown only on the Assets side under the heading 'Current Assets'.
5. **Advance Payment of Taxes and 'Tax deducted at source'** :— These are in the nature of prepaid items and hence will be recorded on the assets side under the heading 'Current Assets, Loans and Advances' under Part B 'Loans and Advances'.
6. **Share Transfer Fees** :— It is the income of the Company received on the transfer of shares from one shareholder to another. It appears on the credit side of the Trial Balance and will be recorded on the credit side of the Profit & Loss Account.
7. **Income-Tax** :— In case of a Company, Income-Tax or tax on profits of the Company is recorded in the Profit & Loss Account on the debit side.
8. **Dividend to Shareholders** :— This item appears on the debit side of Trial Balance and because it represents appropriation of profits of the Company it is shown on the debit side of Profit & Loss Appropriation Account.
9. **Interim Dividend** :— If directors pay dividend even before the year is closed and the payment is out of current year's profit, it is called interim dividend. It is usually given on the debit side of the Trial Balance and because it is an appropriation of profits, it is recorded on the debit side of Profit & Loss Appropriation Account.
10. **Unclaimed Dividend** :— This always appears on the credit side of Trial Balance and represents dividend not collected by the shareholders. It is recorded on the liability side of the balance sheet under the heading 'Current Liabilities'.

11. **Dividend Received** :— This item is shown on the credit side of the Trial Balance and represents the income of the Company on investments made by it in the shares of some other Company, it is recorded on the credit side of Profit & Loss Account.

12. **Calls in Arrears** :— This item usually appears on the debit side of the Trial Balance and represents the amount not paid by the shareholders on the calls made by the Company. This is shown on the liabilities side as a deduction from the called-up capital.

13. **Calls-in-Advance** :— This is shown separately in the Balance Sheet under the sub-heading Subscribed Capital, but it should not be added in the amount of subscribed capital.

14. **Forfeited Shares Account** :— This item appears on the credit side of the Trial Balance and is recorded on the liability side by adding to the paid-up capital under the heading 'Subscribed Capital'.

15. **Securities Premium Account** :— This is recorded on the liability side under the heading 'Reserves and Surplus'.

Divisible Profits

All profits are not divisible profits. Only those profits which are legally available to shareholders for dividend are known as divisible profits. In normal course, divisible profits are the profits left after meeting all expenses, losses, depreciation on fixed assets, fall in the price of current assets, taxation, writing off past losses and after transferring a reasonable amount to reserves. Divisible profits should not include capital profits i.e., the profits of extraordinary nature (non-recurring profits) or profits arising from revaluation or sale of fixed assets or redemption of fixed liabilities. Dividends cannot be declared except out of divisible profits.

Transfer of Profits to Reserve :

Section 205 (2A) of the Companies Act provides that if the percentage of dividend proposed exceeds 10%, the Company is required to transfer a certain percentage of current year's profits to reserves. The percentage of transfer depends on the rate of proposed dividend as specified below :

	Proposed Dividend	Percentage of Profits transferred to Reserve
(a)	10% or less of the paid up Capital	Nil
(b)	Exceeding 10% but not more than 12.5% of the paid up Capital	2.5%
(c)	Exceeding 12.5% but not more than 15% of the paid up Capital	5%
(d)	Exceeding 15% but not more than 20% of the paid up Capital	7.5%
(e)	Exceeding 20% of the paid up Capital	10%

Notes : (i) The term 'Reserves' means General Reserve or free reserves and the expression free reserves denotes that reserves are not created for any specific purpose.

- (ii) Above mentioned percentages of transfer to reserves are the minimum which a Company must transfer. Hence, the Company can transfer higher percentage of profits to reserves. However, if the transfer to reserves exceeds 10% of its current year's profits, the minimum dividend rate should be equal to average rate of dividend declared in preceding three years.
- (iii) In case no dividend was declared over the last three financial years, the Company is prohibited from transferring more than 10% of its profits to reserves.
- (iv) The term 'dividend' means equity dividend and also to the portion of dividend relating to participating preference shares over and above the fixed rate of dividend.

Corporate Dividend Tax (C.D.T.) :

Before 1997, dividend distributed was taxed in the hands of the shareholders. However, with the amendments introduced in the Finance Act 1997, companies distributing dividends are required to pay tax on such dividends. This is called 'Corporate Dividend Tax' (CDT). It means dividend is now absolutely free of tax in the hands of the shareholders. In this respect it may be noted that :

- (i) C.D.T. is disclosed separately in the Profit and Loss Appropriation Account and also on the liabilities side of the Balance Sheet under the head 'Provisions'.
- (ii) Rate of C.D.T. was 10% when it was first introduced in the year 1997. Present rate for financial year 2007-08 for C.D.T. is 15% with an additional surcharge of 10% plus 3% education cess i.e., effective rate is 16.995% as calculated below :

	15
+ 10% of 15	1.50
	16.50
+ 3% of 16.50	.495
	16.995 %

- (iii) C.D.T. is payable on equity as well as on preference dividend.
- (iv) C.D.T. must be paid within 14 days from the date of declaration of dividend.

Profit and Loss Appropriation Account

After ascertaining the divisible profits, the question of its disposal arises. Usually, the articles of the Company empower the directors to decide the amount of profit to be transferred to reserves and also the quantum of dividends. The directors may decide to retain a certain amount of profits to strengthen the financial position of the Company. Such profits may be retained in the form of transfer to various reserves or even by keeping as a balance. A part of the profits may also be distributed as dividends. The account showing the disposal of divisible profits is called 'Profit and Loss Appropriation Account'.

Following items are shown on the credit side of Profit & Loss Appropriation Account :—

1. Balance of Profit brought forward from the previous year, if any.
2. Net Profit of the current year (transferred from P & L A/c), if any.
3. Transfer from various reserves, and
4. Adjustments relating to the previous years.

Following items are shown on the debit side of Profit & Loss Appropriation Account :—

1. Balance of loss brought forward from the previous year, if any.
2. Net loss of the current year (transferred from P & L A/c), if any,
3. **Transfer to various reserves**, such as, General Reserve, Dividend Equalisation Fund, Debenture Redemption Fund etc.
4. **Interim Dividend** : Dividend paid during the year, before ascertainment of the profits for the year is called '**Interim Dividend**'. Directors are empowered to pay the interim dividend, in anticipation of the profits and without the sanction from the shareholders. However, if an interim dividend is paid and it is found subsequently that the Company's profits are inadequate to cover the interim dividend, it amounts to payment of dividend out of capital which is forbidden by law and hence the directors will be liable to make good the amount.
5. (i) **Proposed Dividend** : Dividend proposed by the directors is termed as proposed dividend.
(ii) **Final Dividend** : Dividend proposed by the directors is declared by shareholders (and not by directors) at the annual general meeting. After the declaration the proposed dividend is termed as final dividend. Shareholders cannot increase the rate of dividend proposed by the directors.
6. Corporate Dividend Tax (C.D.T.)
7. Balance of profit and loss appropriation account is shown on the liabilities side of the balance sheet under the heading 'Reserves and Surplus'.

CHAPTER 9

Basic Features of Accounting Standards 4, 5, 15, 17, 18 and 29

AS-4: Contingencies and Events Occurring after the Balance Sheet Date :

This standard was made mandatory for accounting periods commencing on or after April 1, 1995. This standard deals with :

1. Contingencies; and
2. Events occurring after the balance sheet date.

The two are not connected and will therefore be studied separately.

Contingencies : The standard defines a contingency as "a condition or situation the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events."

A Contingency is a condition or situation on the balance sheet date the financial effect of which, gain or loss, will be determined by future events which may or may not occur. Following are the examples of Contingencies :

- (i) Bills receivable discounted but not matured,
- (ii) Claims filed against the Company for breach of contracts.
- (iii) Financial Guarantee : For example, if the Company has stood surety for some loan on behalf of other parties.
- (iv) Product Warranties given to Customers and still unexpired.
- (v) Uncalled liability on account of partly paid shares held by the Company as investment.
- (vi) Pending insurance claims.
- (vii) Pending court cases which are likely to benefit the Company.

A Contingency may either result in a loss or gain. The first five examples can result in a loss whereas the last two can result in a gain.

The amount of a contingent loss should be provided for by a charge in the statement of profit and loss if :

- (a) It is probable that at the date of financial statements, events subsequent thereto will confirm that an asset has been impaired or a liability has been incurred, and
- (b) A reasonable estimate of the amount of the resulting loss can be made.

If either of the two conditions is not met, the existence of a contingent loss should be disclosed in the financial statements unless there is remote possibility of such a loss.

AS-4 does not recommend the recognition of contingent gain in the financial statements unless the realisation of gain is virtually certain.

Events Occurring after the Balance Sheet Date :

Events that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors are referred to as events occurring after balance sheet date. Such events are classified into two categories. They are

- (i) events occurring after the balance sheet date that provide further evidence to the conditions which were prevailing on the balance sheet date; and
- (ii) events occurring after the balance sheet date that are indicative of the conditions which occur subsequent to the balance sheet date.

AS-4 requires that assets and liabilities should be adjusted in the case of events of the first type and only disclosure in the case of events of the second type. For example, if after the balance sheet date, a dispute for bonus to employees was awarded in favour of employees for Rs. 10 Lacs, it is an event of first type and the loss must be provided for in the accounts. On the other hand, if a major fire resulted in a loss of Rs. 25 crore 2 days after the balance sheet date, it is an event of second type and there is no need to change the assets and liabilities as it does not affect the financial position on the balance sheet date. However, the loss must be disclosed in the report of directors.

AS-5: Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies :

This standard is effective for accounting periods commencing on or after April 1, 1996 and is mandatory in nature. This standard ensures uniform classification and disclosure of certain items in the profit and loss, so that all enterprises prepare and present their financial statements on uniform basis to ensure their comparability. It explains that net profit or loss for a period comprises of the following components, each of which should be disclosed separately :

- (i) Profit or Loss from ordinary activities;
- (ii) Extraordinary items, and
- (iii) Prior period items.

(i) **Ordinary Activities :** These are the activities which are undertaken by an enterprise as part of its business. For example, for Tata Motors, production and sale of Nano cars is an ordinary activity. It may also provide finance to purchase Nano to boost the sales and such an activity is also an ordinary activity. This standard requires that certain items of income and expense within profit or loss should be disclosed separately when it is warranted by the size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period. Although the activities are ordinary, however the nature and amount of such items may be useful to the users of financial statements in understanding them. The standard states the following items which may require separate disclosure :

- (a) The write-down of inventories to net realisable value and also the reversal of such write-down.
- (b) Disposal of items of fixed assets.

- (c) Disposal of long-term investments.
- (d) Changes in law having retrospective effect.
- (e) Reversal of any provision.

(ii) **Extraordinary Items** : AS-5 defines extraordinary items as income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently. For example, losses sustained as a result of an earthquake qualifies as an extraordinary item. Extraordinary items should be disclosed in the statement of profit and loss in the manner that their impact on current profit or loss can be perceived.

(iii) **Prior Period Items** : The term 'prior period items' refers 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 prior periods. The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on current profit or loss can be perceived.

Changes in Accounting Estimates :

Estimates are usually made for various items such as bad debts, inventory obsolescence or the useful life of an asset. Such estimates have to be revised due to changes in the circumstances on which the estimate was based or as a result of new information or subsequent developments.

The effect of change in an accounting estimate should be included in the determination of net profit or loss. Change may effect the profits of current period only or the profits of future periods also. For example, a change in the estimate of the amount of bad debts affects only the current period but a change in the estimated useful life of a fixed asset affect the depreciation for the current as well as future period.

The nature and amount of a change in accounting estimate which has a material effect should be disclosed. If it is not possible to quantify the amount, the fact should be disclosed in the financial statements.

Changes in Accounting Policies :

In order to enable the users to compare the financial statements over a period of time, the same accounting policies are adopted for similar events or transactions in each period. A change in an accounting policy should be made only in the following cases :

- (a) The adoption of new method is required by Statute,
- (b) Or the new method is required for compliance with an accounting standard,
- (c) Or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise.

This standard states that any change in an accounting policy which has a material effect should be disclosed. The impact of such change should be shown in the financial statements of the period in which such change is made.

AS-15 (Revised): Accounting for Retirement Benefits in the Financial Statements of Employers :

This standard deals with accounting for retirement benefits in the financial statements of employers. It is effective from April 1, 1995 and is mandatory in nature.

This standard has been revised in 2005 and is applicable in its revised form from 1-4-2006. Retirement benefits usually consist of the following :

- (i) **Provident Fund** : It is a **defined contribution scheme** to which both employer and employee make contributions and such amounts are kept in a separate trust fund. The employee at the time of retirement is paid the accumulated balance together with interest. Sometimes such contributions are handed over to employee's provident fund managed by the Central Government who makes the final payment to retiring employees.
- (ii) **Pension Benefit** : It is a **defined benefit scheme** under which amount payable to an employee is determined by reference to employees final salary and the number of years of service. For a pension scheme, a trust fund can be created or an agreement can be entered with an insurance company.
- (iii) **Gratuity Benefit** : It is also in the nature of **defined benefit scheme** and a lump sum payment is made by the employer as and when employee leaves.

Under the Gratuity Act every employer who is liable to pay gratuity has to obtain insurance cover so that annual contribution, calculated actuarially, can be made by the employer each year.

- (iv) Leave encashment benefit on retirement.
- (v) Post-retirement health and welfare schemes.
- (vi) Other retirement benefits.

Accounting Treatment :

- (i) In respect of retirement benefits in the form of provident fund and other defined contribution schemes, the contribution payable by the employer for a year should be charged to the statement of profit and loss for the year.
- (ii) In respect of gratuity and other defined benefit schemes, an appropriate charge to the statement of profit and loss for the year should be made through a provision for the accruing liability. The accruing liability is calculated as per actuarial valuation.

Disclosures :

According to AS-15,

- (i) Method by which retirement benefit costs for the period have been determined should be disclosed in the financial statements.
- (ii) Where the costs related to gratuity and other defined benefit schemes are based on an actuarial valuation, the financial statements should disclose whether the actuarial valuation was made at the end of the period or at an earlier date and where the actuarial valuation was done at an earlier date, the date of actuarial valuation should be specified.
- (iii) Method by which the accrual for the period has been determined should also be described in brief, if the same is not based on the report of the actuary.

AS-17 : Segment Reporting :

This standard is mandatory in nature in respect of accounting periods commencing on or after April 1, 2004. This is applicable to all listed companies whose annual turnover exceeds Rs. 50 crores. It requires that alongwith consolidated information



related party relationship, the reporting enterprise should disclose the following :

- (i) the name of the transacting related party;
- (ii) relationship with related party;
- (iii) nature of transaction with related party;
- (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) amount of outstanding items pertaining to related parties at the Balance Sheet date and provision 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.

In case where common control exists between the reporting enterprise and related party, the name of the related party alongwith relationship should be disclosed irrespective of whether or not there have been transactions between the related parties.

The disclosure requirements do not apply in the following cases :

- (i) If disclosure conflicts with reporting enterprise's duties of confidentiality in terms of a statute or any other competent authority;
- (ii) If related party happens to be a state controlled enterprise; and
- (iii) In consolidated statements of intra-group transactions.

AS-29 : Provisions, Contingent Liabilities and Contingent Assets :

This standard was made mandatory for accounting periods commencing on or after April 1, 2004. Purpose of this standard is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities. It also ensures that sufficient information is disclosed in the notes to financial statements to enable the users to understand the nature, timing and amount of provisions and contingent liabilities.

As per AS-29, **for each class of provision**, an enterprise should disclose the carrying amount at the beginning and at the end of the period, additional provision made during the period, amount utilised and unused amounts reversed during the period. An enterprise should disclose for each class of provision :

- (a) A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits,
- (b) An indication of the uncertainties about those outflows,
- (c) amount of any expected reimbursement stating the amount of any asset which has been recognised for that expected reimbursement.

For each class of contingent liability at the Balance Sheet date, an enterprise should disclose a brief description of the nature of contingent liability and where applicable :

- (a) an estimate at its financial effect,
- (b) An indication of the uncertainties relating to any outflow, and
- (c) The possibility of any reimbursement.

CHAPTER 10

Liquidation of Company

Meaning of Liquidation :

A Company, being an artificial person is created by law and it can come to an end only through a process of law. The legal process of winding up a Company is designated as liquidation. It is not necessary that only an insolvent Company should be liquidated. Sometimes, it becomes necessary to liquidate even a prosperous and solvent Company. The Companies Act, 1956 has laid down the procedure by which Companies can be wound up.

When liquidation takes place, assets of the Company are sold and out of the proceeds claims of creditors are settled. If any surplus is left, it is distributed among the shareholders according to the provisions of articles of association of the Company. If the amount realised on sale of assets is inadequate to meet the claims of creditors in full and if the shares of the Company are partly paid, call is made on them to pay off the creditors. A person appointed to conduct the winding up proceedings is called the 'Liquidator'.

Methods of Liquidation :

The liquidation can take place in any of the following three ways :

- (A) Compulsory Winding-up
- (B) Voluntary Winding-up
- (C) Voluntary Winding-up under the supervision of the court.

(A) Compulsory Winding-up

This is also called Winding up by the Court. Court may order the Winding up of a Company in the following circumstances :

- (i) When the Company has, by special resolution, resolved to be wound up by the court.
- (ii) When default is made in filing statutory report to the Registrar or in holding the statutory meeting.
- (iii) When the Company does not commence its business within a year from its incorporation or suspends its business for a whole year.
- (iv) When the number of its members falls below seven in case of a Public Company and below two in Case of Private Company.
- (v) When the Company is unable to pay its debts; and
- (vi) When the Court is of the opinion that it is just and equitable that the Company should be wound up.

In case of compulsory winding up the liquidator is appointed by the Court.

(B) Voluntary Winding-up (Section 884 of Companies Act, 1956)

This type of winding up may be of two types

- (1) Members Voluntary Winding-up.
- (2) Creditors Voluntary Winding-up.

(1) **Members Voluntary Winding-up** : This type of winding-up takes place when a declaration of the Company's solvency is made by its directors and filed with the Registrar. In this declaration directors have to give an assurance that the Company will be able to pay its debts in full. Within five weeks of sending such declaration to the Registrar, the members should pass a special resolution for voluntary winding-up.

Appointment of Liquidator and Fixing his Remuneration :—

On passing the special resolution for winding-up, the members must, in the same meeting, appoint one or more liquidators and fix his or their remuneration. If winding-up continues for more than one year, the liquidator should call the general meeting of the Company at the end of each year and should place in these meetings his acts and dealings regarding realisation of assets etc.

As soon as the affairs of the Company are fully wound up, the liquidator should call a meeting of the Company and place his full account (known as Liquidator's final statement of account) before this meeting. Liquidator should send a copy of his account and statement to the Registrar within one week of this meeting. On receipt of the above statement and account, Registrar will register them and after 3 months of this registration Company is completely wound up.

(2) **Creditors Voluntary Winding-up** :— When a declaration of solvency is not made and filed with the Registrar, it is presumed that the Company is insolvent and winding-up is called a Creditors Voluntary Winding-up. In such a case, when a meeting of the members is called, the next day is fixed for the meeting of the creditors of the Company. One of the directors presides in the meeting of the creditors. In this meeting the full statement of assets and liabilities of the Company is placed. The copy of the resolution passed in this meeting is sent to the registrar within 10 days.

Members and Creditors both appoint liquidators in their meetings. If both the parties appoint different persons as liquidator, the person appointed by creditors will act as liquidator.

(C) Voluntary Winding up Under the Supervision of the Court (Section 522 of Companies Act, 1956)

When a Company is being wound up voluntarily, an application may be made to the court by a member or creditor of the company that winding-up should be under the supervision of the court. In such a case, the court may order the continuation of voluntary winding-up subject to its supervision. Such an order is made when the court is satisfied that there is fear of favouritism, negligence or unnecessary delay by the liquidator or the resolution for winding-up was obtained by influencing minority shareholders.

Liquidator's Final Statement of Account

The Liquidator's task is to realise the assets and disburse the amounts among the

various claimants who are entitled to receive the same. It must be noted that disbursements to the claimants have to be made strictly in a prescribed order of payment. When the winding-up is completed, the liquidator has to prepare a final statement showing how much he realised and how the amount was distributed. This final statement of receipts and payments or final cash book is termed as 'Liquidator's Final Statement of Account'. It must be pointed out that although it is prepared in the form of an account, it is only a statement i.e., an abstract of cash book and not an account and hence no double entry principles are followed in the preparation of this statement.

Following format of Liquidator's Final Statement of Account may be used in the examination.

LIQUIDATOR'S FINAL STATEMENT OF ACCOUNT

Receipts	Amount	Payments	Amount
	Rs.		Rs.
To Cash in hand		By Legal Charges	
or		By Liquidator's Remuneration :	
Cash at Bank		(i) % on amount realised	
To Amount Realised from the sale		from assets	
of Assets as :—		(ii) % on amount paid to Creditors	
Land & Building		(iii) % on amount paid to	
Plant & Machinery		Shareholders	
Furniture		By Liquidation Expenses or	
Stock		Cost of Winding up	
Debtors etc.		By Debentureholders or other Creditors	
To Surplus amount received from		having a floating charge on the assets	
Secured Creditors		of Co.	
To Calls from Shareholders		By Preferential Creditors	
(@ Rs. on Shares)		By Other Unsecured Creditors	
		By Preference Shareholders	
		(Refund of Capital)	
		By Equity Shareholders	
		(Refund of Capital)	

Order of Payments

Liquidator must make the payments in the following order :—

(1) **Legal Charges** :— These include expenses incurred on filing the suit for the recovery of amounts due to the Company or in defending the claims filed against the Company. Legal charges are paid first of all.

(2) **Liquidator's Remuneration** :— Remuneration to the Liquidator is mostly calculated in the following three ways :—

(i) **Commission on amounts realised from Assets** :— The liquidator normally gets remuneration in the form of commission which is based as a percentage on assets realised. While calculating liquidator's remuneration on assets realised, cash and bank balance is not included because such balance is already existing and the liquidator has made no effort in this respect. However, if the list of assets sold by the liquidator includes cash and bank balance also, these must be considered for the purpose of commission.

Total realised value of the assets held by fully or partly secured creditors is included in the amount of assets realised for calculating the liquidator's remuneration. But if it is clearly mentioned in the question that the mortgaged assets were sold off by the secured creditors themselves, the liquidator will be entitled to a commission only on the excess value of such assets over secured creditors.

(ii) **Commission on amount paid to Unsecured Creditors** :— When the liquidator is entitled to a commission based on the amount paid or distributed to unsecured creditors, preferential creditors must also be taken into consideration because they are also unsecured creditors.

Calculation of commission on the amount paid to unsecured creditors :—

(a) If sufficient amount is available to pay the unsecured creditors in full, the amount of commission will be :—

$$\frac{\text{Amount of Unsecured Creditors} \times \% \text{ of Commission}}{100}$$

Suppose, the amount realised by sale of assets is Rs. 35,700 and the amount due to unsecured creditors is Rs. 25,000. Then, if the liquidator is entitled to a commission of 2% on the amount distributed among the unsecured creditors, his remuneration will be calculated as follows :—

$$\frac{25,000 \times 2}{100} = \text{Rs. 500}$$

(b) If the amount available is less than the amount of unsecured creditors :—

$$\frac{\text{Amount Available for Unsecured Creditors} \times \% \text{ of Commission}}{100 + \% \text{ of Commission}}$$

Suppose, in the above mentioned example, if the amount of unsecured creditors were Rs. 40,000 instead of Rs. 25,000, the remuneration of the liquidator would be as follows :—

$$\frac{35,700 \times 2}{102} = \text{Rs. 700}$$

Hence, the commission is Rs. 700 and unsecured creditors will get Rs. 35,000 (i.e., Rs. 35,700 – Rs. 700). It is done like this because Rs. 35,700 includes the amount of commission too and after payment of Rs. 2 to the liquidator, Rs. 100 should be left for the unsecured creditors.

(iii) **Commission on Amount paid to shareholders** :— Sometimes, the liquidator is allowed a commission on the amount distributed among shareholders. In such a case, the commission is calculated on the amount left after payment to unsecured creditors :—

$$\frac{\text{Amount Available for Shareholders} \times \% \text{ of Commission}}{100 + \% \text{ of Commission}}$$

Sometimes, it is mentioned in the question that the commission is to be allowed on the amount distributed among equity shareholders only. In such a case, the amount paid to preference shareholders is also deducted from the available balance :

$$\frac{\text{Amount Available for Equity Shareholders} \times \% \text{ of Commission}}{100 + \% \text{ of Commission}}$$

(3) **Liquidation Expenses or Cost of Winding Up** :— Liquidation expenses are paid at number three just after the liquidator's remuneration.

(4) **Debentureholders or other Creditors having a floating charge on Assets** :— These are paid at number four.

Interest on Debentures :— The date, upto which interest on debentures will be paid, depends on the fact whether the Company is solvent or insolvent. In case the Company is solvent (*i.e.*, surplus is left after paying the unsecured creditors) interest on debentures will be paid upto the date of actual payment. On the other hand, if the Company is insolvent the interest on debentures will be paid only upto the date of liquidation.

(5) **Preferential Creditors** :— Following are the preferential creditors according to Section 530 (i) of the Companies Act :—

- (a) All taxes, cesses and rates due from the Company to the Central or a State Government or to a local authority within 12 months next before the commencement of winding-up.
- (b) All wages or salaries of any employee due for a period not exceeding 4 months within the 12 months next before the commencement of winding up, provided the amount payable to one claimant will not exceed Rs. 20,000. (The limit is effective from February 17, 1997).
- (c) All accrued holiday remuneration becoming payable to any employee (excluding an officer) on the termination of his employment before, or by the effect of, the winding-up order.
- (d) Persons who advance money for the purpose of making preferential payments under (b) and (c) above will be treated as preferential creditors.
- (e) All amounts due in respect of contributions payable during the 12 months next before winding up, by the Company as the employer of any persons under the Employees State Insurance Act, 1948 or any other law.
- (f) All sums due as compensation under the Workmen's Compensation Act, 1923.
- (g) All sums due to an employee from a provident fund, pension fund, gratuity fund or any other fund for the welfare of the employees, maintained by the Company.
- (h) The expenses of any investigation held under section 235 or 237, in so far as they are payable by the Company.

(6) **Unsecured Creditors** :— These are paid out of the balance left after payment to preferential creditors.

(7) **Payment of Preference Shareholders** :— Preference Shareholders are entitled to the return of capital in priority to any return of capital to equity shareholders. As regards the arrears of dividend on Preference Shares, the provisions of articles of association will apply. If the articles of a Company or terms of issue provide that in the event of winding up of the Company, the preference shareholders shall be entitled to repayment of capital and arrears of dividend in priority to the equity shareholders, the arrears will be paid in priority to equity shareholders. In case nothing is provided in the articles about the payment of arrears of preference dividend, such arrears will be paid only when equity share capital is returned in full and surplus is left.

10.6

The reason given is that preference shareholders have :—

(i) Priority as regards repayment of capital over the repayment of equity capital, and (ii) priority of payment of preference dividend over the payment of equity dividend. There is no priority of payment of preference dividend over the return of equity capital.

No dividend is paid for any period falling after the date of liquidation.

(8) Payment to Equity Shareholders :— Any amount left after payment to preference shareholders will be distributed entirely among equity shareholders. However, if it is specifically mentioned in the articles that preference shares have the right to participate in the surplus left after paying equity capital, then the preference shareholders will also participate in such surplus.

UNIT - IV

CHAPTER 11

Valuation of Goodwill

Meaning of Goodwill :—

Goodwill means the 'good-name' or the reputation earned by a firm. If a firm renders good service to the customers, the customers who feel satisfied will come again and again and the firm will be able to earn more profits in future.

Thus, goodwill is the magnet which attracts the customers to a particular business concern thereby enabling the concern to earn higher profits in comparison to the normal profits earned by other firms in the same trade.

In technical language it may be defined as "the present value of the firm's anticipated excess earnings".

Definitions of Goodwill :—

The term goodwill is very easy to describe, but very difficult to define. Various persons have tried their hands at defining goodwill :—

"The term goodwill is generally used to denote the benefit arising from connections and reputation."
— Lord Lindley

"Goodwill is nothing more than the probability that the old customers will resort to the old place."
— Lord Eldon

"Goodwill may be said to be that element arising from the reputation, connections or other advantages possessed by a business which enables it to earn greater profits than the return normally to be expected on the capital represented by the net tangible assets employed in the business."
— Spicer and Pegler

Thus it can be said that goodwill is the extra earning capacity of a business. It is, therefore, treated as an asset of the firm. It is an intangible asset since it cannot be seen or felt. But it is not a fictitious asset, as it can be purchased or sold and its value increases or decreases according to the profit earning capacity of the business. If the profits are more, the value of goodwill increases and if the profits are less, the value of goodwill decreases.

Features of Goodwill :— Goodwill has certain peculiar features which distinguish it from other assets. It is relevant to state such features here :—

1. **It is an intangible asset :—** Goodwill belongs to the category of intangible assets such as patents, trade marks, copy rights etc. It does not suffer wear and tear and as such the question of depreciation does not arise on it, as is the case of other assets.
2. **It is liable to constant fluctuations :—** While goodwill does not depreciate, it is liable to constant fluctuations. It is always present as a silent asset in a

business where there are super profits (*i.e.*, more than the normal) but declines in value with the decline in earnings.

3. **It is valuable only when entire business is sold :—** Goodwill cannot be sold in part. It can be sold with the entire business only. The only exception is at the time of admission and retirement of a partner. On admission, the new partner obtains the rights and privileges of being a partner by compensating the old partners in their sacrifice ratio. On retirement, the retiring partner gives up his rights and privileges in favour of remaining partners who contribute in their gaining ratio. Except for these two exceptions, goodwill is valuable only when entire business is sold.
4. **It is difficult to place an exact value on goodwill :—** This is because its value may fluctuate from time to time due to changing circumstances which are internal and external to business.
5. **There can be no objective valuation of goodwill :—** Its valuation is based on the subjective (personal) judgement of the valuer and hence differs from estimator to estimator inspite of different methods of its valuation.
6. **Goodwill may be purchased or non-purchased (*i.e.*, raised) :—** Purchased goodwill arises when one business enterprise is purchased by another business enterprise and the purchase consideration is in excess of the value of the net assets acquired whereas non-purchased or raised goodwill arises when business generates its own goodwill over a period of time due to various factors such as favourable location, efficient management, good quality of product etc. Accounting profession recognises only the purchased goodwill because some price has been paid for it. As such, purchased goodwill can be shown in the balance sheet whereas non-purchased goodwill is not shown in the balance sheet.

Origin of Goodwill

or

Factors Affecting the Value of Goodwill

It is clear from the above, that the goodwill is the extra earning capacity of a business. Thus all factors which help a firm in earning profits affect the goodwill of the firm. Following factors affect the goodwill of a firm :

1. **Favourable location of the business :—** If the business is located at a convenient or prominent place, it will attract more customers and therefore will have more goodwill.
2. **Efficiency of Management :—** If the business is run by experienced and efficient management, its profits will go on increasing, which results in increase in the value of goodwill.
3. **The longevity of the business :—** An older business is better known to its customers, therefore it is likely to have more goodwill. When a business enterprise has built up good reputation over a period of time, the number of customers will be more in comparison to the customers of new entrants. Number of customers is an indicator of profit earning capacity of a business.
4. **Nature of Goods :—** If a business deals in goods of daily use, it will have

VALUATION OF GOODWILL

steady profits as the demand for these goods will be stationary. Such business will have more goodwill. But if it deals in fancy goods, its profits will be uncertain and as such the value of the goodwill will be less.

5. **Possession of Licence** :— If a firm holds an import licence, the goodwill of the firm will be more as it will be very difficult for other firms to enter this business in the absence of this licence.

6. **Monopolistic and other rights** :— If a business enjoys monopoly market, it will have assured profits. Similarly, if it holds special rights such as patents, trade marks, copy rights or concession etc., it will have more goodwill.

7. **Risk involved** :— If there is more risk involved in the business, the value of the goodwill will be less.

8. **Trend of Profit** :— If the profits of a business are increasing continuously, the value of its goodwill will be more. If the profits are declining or if the profits are uncertain, the value of its goodwill will be less.

9. **Future Competition** :— The likelihood or possibility of increased competition in future would definitely reduce the value of goodwill.

10. **Capital required** :— The amount of capital required for a business will also influence the value of goodwill. If two business enterprises earn the same rate of profit, the business with lesser capital requirement shall enjoy more goodwill.

11. **Other Factors** :—

- (i) Good industrial relations.
- (ii) Favourable Government regulations
- (iii) Stable political conditions
- (iv) Research and development efforts
- (v) Effective advertising to establish brand popularity
- (vi) Popularity of products in terms of quality

Need for Valuation of Goodwill

The need for valuing the goodwill arises in the following circumstances :—

1. In case of sole trade :—

- (i) When the business is to be disposed off,
- (ii) When someone is to be admitted as a partner, and
- (iii) For assessing the wealth-tax on the death of the proprietor.

2. In Case of Partnership :—

- (i) When a new partner is admitted,
- (ii) When a partner retires or dies,
- (iii) When there is a change in the profit sharing ratio among the partners, and
- (iv) When there is dissolution either by sale to a Company or amalgamation with another firm.

3. In case of a Company :—

- (i) When one Company takes over another,

- (ii) When two or more Companies amalgamate,
- (iii) When a Company wants to purchase a large block of shares for acquiring controlling interest in another Company,
- (iv) When government takes over the business, and
- (v) When stock exchange quotations not being available, shares have to be valued for taxation purposes such as estate duty, gift tax etc.

Methods of Valuation of Goodwill

(It is very difficult to assess the value of goodwill, as it is an intangible asset. There are various methods of valuing goodwill and all of them are based on the profitability of the concern because the value payable for goodwill depends mainly on the earning capacity of a business. Following are the methods of valuing goodwill :

1. Average Profit Method
2. Super Profit Method
3. Capitalisation Method
4. Purchase Consideration Method
5. Annuity Method

✓ **1. Average Profit Method :**— This is very simple and widely followed method of valuation of goodwill. In this method, goodwill is calculated on the basis of the number of past years profits. Average of such profits is multiplied by the agreed number of years (such as two or three) to find out the value of goodwill. Thus the formula is :—

✓ **Value of Goodwill = Average Profit × Number of Years purchased**

For example, if the goodwill of a firm is estimated at two year's purchase of the average profits of the last four years and if the profits of the last four years are Rs. 10,000; Rs. 15,000; Rs. 20,000 and Rs. 5,000; the value of the goodwill will be calculated as under :—

Total Profits of last four years = Rs. 10,000 + Rs. 15,000 + Rs. 20,000 + Rs. 5,000
= Rs. 50,000

Average Profit = Rs. $\frac{50,000}{4}$ = Rs. 12,500

Goodwill = Average Profits × Number of Years Purchased
= 12,500 × 2 = Rs. 25,000

Why Average Profits are Used as the Base

The buyer of a business pays for goodwill for obtaining the future profits of that business. As such he always wants to estimate the future profits of a business. Future profits depend upon the average performance of the business in the past. Past profits indicate as to what profits are likely to accrue in the future. Therefore, the past profits are taken as the base for valuing the goodwill. Such profits are averaged because of the fact that profits for many years taken together and averaged provide a more reliable base in comparison to a single year's profits. Single year's profit may be affected by some abnormal circumstances and thus may not be reliable.

Concept of number of year's purchase :— Logic behind the number of year's purchase seems to be that the purchaser of the business has to hand over to the seller the

VALUATION OF GOODWILL

profits of the business which the buyer would receive from the business due to seller's efforts. For some years to come the business will earn profits entirely due to seller's efforts. Before the purchaser's efforts begin to get due recognition from the consumers. As such, the purchaser compensates the seller for the few years profits which the purchaser gets because of seller's efforts.

In averaging past profits, the trend of profits must be taken into account :—

(i) In case there is a sufficient and continuous rise in profits, it will be better to attach more importance to the profits of the latest year and least importance to the profits of the remotest year. This is because, the profits in, say 1998-99 are more likely to be like those in 1997-98 than in 1993-94. As such, the highest weight is assigned to the profit of the most recent year. The profits of various years are multiplied by the weights, the products are totalled and then divided by the total number of weights. If, suppose, the five years profits are to be averaged, the first year may be assigned a weight of one, the second year of two and so on. Thus :

Year	Profits	Weights	Products
1993-94	3,00,000	1	3,00,000
1994-95	5,00,000	2	10,00,000
1995-96	5,40,000	3	16,20,000
1996-97	6,70,000	4	26,80,000
1997-98	8,00,000	5	40,00,000
			<u>96,00,000</u>

Weighted Average is $\frac{96,00,000}{15} = \text{Rs. } 6,40,000$

(ii) In case there is sufficient and continuous decline of profits, instead of assigning the weights, the profits for the future year should be estimated on the basis of the trend — they will be lower than the profits for the latest year.

Precautions while Calculating Actual Average Profits

The purpose of averaging past profits is to project the future earnings i.e., what profits are likely to be earned in future? As such, the profits earned in the past must be adjusted in the light of future expectations. In arriving at the past average the following adjustments should be made :—

1. **Abnormal gain** :— If there is some abnormal income in a year, it should be deducted out of the profit of that year. For example, there was profit of Rs. 5,00,000 on sale of land in the year 1998. It should be deducted from the profit of 1998 in order to arrive at the normal profit of that year.
2. **Abnormal loss** :— If there is some abnormal loss in a year resulting from floods, fires, earthquakes, theft etc. it should be added back to the profit of that year, in order to arrive at the normal profit of that year.
3. **Income from investments** :— Income from investments should be deducted out of the profit of that year, because this income is received from outside the business and cannot be regarded as part of the main business activity of the Company.

4. **Non-Operating income** :— Non-operating income is the income received from non-trading assets, say, receipt of rent from property. It should be deducted from the profits.
5. **Operating expenses expected to be incurred in future** :— If there is some expenditure which was not incurred upto now but which is expected to be incurred in future years, it should be deducted from average profits. For example, if the stock was not insured upto now but it is sure to be insured in future, the insurance premium must be deducted from average profits.
6. **Income expected in future** :— Any income, which was not received so far but is likely to be received regularly in future, should be added to the average profits.
7. **Stoppage of future earnings** :— Any income, which used to be received regularly so far but is likely to be discontinued in future, should be deducted from average profits.
8. **Managerial Remuneration** :— If managerial remuneration estimated to be paid in future is in excess of the remuneration paid in past years, it should also be deducted from average profits.
9. **Income Tax** :— The past average profits should be calculated after deducting tax at current rates.

After the above adjustments, average profits which can be expected to be maintained in future shall be arrived at. These are termed as future maintainable profits.

Value of Goodwill = Average Profit \times Number of years Purchased

ILLUSTRATION 1.

The Profit & Loss Account of Mr. X disclosed the following results :—

1992 Profits Rs. 1,00,000; 1993 Profits Rs. 2,00,000; and 1994 Profits Rs. 1,70,000.

X intends to sell the business to Y. Ascertain the amount of goodwill after taking into consideration the following factors :—

- (I) Profits of 1992 include a speculative profit of Rs. 20,000.
- (II) Profits of 1993 were reduced by Rs. 30,000 due to loss by fire.
- (III) The properties were not insured and it was thought prudent to insure the business in future. The premium was estimated Rs. 4,000 per annum.
- (IV) The existing tenancy contract has expired and Y will have to pay Rs. 2,000 per month in place of Rs. 1,200 per month.
- (V) Y will not need the services of X's manager who is paid a salary of Rs. 3,000 p.m. He will supervise the business himself. At present he is serving in a private company at a salary of Rs. 4,000 p.m. which post he shall have to resign.

Goodwill is to be valued at two year's purchase of the average profits of past three years'.

Valuation of Shares

In case of shares which are quoted on the stock exchanges, the value of the share can be obtained from the daily list of prices published by stock exchanges. Although in some cases the stock exchange prices may reflect the proper value, in many cases they do not reflect the true value of shares since the stock exchange quotations are subject to bullish and bearish phases, when the same share is quoted at considerably different prices. Stock exchange quotations are not related directly to the value of a Company's assets or to the amount of its profits and consequently these quotations cannot form a fair and equitable basis for valuation of shares. Hence, the valuation of shares has to be done by an expert valuer by adopting sound and reasonable basis. Besides, all shares are not quoted on the stock exchange. Shares of private companies in any case will not be quoted. If, therefore, shares of such a Company are to be sold or pledged, the value of such shares will have to be ascertained.

Although various tax laws have made specific provisions for the valuation of shares and have laid down the exact procedure to be followed, the valuation of shares is the most complex of the accounting problems.

According to B.S. Kothari :—

“The valuation of shares is not an exact Science and cannot be reduced to rigid rules or formulae..... The valuation of two persons hardly agrees, and there is wide divergence in the valuation made by different valuers and the tax authorities. However, due to conventions and judicial decisions over a long time, certain principles have been evolved, on which we can base our judgement.”

— Kothari, B.S. *The Chartered Accountant*, April, 1971

According to William Pickles :—

“The underlying principles are by no means difficult, but their application calls for a considerable knowledge of technical points.”

Need or Purpose of Valuation of Shares

The following circumstances warrant the valuation of shares :—

1. When shares are received as a gift, it may be necessary to place a value on the shares for the purpose of assessing gift duty payable by the receiver.
2. When a person dies and leaves the shares in a Company as a part of his estate, it is necessary to value such shares for the purpose of assessing estate (death) duties.
3. For the assessment of wealth tax.
4. For purchase and sale of shares in private companies and other unquoted shares.

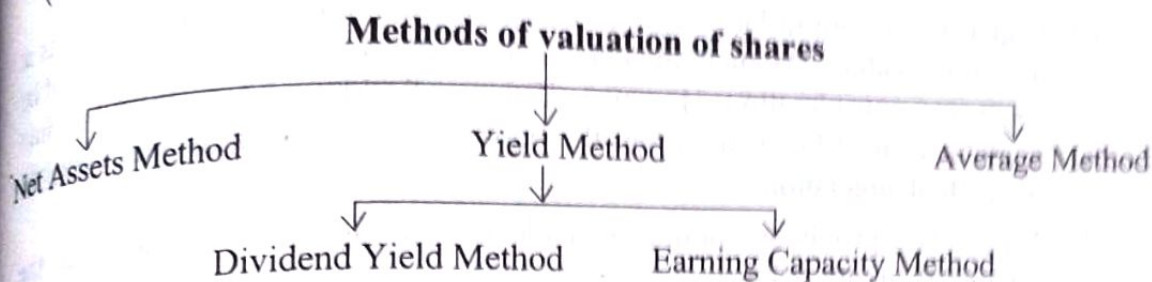
5. For formulating amalgamation and internal reconstruction schemes.
6. When shares are pledged as a security for a loan.
7. For determining the amount payable to dissentient shareholders at the time of amalgamation.
8. For compensating the shareholders when the Company is nationalised.
9. When shares of one class are to be converted into shares of another class. For example, conversion of preference shares into equity.
10. For the valuation of shares held by a trust or an investment company.

Factors Affecting Valuation of Shares

The same factors that affect the value of goodwill of a Company also affect the value of shares. The principal factors which have to be taken into consideration for valuing the shares are :—

- (1) **Present earnings of the Company** :— The following points are considered in this regard :
 - (i) Average profits earned in the past;
 - (ii) The lowest and highest profits earned in the past;
 - (iii) The average rate of return on capital employed;
 - (iv) Profits remaining after tax and preference dividends;
 - (v) Recent events and those likely to occur, which will affect the profits.
- (2) **The yield or returns from similar Companies** :— The value of a share will much depend on the dividend yield that the investor expects to get as compared to the normal rate prevailing in the market in the same industry.
- (3) **The dividend policy of the Company** :— For small investors, rate of dividend declared by the directors plays an important role in the valuation of shares while investors holding bulk of shares (say 20% to 25%) would be in the position to influence the dividend rate and therefore for them total profits play an important role in the valuation of shares.
- (4) **Financial ratios** :— A Company with sound financial ratios such as current ratio, debt-equity ratio etc. is favoured by the investors.
- (5) **Efficient Management** :— The shares of reputed Companies with efficient and progressive management command good value.
- (6) **Government Policy** :— The government offers special incentives for particular type of business e.g., Tax concessions for Companies in backward areas. If a Company enjoys such concessions, the value of its shares will increase.
- (7) **Shares are partly paid or fully paid** :— Investors take a negative view of the partly paid shares.
- (8) **Demand and Supply for shares of the Company.**
- (9) **Accumulated reserves of the Company.**
- (10) **Prospects of bonus or right issue.**

- (11) Net tangible assets of the Company.
- (12) Nature of business.
- (13) Extent of Competition.
- (14) Future prospects of the Company.
- (15) Future prospects of the industry in which a Company is engaged.
- (16) Extent of Government control on the Company.
- (17) Position of peace and security in the country.
- (18) Political conditions such as fear of nationalisation etc.



As such, there are four methods of valuation of shares :—

- (1) Net Assets Method.
- (2) Dividend Yield Method.
- (3) Earning Capacity Method.
- (4) Average Method.

1st Method

Net Assets Method

This method is also called 'Break up Value Method', 'Intrinsic Value Method', 'Assets Valuation' or 'Assets Backing Method'. Under this method, the value per share is determined by valuing the assets of a Company and deducting therefrom all the liabilities and claims of the preference shareholders and dividing the remainder (i.e., net assets) by the number of equity shares. Thus :

$$\text{Value of Share} = \frac{\text{Net Assets}}{\text{Number of Equity Shares}}$$

There are two methods of calculating the Net Assets :

(i) First Method :—

Assets at Market Value :—

Goodwill, Land & Building, Plant & Machinery, Stock, Sundry Debtors, B/R etc.

Less : Outside Liabilities :—

Debentures

Sundry Creditors

Other Liabilities

Less : Preference Share Capital

Value of Net Assets available for Equity Shareholders

Rs.

Rs.

Rs.

(ii) Second Method :—

Net Assets = Equity Share Capital + Reserves & Surplus + Accumulated Profits
 + Profit on Revaluation of Assets – Accumulated Losses – Preliminary Expenses etc.

Amount of net assets calculated by either of the two methods will be the same. Such an amount will then be divided by the number of equity shares to arrive at the value of each share.

Precautions for valuing the shares under net assets method :—

Following precautions must be taken into account while valuing the shares under this method :—

(1) Precautions in valuing the assets :—

- (i) Under the present inflationary conditions it is unrealistic to take the assets at their book values. As such, the realisable value (*i.e.*, market value) should be taken into consideration. However, if the realisable value is not taken into account, it must be ensured that the book value is arrived at after charging adequate depreciation.
- (ii) Appropriate provision should be made for bad and doubtful debts on the amount of sundry debtors.
- (iii) All fictitious assets appearing under the head 'miscellaneous expenditure' must be ignored. Such assets include preliminary expenses etc.
- (iv) Intangible assets which consist of goodwill, patents, trade marks, copyrights etc. should be included in assets, whether they are appearing in the balance sheet or not.

(2) Precautions in valuing the liabilities :—

- (i) All liabilities, whether appearing in the balance sheet or not, must be taken into account.
- (ii) Outstanding expenses and an appropriate amount of contingent liabilities must be taken into account.
- (iii) Adequate provision for taxation must be made.
- (iv) In ascertaining the value of an equity share, the claims of preference shareholders must also be deducted from the net assets.

Demerits or limitations of net assets method :—

- (1) This method ascertains the amount available to equity shareholders in case of liquidation of the Company. Since the Company is treated as a going concern and where there is no possibility of its liquidation in the near future, this method is far from reality.
- (2) This method does not take into consideration the earning (profits) of the Company but an investor is interested in the earning potential of the Company.
- (3) It is difficult to estimate the market value of assets since there is considerable scope for personal bias.
- (4) This method ignores many factors which have a considerable effect on the valuation of shares. Such factors are financial ratios of the Company, nature of business, future prospects of the Company, govt. policy etc.

Purposes or Circumstances where this method is appropriate :—

Some of the circumstances where net assets method is preferred in comparison to yield method are :

- (1) Where reliable information about the earning capacity of the Company is not available, as in the case of newly established Companies.
- (2) Where the Company is continuously incurring losses and there is no prospect of earning profits in near future. In such a case yield method would produce a negative value.
- (3) Where a scheme of amalgamation is to be formulated.
- (4) When it is intended to liquidate the Company.
- (5) Provisions of various tax laws especially the wealth tax rules provide for this method of valuing the shares.

ILLUSTRATION 1.

CHAPTER 13

Accounts of Banking Companies

The Indian Banking Companies are governed by Banking Regulation Act, 1949. Section 5 (b) of the Act defines banking as "the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise". A Company engaged in banking business is called 'Banking Company'.

✓ Bank Book-Keeping or Bank's Working

(The Bank accounts are maintained using 'Double Entry System'. For successful operation of banking business, such a system of accounting is required with which the day-to-day transactions can be accounted for properly. Main features of book-keeping in a Bank are as follows :)

✓ Slip-System :—

(A bank must keep its ledger accounts especially those of its customers always up-to date. A cheque may be presented to the bank for payment by a customer at any moment and unless the customer's accounts are maintained up-to-date, bank will not be able to decide whether to honour or dishonour the cheque. As such the transactions in the bank are recorded as soon as they have taken place.)

(For the purpose of rapid posting, 'slip system of ledger posting' is adopted. Under this system, posting of transactions in personal ledgers is made directly from slips rather than from subsidiary books or journal. A slip is also called a voucher. The main slips used in a bank are pay-in-slips, withdrawal form, cheques etc. These are filled up by the clients of the bank themselves or by the bank staff on the printed forms of the bank. For example :—

1. (For making deposit with a bank, the customer has to fill-up 'pay-in-slip' form and submit it to the receiving cashier of the bank along with cash. The form of 'Pay-in-slip' has two parts (as explained by the proforma given on the next page). The left-hand-side portion of it is called 'counterfoil'. It is returned by the receiving cashier after counting the cash. The counterfoil bears signature of receiving cashier and it is duly stamped with rubber-stamp of the bank. It serves as an acknowledgement of deposit made by the customer with the bank. Now the right-hand-side part of the slip remains with the bank which serves as voucher for bank. The receiving cashier makes entry in cash book and then passes on this slip to the 'Personal Accounts Ledger Keeper' for posting in the ledger account of the customer. Similarly —

(2. For withdrawing an amount from a bank, the customer has to fill-up 'cheque' or 'withdrawal-form' and submit it to 'Personal Accounts Ledger Keeper' who gives a token to the customer. Now Ledger Keeper checks the slip for signature of customer and for adequacy of amount in his ledger account. He also makes posting of withdrawal

[illegible]



3. **Possibility of Misappropriation** — Since the slips are loose and small in size, these can be easily misappropriated.)

4. **Difficulty to customers** — Utmost caution has to be exercised by the customers of bank in filling the various slips. Many customers feel difficulty on account of this.

But, inspite of the above disadvantages, (the slip system has become essential and is adopted by each and every bank due to its advantages.) Its shortcomings can be overcome by adopting a proper system of internal audit.

Teller System

This system is also called Quick Payment System. Banks introduce different systems so that their customers may receive payment of cash, etc. quickly. The most prevalent system is the teller system. Under this system, tellers keep cash as well as ledger cards and specimen signature cards of each customer in respect of Current and Savings Bank Accounts. A teller is authorised to make payment upto a particular amount say, Rs. 2,500. On receipt of a cheque, he checks it, passes it for payment, enters it in ledger card and makes payment to the customer. The teller also receives cash deposited in these accounts.

Stock Invest

Recently, a scheme of Stock Invest has been introduced for the benefit of small investors in public issue by a Company. The scheme facilitates investors to earn the interest on their application money and the amount is withdrawn from their accounts only after allotment of securities to them.

For getting benefits of this scheme, the investor has to open a fixed-deposit account with a bank. Out of this account, Stock Invest cheques are issued as and when required by the investor. These cheques are sent alongwith application forms. Subsequently, if he succeeds in getting allotment of securities, the amount is withdrawn by the Company's banker from his account and the fixed-deposit account remains operative for the balance of the amount remaining in it. In case no allotment is made to the investor, the amount in his fixed-deposit stock-invest account remains in the account as before. Thus under the stock-invest scheme delays in refund of application money and loss of refund-warrants in transit are avoided. The facility is being provided in India by many banks now.

Final Accounts of Banking Companies

Every Banking Company prepares its final accounts at the end of the year. Banking Companies are required to prepare the final accounts in the format prescribed in the third schedule of The Banking Regulations Act, 1949.

The formats are in vertical form. Form 'A' of third schedule prescribes the format of Balance Sheet and Form 'B' prescribes the format of Profit and Loss Account. Some schedules are also prescribed in the formats which are eighteen in number. Schedules No. 1 to 12 relate to Balance Sheet items and Schedules No. 13 to 16 relate to Profit and loss Account items. Schedules No. 17 and 18 consist of notes and accounting policies which are to be followed by Banking Companies. We shall now study the formats of Profit and Loss Account and Balance Sheet alongwith schedules relating thereto.

Note — Schedule No. 17 and 18 consist of notes and accounting policies which are to be

followed by Banking Companies and it is of little importance for students to study these in detail and they are not expected to have gone through these.

First, we shall study format of Profit & Loss Account which is as follows :—
(Schedules prescribed by the Act alongwith format are integral part of it, therefore while solving the question, schedules shall also be prepared).

NEW REVISED FORMAT OF PROFIT AND LOSS ACCOUNT

The Third Schedule

(See Section 29)

Form 'B'

PROFIT AND LOSS ACCOUNT for the year ended 31st March (Year)

	Schedule No.	Year ended 31.3... (Current Year) Rs.	Year ended 31.3.... (Previous year) Rs.
I. INCOME			
Interest earned	13		
Other income	14		
Total :			
II. EXPENDITURE			
Interest expended	15		
Operating expenses	16		
Provisions and contingencies			
Total :			
III. PROFIT/LOSS			
Net profit/loss (–) for the year			
Profit/Loss (–) brought forward			
Total :			
IV. APPROPRIATIONS			
Transfer to Statutory Reserves (See Note 1)			
Transfer to other reserves			
Transfer to Government/ Proposed dividends			
Balance carried over to balance sheet			
Total :			

Note : (1) As per section 17 of Banking Regulation Act, a bank must transfer 25% of Current Year's profit every year to statutory reserve.

- IV. Advertisement and Publicity
- V. Depreciation on Bank's Property
- VI. Directors' Fees, Allowances and Expenses
- VII. Auditors' Fees and Expenses
(Including branch auditors)
- VIII. Law Charges
- IX. Postage, Telegrams, Telephones, etc.
- X. Repair and Maintenance
- XI. Insurance
- XII. Other Expenditure

TOTAL :

Explanation of Schedules Given in Profit and Loss Account

Schedule 13 - Interest Earned :— Interest earned by the bank is included in this schedule and is classified into the following heads given in this schedule :—

- I. **Interest on Advances and Discount on Bills** :— The most important income for the banks is the interest earned on all types of loans like cash credit, demand loans, overdrafts, term loans etc. Likewise, customers may discount the bills from the bank and the amount of discount deducted by the bank from the amount of such bills is also an income for the bank. Such amount of discount is also shown here.
- II. **Income on Investments** :— It includes all income derived from the investment portfolio by way of interest and dividend.
- III. **Interest on balances with Reserve Bank of India and other inter-bank funds.**
- IV. **Others** :— It includes any other interest/discount income not included in the above heads.

Schedule 14 — Other Income :— This schedule includes all incomes except interest :—

- I. **Commission, Exchange and Brokerage** :— It includes all remuneration on services rendered by the bank to its customers such as commission on collections, commission or exchange on remittances and transfers, commission on letters of credit, letting out of lockers and guarantees, brokerage on securities purchased on behalf of its customers etc.
- II. Profit on sale of investments Less loss on sale of investments.
- III. Profit on revaluation of investments Less loss on revaluation of investments.
- IV. Profit on sale of land, buildings and other assets Less loss on sale of land, buildings and other assets.
- V. Profit on exchange transactions Less loss on exchange transactions : It includes all incomes earned by way of foreign exchange, commission and charges on foreign exchange transactions excluding interest which will be shown under interest.

13.8

- VI. Income earned by way of dividends etc. from subsidiary Companies, joint-ventures etc.
- VII. Miscellaneous income.

Schedule 15 — Interest Expended :— It includes interest paid and is classified as follows :—

- I. **Interest on deposits :—** It includes interest paid on all types of deposits such as Interest on Current Deposits, Interest on Saving Deposits and Interest on Term Deposits.
- II. Interest on borrowings from Reserve Bank of India or from other Banks.
- III. **Others :—** It includes interest on all other borrowings.

Schedule 16 — Operating Expenses :—

- I. **Payment to and provisions for employees :—** It includes staff salaries, wages, allowances, bonus or other staff benefits like provident fund, pension, gratuity etc.
- II. Rent, Taxes and Lighting
- III. Printing and Stationery
- IV. Advertisement
- V. **Depreciation on bank's property :** It includes depreciation on bank's own property, motor cars, furniture, non-banking assets etc.
- VI. Director's fees, allowances and expenses
- VII. Auditor's Fees
- VIII. Law Charges
- IX. Postage, Telegrams and Telephone Exp.
- X. Repairs and Maintenance
- XI. Insurance
- XII. **Other Expenditure :** It includes all expenses which have not been included in any of the other heads, like licence fees, donations, subscriptions to papers, periodicals, entertainment exp., travel exp., etc.

Provisions and Contingencies :— This head is just below schedule 16 and provision for bad debts and taxation are shown under this head.

General Guidelines for solving the practical questions

- 1. All the schedules must be shown in each question in P & L A/c and Balance Sheet. However, if the amount of a particular item included in any schedule is not given in the question, it may be ignored to be written.
- 2. Comparative figures for previous years, if given in the question, should be shown on the right hand side and current year's figures should be shown on left hand side.
- 3. Banking Companies must prepare their annual reports in Hindi also.

✓ Rebate on Bills Discounted

13.9

Banks discount hundreds of bills every day and when someone gets a bill discounted, the bank credits the Discount Account with the full amount of the discount the bank will earn in respect of that bill. But in practice, it frequently happens that some of these bills will not mature by the close of the accounting year. The portion of the discount which relates to the period falling after the close of the accounting period is called 'Unearned Discount' or 'Rebate on Bills Discounted'.

Supposing, X discounted a three month's bill from State Bank of India on 1st March 1995 and bank charged Rs. 600 as discount. Accounts are closed on 31st March every year. The date of maturity of the bill is 31st May 1995. In this transaction the bank must have credited the Discount Account with Rs. 600 on 1st March. But out of this, the discount for the months of April 1995 and May 1995 is not actually earned. Unearned discount for these two months @ Rs. 200 per month amounts to Rs. 400. This is the income which is related to the next accounting period and is called 'income received but not earned'. It is also termed as 'Rebate on Bills Discounted' or 'Unexpired Discount' or 'Discount Received in Advance'.

Since discount on bills discounted is an income for the bank and is shown in the Profit & Loss Account under Schedule 13, the amount of unexpired discount, if given in the adjustments, is deducted from schedule 13 and is also shown on the liabilities side of the balance sheet in the item 'Other Liabilities and Provisions' in schedule 5. Following entry is passed for this adjustment :—

Discount A/c

Dr.

To Rebate on Bills Discounted A/c
(With the amount of unexpired discount)

However, if the item of unexpired discount is given inside the Trial Balance, it is shown only in the balance sheet.

ILLUSTRATION 1

CHAPTER 14

Accounts of Insurance Companies

Insurance is a form of contract under which, one party known as the 'insurer' undertakes to indemnify the other party known as 'insured' for any loss suffered by him due to specified causes. The document containing the terms of contract is termed as 'Policy'. The consideration in return for which the insurer agrees to make good the loss is termed as 'Premium'.

Types of Insurance

From accounting point of view, insurance may be broadly divided into two types :—

(1) **Life Insurance** :— Under this type of insurance, the insurer (i.e., the insurance company) guarantees to pay a fixed sum of money to the insured on his reaching a certain age or to his nominees on his death, whichever is earlier. Hence, apart from the fact that it covers the risk, Life Insurance is a form of investment too. Life insurance is also known as 'Assurance' because ultimately the amount of the policy must be paid. In 1956, Life Insurance business was nationalised in India but since 2000 the life insurance business has been thrown open to the private sector also.

Types of Life Insurance Policies

Life insurance policies can be broadly divided into two types :—

(i) **Whole Life Policy** :— Under this policy, the policy-holder does not get the amount of policy during his life-time. The amount is paid only to his nominees or legal heirs on his death.

(ii) **Endowment Policy** :— Under this policy, the amount is paid to the policyholder on his attaining a certain age or to his nominees or legal heirs on his death, whichever is earlier.

Both these policies may be with profit or without profit :—

1. **With Profit or Participating Policy** :— With profit policies are those on which, in addition to a guaranteed sum payable on maturity, a share of profits of the Insurance Company will also be payable as bonus. Such bonus is credited only to the holders of 'With Profit Policies'.

2. **Without Profit or non-participating Policy** :— Without profit policies are those on which, only a fixed amount is paid on maturity. Holders of such policies have no right to bonus. Naturally, the premium in case of without profit policy is less than the premium payable in case of with profit policy.

(2) **General Insurance** :— It includes all other types of insurance except life insurance. Under section 2 (6B) of the Insurance Act, 1938, general insurance has been

defined as the insurance which includes fire insurance, marine insurance and miscellaneous insurance. Miscellaneous insurance includes Accident Insurance, Motor Vehicle Insurance, Credit Insurance, Burglary Insurance, Workmen's Compensation Insurance, Professional Liability Insurance, Cash in Transit Insurance etc. Under this type of insurance, the insurer undertakes to indemnify the loss suffered by the insured on happening of a certain event in consideration for a fixed premium. General Insurance business was nationalised in India in 1971 but since 2000 it has been thrown open to the private sector also.

Distinction between Life Insurance and General Insurance :

	Basis of Difference	Life Insurance	General Insurance
1.	Nature of Contract	It is a contract of 'Assurance' because, the sum assured is payable on the happening of an event which is bound to occur i.e., the expiry of the term of the policy or the death of the insured.	It is a contract of 'Indemnity' because the claim may arise or may not arise. Only those who suffer loss are compensated.
2.	Amount of Claim	In life insurance, the full amount covered by the policy is paid.	In this case, the sum payable is limited to the amount of actual loss suffered by the insured.
3.	Purpose	Purpose of life insurance is protection as well as investment.	Purpose of general insurance is protection from risks.
4.	Period	These are long term contracts running over a number of years.	These are only for one year though renewable year after year.
5.	Rate of Premium	In life insurance, premium is fixed according to the age of the insured and the term of the policy.	In general insurance, premium is fixed according to the nature of commodity insured and the risk involved.
6.	Surrender Value	Life insurance policy carries a surrender value.	General insurance policy does not carry a surrender value.
7.	Reserve for Unexpired Risk	No reserve for unexpired risk is created in case of life insurance.	Reserve for unexpired risk must be created in it. Specified rate is 50% of net premium in case of fire and miscellaneous and 100% in case of marine business.
8.	Calculation of Profit	In case of life insurance, profit or loss of the business is calculated on the basis of valuation of assets and liabilities made for each financial year according to the Actuarial Valuation.	In this case, profit is calculated at the end of each year by creating a reserve for unexpired risk at specified rates.

9.	Division of Profit	One-ninth of the profit is allocated to the policy-holders in case of life fund maintained for participating policy-holders.	In this case, no profit is distributed among policy-holders.
----	--------------------	--	--

Regulation of Insurance Business

At present, insurance business in India is regulated by the provisions of the Insurance Regulatory and Development Authority (IRDA) Act, 1999. Some of the salient features of the Act are listed below :

- (i) For every company carrying on business of life insurance or general insurance, the minimum paid-up equity capital has been fixed at Rs. 100 crores. For a company carrying on exclusively the business as a reinsurer, the minimum paid-up equity capital is Rs. 200 crores.
- (ii) Every year, the accounting year of every insurance company is to end on 31st March.
- (iii) The insurance companies are required to prepare their financial statements i.e., Revenue Account, Profit and Loss Account and Balance Sheet according to the IRDA regulations.
- (iv) Insurers carrying on Life Insurance Business should comply with the requirements of **Schedule A** of the IRDA regulations. The Schedule A, among other things, gives the following forms :

Revenue Account	—	Form A — RA
Profit and Loss Account	—	Form A — PL
Balance Sheet	—	Form A — BS

Insurers carrying on General Insurance Business should comply with the requirements of **Schedule B** of the IRDA regulations. The Schedule B, among other things, gives the following forms :

Revenue Account	—	Form B — RA
Profit and Loss Account	—	Form B — PL
Balance Sheet	—	Form B — BS

In both cases, there are 15 Schedules, out of which first four relate to Revenue Account and the remaining eleven Schedules relate to Balance Sheet. In both Schedules A and B, Profit and Loss Appropriation Account is dispensed with and appropriations are accommodated in the Profit and Loss Account.

Preparation of Financial Statements of Life Insurance Business

In case of life insurance, Revenue Account (Policyholders' Account), Profit and Loss Account (Shareholders' Account) and Balance Sheet are prepared as per Form A-RA, Form A-PL and Form A-BS respectively. The formats of these forms are given below :

FORM A-RA

Name of the Insurer :
Registration No. and Date of Registration with the IRDA

REVENUE ACCOUNT FOR THE YEAR ENDED 31st MARCH, 20----

Policyholders' Account (Technical Account)

Particulars	Schedule	Current Year (Rs. '000)	Previous Year (Rs. '000)
Premiums earned — net	1		
(a) Premium			
(b) Reinsurance ceded			
(c) Reinsurance accepted			
Income from Investments			
(a) Interest, Dividends & Rent — Gross			
(b) Profit on sale/redemption of investments			
(c) (Loss on sale/redemption of investments)			
(d) Transfer/Gain on revaluation/change in fair value			
Other Income (to be specified)			
TOTAL (A)			
Commission	2		
Operating Expenses related to Insurance Business	3		
Provision for doubtful debts			
Bad debts written off			
Provision for Tax			
Provisions (other than taxation) :			
(a) For diminution in the value of investments (Net)			
(b) Others (to be specified)			
TOTAL (B)			
Benefits Paid (Net)	4		
Interim Bonuses Paid			
Change in valuation of liability in respect of life policies in force			
(a) Gross			
(b) Amount ceded in Reinsurance			
(c) Amount accepted in Reinsurance			
TOTAL (C)			
SURPLUS/(DEFICIT) (D) = (A) - (B) - (C)			
APPROPRIATIONS			
Transfer to Shareholders' Account			
Transfer to Other Reserves (to be specified)			
Balance being Funds for Future Appropriations			
TOTAL (D)			

See Notes appended at the end of Form A-PL



188

source being included under 'Advance taxes paid and taxes deducted at source'.

- (e) Income from rent shall include only the realized rent. It shall not include any national rent.

FORM A-BB

Name of the Insurer :
Registration No. and Date of Registration with the IRDA

BALANCE SHEET AS AT 31ST MARCH, 20

Particulars	Schedule	Current Year (Rs. '000)	Previous Year (Rs. '000)
Sources of Funds :			
Shareholders' Funds :			
Share Capital	5		
Reserves and Surplus	6		
Credit/(Debit) Fair Value Change Account*			
Sub-Total	7		
Borrowings			
Policyholders' Funds :			
Credit/(Debit) Fair Value Change Account			
Policy Liabilities			
Insurance Reserves			
Provision for Linked Liabilities			
Sub-Total			
Funds for Future Appropriations			
Total			
Application of Funds :			
Investments :			
Shareholders'	8		
Policyholders'	8A		
Assets held to cover linked liabilities	8B		
Loans	9		
Fixed Assets	10		
Current Assets :			
Cash and Bank Balances	11		
Advances and Other Assets	12		
Sub-Total (A)	13		
Current Liabilities	14		
Provisions			
Sub-Total (B)			
Net Current Assets (C) = (A) - (B)			
Miscellaneous Expenditure (to the extent not written off or adjusted)	15		
Debit Balance in Profit & Loss Account (Shareholders' Account)			
Total			

* Debit or Credit balance of 'Investment Fluctuation Account' or 'Investment Reserve' is shown under this head.

ACCOUNTS OF INSURANCE COMPANIES

CONTINGENT LIABILITIES

14.7

Particulars	Current Year (Rs. '000)	Previous Year (Rs. '000)
1. Partly paid-up investments		
2. Claims, other than against policies, not acknowledged as debts by the company		
3. Underwriting commitments outstanding (in respect of shares and securities)		
4. Guarantees given by or on behalf of the Company		
5. Statutory demands/liabilities in dispute, not provided for		
6. Reinsurance obligations to the extent not provided for in accounts		
7. Others (to be specified)		
TOTAL		

SCHEDULES FORMING PART OF FINANCIAL STATEMENTS

SCHEDULE—1

PREMIUM

Particulars	Current Year (Rs. '000)	Previous Year (Rs. '000)
1. First Year Premiums		
2. Renewal Premiums		
3. Single Premiums		
TOTAL PREMIUM		

SCHEDULE—2

COMMISSION EXPENSES

Particulars	Current Year (Rs. '000)	Previous Year (Rs. '000)
Commission paid :		
Direct : First year premiums		
Renewal premiums		
Single premiums		
Add : Commission on Re-insurance Accepted		
Less : Commission on Re-insurance Ceded		
Net Commission		

SCHEDULE—3

OPERATING EXPENSES RELATED TO INSURANCE BUSINESS

Particulars	Current Year (Rs. '000)	Previous Year (Rs. '000)
1. Employees' remuneration & welfare benefits		
2. Travel, conveyance and vehicle running expenses		
3. Training expenses		
4. Rents, rates & taxes		
5. Repairs		

ACCOUNTS OF INSURANCE COMPANIES

148

6	Printing & stationery		
7	Communication expenses		
8	Legal & professional charges		
9	Medical fees		
10	Auditors' fees, expenses etc.		
	(a) as auditor		
	(b) as adviser or in any other capacity, in respect of		
	(i) Taxation matters		
	(ii) Insurance matters		
	(iii) Management services; and		
	(c) in any other capacity		
11	Advertisement and publicity		
12	Interest & Bank Charges		
13	Others (to be specified)		
14	Depreciation		
	TOTAL		

SCHEDULE—4 BENEFITS PAID [NET]

Particulars	Current Year (Rs. '000)	Previous Year (Rs. '000)
1. Insurance Claims :		
(a) Claims by Death,		
(b) Claims by Maturity,		
(c) Annuities/Pension payment,		
(d) Other benefits, specify		
2. (Amount ceded in reinsurance) :		
(a) Claims by Death,		
(b) Claims by Maturity,		
(c) Annuities/Pension payment,		
(d) Other benefits, specify		
3. Amount accepted in reinsurance :		
(a) Claims by Death,		
(b) Claims by Maturity,		
(c) Annuities/Pension payment,		
(d) Other benefits, specify		
TOTAL		

Notes : (a) Claims include specific claims settlement costs, wherever applicable.

(b) Legal and other fees and expenses shall also form part of the claims cost, wherever applicable.

SCHEDULE—5 SHARE CAPITAL

Particulars	Current Year (Rs. '000)	Previous Year (Rs. '000)
1. Authorised Capital		
.....Equity Shares of Rs. each		

2.	Issued Capital		
	Equity Shares of Rs. each		
3.	Subscribed Capital		
	Equity Shares of Rs. each		
4.	Called-up Capital		
	Equity Shares of Rs. each		
Less :	Calls unpaid		
Add :	Shares forfeited (Amount originally paid up)		
Less :	Par Value of Equity Shares bought back		
Less :	Preliminary Expenses		
	Expenses including commission or brokerage on underwriting or subscription of shares		
TOTAL			

- Notes : (a) Particulars of the different classes of capital should be separately stated.
 (b) The amount capitalised on account of issue of bonus shares should be disclosed.
 (c) In case any part of the capital is held by a holding company, the same should be separately disclosed.

SCHEDULE—5 A PATTERN OF SHAREHOLDING [As certified by the Management]

Shareholders	Current Year		Previous Year	
	Number of shares	% of Holding	Number of shares	% of Holding
Promoters :				
— Indian				
— Foreign				
Others				
TOTAL				

SCHEDULE—6 RESERVES AND SURPLUS

Particulars	Current Year (Rs. '000)	Previous Year (Rs. '000)
1. Capital Reserve		
2. Capital Redemption Reserve		
3. Securities Premium		
4. Revaluation Reserve		
5. General Reserves		
Less : Debit balance in Profit and Loss Account, If any		
Less : Amount utilized for Buy-back		
6. Catastrophe Reserve*		
7. Other Reserves (to be specified)		
8. Balance of profit in Profit and Loss Account		
TOTAL		

*Such reserve is created to provide for the losses which might arise due to entirely unexpected set of events and not for any specific known purpose.

SCHEDULE 1A
LIABILITIES

Particulars	Current Year (Rs. '000)	Previous Year (Rs. '000)
1. Secured borrowings:		
(a) Bank		
(b) Financial Institutions		
(c) Others (to be specified)		
TOTAL		

- Notes: (a) The extent to which the borrowings are secured shall be separately disclosed stating the nature of the security under each sub-head.
- (b) Amounts due within 12 months from the date of Balance Sheet should be shown separately.

SCHEDULE 4

INVESTMENTS-SHAREHOLDERS

Particulars	Current Year (Rs. '000)	Previous Year (Rs. '000)
LONG TERM INVESTMENTS		
1. Government securities and Government guaranteed bonds including Treasury Bills		
2. Other Approved Securities		
3. Other Investments:		
(a) Shares		
(i) Equity		
(ii) Preference		
(b) Mutual Funds		
(c) Derivative Instruments		
(d) Debentures/Bonds		
(e) Other Securities (to be specified)		
(f) Subsidiaries		
(g) Investment Properties-Real Estate		
4. Investments in Infrastructure and Social Sector		
5. Other than Approved Investments		
SHORT TERM INVESTMENTS		
1. Government securities and Government guaranteed bonds including Treasury Bills		
2. Other Approved Securities		
3. Other Investments:		
(a) Shares		
(i) Equity		
(ii) Preference		
(b) Mutual Funds		
(c) Derivative Instruments		

4	MATURITY-WISE CLASSIFICATION :
	(a) Short Term
	(b) Long Term
	TOTAL

Notes :

(a) Short-term loans shall include those, which are repayable within 12 months from the date of balance sheet. Long term loans shall be the loans other than short-term loans.

(b) Provisions against non-performing loans shall be shown separately.

(c) The nature of the security in case of all long term secured loans shall be specified in each case. Secured loans for the purposes of this schedule, mean loans secured wholly or partly against an asset of the company.

(d) Loans considered doubtful and the amount of provision created against such loans shall be disclosed.

SCHEDULE—10**FIXED ASSETS**

(Rs. '000)

Particulars	Cost/Gross Block				Depreciation			Net Block		
	Opening	Additions	Deductions	Closing	Up to Last Year	For the Year	On Sales/Adjustments	To Date	As at Year end	Previous Year
Goodwill										
Intangibles (specify)										
Land-Freehold										
Leasehold Property										
Buildings										
Furniture & Fittings										
Information & Technology										
Equipment										
Vehicles										
Office Equipment										
Others (Specify nature)										
TOTAL										
Work in progress										
Grand Total										
PREVIOUS YEAR										

Note : Assets included in land, property and building above exclude Investment Properties as defined in note (a) to Schedule 8.

SCHEDULE—11 **CASH AND BANK BALANCES**

Particulars		Current Year (Rs. '000)	Previous Year (Rs. '000)
1	Cash (including cheques, drafts and stamps)		
2	Bank Balances		
	(a) Deposit Accounts		
	(aa) Short-term (due within 12 months of the date of Balance Sheet)		
	(bb) Others		
	(b) Current Accounts		
	(c) Others (to be specified)		
3	Money at Call and Short Notice :		
	(a) With Banks		
	(b) With Other Institutions		
4	Others (to be specified)		
	TOTAL		
	Balances with non-scheduled banks included in 2 and 3 above		
	CASH & BANK BALANCES :		
1	In India		
2	Outside India		
	TOTAL		

Note : Bank balance may include remittances in transit. If so, the nature and amount shall be separately stated.

SCHEDULE—12 **ADVANCES AND OTHER ASSETS**

Particulars		Current Year (Rs. '000)	Previous Year (Rs. '000)
	ADVANCES		
1	Reserve deposits with ceding companies		
2	Application money for investments		
3	Prepayments		
4	Advances to Officers / Directors		
5	Advance tax paid and taxes deducted at source (Net of provision for taxation)		
6	Others (to be specified)		
	TOTAL (A)		
	OTHER ASSETS		
1	Income accrued on investments		
2	Outstanding Premiums		
3	Agent's Balances		
4	Foreign Agencies' balances		
5	Due from other entities carrying on insurance business (including reinsurers)		
6	Due from subsidiaries/holding company		

7.	Deposit with Reserve Bank of India [Pursuant to section 7 of Insurance Act, 1938]		
8.	Others (to be specified)		
	TOTAL (B)		
	TOTAL (A) + (B)		

Notes :

(a) The items under the above heads shall not be shown net of provisions for doubtful amounts. The amount of provision against each head should be shown separately.

(b) Sundry debtors will be shown under item 8 (Others)

SCHEDULE—13**CURRENT LIABILITIES**

Particulars	Current Year (Rs. '000)	Previous Year (Rs. '000)
1. Agents' Balances		
2. Balances due to other insurance companies		
3. Deposits held on reinsurance ceded		
4. Premiums received in advance		
5. Unallocated premium		
6. Sundry creditors		
7. Due to subsidiaries/holding company		
8. Claims Outstanding		
9. Annuities Due		
10. Due to Officers/Directors		
11. Others (to be specified)		
TOTAL		

SCHEDULE—14**PROVISIONS**

Particulars	Current Year (Rs. '000)	Previous Year (Rs. '000)
1. For taxation (less payments and taxes deducted at source)		
2. For proposed dividends		
3. For dividend distribution tax		
4. Others (to be specified)		
TOTAL		

SCHEDULE—15**MISCELLANEOUS EXPENDITURE**

(To the extent not written off or adjusted)

Particulars	Current Year (Rs. '000)	Previous Year (Rs. '000)
1. Discount Allowed in issue of shares/debentures		
2. Others (to be specified)		
TOTAL		

- Notes:** (a) No item shall be included under the head "Miscellaneous Expenditure" and carried forward unless
1. some benefit from the expenditure can reasonably be expected to be received in future, and
 2. the amount of such benefit is reasonably determinable
- (b) The amount to be carried forward in respect of any item included under the head "Miscellaneous Expenditure" shall not exceed the expected future revenue/other benefits related to the expenditure

Explanation of Various Items :

1. **Premium** : Premium received by the insurance company during the year is shown in the Revenue Account (as per Schedule 1). Premium received may be first year premium, renewal premium and single premium. First year's premium is premium paid by the policyholder in the first year of the life policy. Premium paid in later years are called Renewal Premiums. When a policyholder pays all the premium in a lump sum in the beginning, it is called Single Premium. Premiums outstanding at the end of the year are added to the amount of premiums received during the year whereas premiums outstanding in the beginning of the year are deducted. As such, premiums shown in Schedule 1 may appear as follows :

1. First Year Premium
2. Renewal Premium
3. Single Premium

Add : Premiums Outstanding at the end of the year
Less : Premiums Outstanding in the beginning of the year

Premium income received from business concluded in India and Outside India should be separately disclosed.

2. **Reinsurance Premium** : Sometimes the insurer considers a particular risk too much for his capacity and reinsures a part of the risk with some other insurer. It is called reinsurance. In such a case, depending on the share of risk undertaken by the second reinsurer, proportionate amount of premium is ceded by the first insurer. **Re-insurance Premium Ceded** to the second insurer has to be deducted from the premium received in Revenue Account. Likewise, **Re-insurance Premium received** is added to the premium received in Revenue Account.

3. **Commission** : An insurance contract is usually entered into through an agent. Since the agents get business for the insurance company they are paid commission according to the amount of business they are fetching. The commission paid to agents is shown in the Revenue Account (as per Schedule 2).

In addition, when a company gets re-insurance business it has to pay commission to some other company. This commission is called '**Commission on re-insurance accepted**' and is added to the amount of commission in Schedule 2. Likewise, when a company passes on a part of business to some other company then this company (which gives business) get commission from the company to whom it gives business. Such a commission is called '**Commission on re-insurance ceded**' and is a gain to the company surrendering the business. It is deducted from the amount of commission in Schedule 2.

4. Operating Expenses Related to Insurance Business : Operating expenses which are directly related to insurance business are taken to the Revenue Account by including them in Schedule 3. Usually, the following expenses are considered directly related to insurance business :

- (i) Employee's salaries and welfare benefits.
- (ii) Travelling Expenses
- (iii) Training Expenses
- (iv) Expenses of Management (Administrative Expenses)

All other expenses are considered not directly related to insurance business and hence are taken to Profit & Loss Account.

5. Claims : Claims means the amount payable by the insurance company. In life insurance, claim becomes payable on the expiry of the term of the policy or on the death of the policyholder, whichever is earlier. Claims paid to the policyholder after the expiry of a fixed period are called 'Claims by Maturity'. Claims outstanding at the end of the year are added to the amount of claims paid during the year whereas claims outstanding in the beginning of the year are deducted. If there are expenses incurred in connection with claims such as fees for police reports, legal fees, survey fees etc., the same must be added to the amount of claims. Amount of re-insurance claim recovered from other reinsurance companies under reinsurance contract must be deducted from the amount of claims payable by the business. Claims shown in Schedule 4 may appear as follows :

	Rs.
Claims by Death
Claims by Maturity
Add : Expenses in connection with claims
Add : Outstanding Claims at the end of the year

Less : Outstanding Claims in the beginning of the year

Less : Reinsurance Recoveries (Claims covered under reinsurance)

Claims paid in India and Outside India should be shown separately.

6. Annuity : It is an annual payment which an Insurance Company guarantees to pay to the insured throughout his life in consideration of a lump sum money paid by the insured in the beginning. Annuity paid is an expense for the Insurance Company and is shown under Schedule 4. For example, a person deposits Rs. 1,00,000 with the Insurance Company in the beginning and the insurance Company guarantees to pay him Rs. 20,000 per annum, as long as he lives. In this example, Rs. 20,000 represents an expenditure of the Insurance Company and is included in Schedule 4 whereas Rs. 1,00,000 is known as "**Consideration for annuities granted**" and will be shown in the Revenue Account under the head 'Other Income'.

7. Surrender Value : If a policyholder is unable or does not want to pay further premium on his policy, he can surrender his policy to the insurance company. Surrender value is the amount which a policyholder can get immediately in cash from

the Life Insurance Company in the event of his surrendering all the rights of the policy.) After surrender, no further premiums are payable to the Insurance Company. Usually, life policies acquire surrender value only after the payment of two annual premiums and thereafter the surrender value goes on increasing with the payment of each subsequent year's premium. Amount paid as surrender value is an expenditure for the Insurance Company and as such it is shown under Schedule 4 along with claims.

8. **Bonus** : A part of the profits of the Life Insurance Companies are distributed to with profit policyholders as bonus. As per the provisions of the Insurance Regulatory and Development Authority (IRDA) Act, One-ninth of the profits is allocated as bonus to the policyholders in case of with profit policyholders. Such bonus can be paid to the policyholders in either of the two ways :—

- (i) **Bonus in Cash** : It is paid in cash immediately on declaration.
- (ii) **Reversionary Bonus** : It is credited to the policyholders accounts and is paid only on the maturity of the policy alongwith the policy money.

Now a days, Life Insurance Corporation is paying bonus only on the maturity of the policy. Bonus paid is included in Schedule 4.

9. **Bonus in Reduction of Premium** : Sometimes Life Insurance Companies reduce the amount of premium by offering bonus to policyholders. Such a reduction in premium is termed 'bonus in reduction of premium'. It is an expenditure for the Insurance Company and is included in Schedule 4 (Benefits Paid). In case it is given in adjustments it will also be added to the amount of premium in Schedule 1.

10. **Policy Renewal Fees** : It is shown in the Revenue Account under the head 'Other Income'.

11. **Registration Fees** : Life Insurance Companies usually charge some fees for registering the policy. Since it is not directly related to insurance business, it is shown in the Profit & Loss Account under the head 'Other Income'.

12. Share transfer fees, endorsement fees and assignment fees are incomes for the insurance company. Since these are not directly related to the insurance business they are taken to the Profit and Loss Account under the head 'Other Income'.

13. **Interest, Dividend and Rents** : Amount received as interest on various loans granted by the insurance company and interest and dividends received on various investments (such as debentures, shares etc.) is shown in the Profit and Loss Account under the head 'Income from Investments'.

14. **Bad Debts** : Amount left unrecovered out of the advances made by insurance company is called bad debts. Bad debts are shown in the Profit & Loss Account under a separate head.

15. **Depreciation** : It is shown in the Profit & Loss Account under the head 'Provisions'.

16. **Income Tax** : Amount of income-tax paid by the insurance company and also the provision made for Income Tax is shown in the Profit & Loss Account separately under the head 'Provision for Taxation'.

17. **'Interim dividend'** paid to shareholders and the **'proposed dividend'** are shown in the Profit & Loss Account under the head 'Appropriations'.

Balance left in Revenue Account i.e. Surplus of Revenue Account is transferred to Profit and Loss Account and the balance left in Profit and Loss Account is transferred to the Balance Sheet under the head 'Funds for Future Appropriation'. Funds for future appropriation represent all funds, the allocation of which, either to the policyholders or to the shareholders, has not been determined by the end of the financial year.

Determination of Profit of Life Insurance Business

The method of calculating profit in case of life insurance is different from other types of insurances. It is to be noted that Profit & Loss Account of a Life Insurance Company does not disclose profit or loss for the period. In order to ascertain the profit of a life insurance company, it is essential to compute its net liability on all outstanding policies.

Net Liability : The computation of net liability is a highly complicated mathematical process and is done by experts called **actuaries**. The process of computation of net liability is termed as '**Actuarial Valuation**' and as per IRDA Act such a valuation has to be made every year. In order to calculate the net liability, the actuaries calculate the present value of future liability on all policies in force as well as present value of future premium to be received on them. The excess of present value of future liability over the present value of future premium is known as the net liability.

In other words :

Present value of future liability – Present value of future premium = Net Liability

For example, if the present value of future liability is estimated at Rs. 800 Crores and the present value of future premium is Rs. 200 Crores, the net liability will be Rs. 600 Crores.

The profit of life business will be ascertained by comparing the balance of Life Assurance Fund and funds for future appropriations on a particular date with the net liability on all policies on that date. The excess of Life Assurance Fund and funds for future appropriations over the net liability represents the actuarial valuation surplus (or profits) of the insurance company.

Distribution of Surplus Regulations :

A life insurer should maintain separately (a) a life fund for participating policyholders and (b) a life fund for non-participating policyholders. Failure to comply with this requirement would mean that the life fund maintained by the insurer would be for the benefit of the participating policyholders only.

Procedure for Distribution :

(i) An insurance company should reserve 100 percent of actuarial valuation surplus for its shareholders in case of life fund maintained for non-participating policyholders.

(ii) One-ninth of the surplus should be allocated to the policy-holders in case of life fund maintained for participating policyholders. The insurance company would have to obtain prior approval of the IRDA when the allocation is not one-ninth of the surplus. However, the insurance company cannot allocate in excess of 10 percent of the actuarial surplus to its shareholders.