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2.1 : Final Accounts of Companies

2.2 : Managerial Remuneration

2.3 : Profit Prior to Incorporation

2.4 : Consolidated Financial Statements

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FINAL ACCOUNTS OF COMPANIES

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2.1.0 Objective

The main objective of the chapter are as follows:

1. To prepare final accounts
2. To learn the adjustments while preparing the final accounts of the companies.
3. To understand the aspects of Balance Sheet.

2.1.1 INTRODUCTION

After the Trial Balance the next step involved in the preparation of final accounts of

the company is the preparation of trading account. The profit and loss account of the company is divided into two parts, the first part is termed as Trading account which is required to prepare to know the profit and loss of the company and such a profit is known as Gross profit. It is the difference between the cost of goods sold and the proceeds of their sales without any deduction in expenses. In a trading account therefore, it is necessary to include all items of direct charges affecting the cost of goods sold. It may be expressed in the following form :

Gross profit = Net Sales - Cost of goods sold

In case the cost of goods sold exceeds the value of net sales, the result is gross loss. The following items usually appear on th debit and credit side of trading account :

Debit Side :

Opening Stock, purchases (Net), Direct expenses like wages, carriage inwards, freight, motive power, gas fuel stores, royalties.

Credit Side :

Sales (Net), Closing stock (Valued at cost or market price whichever is less) profit, the next step is to prepare the Profit and Loss account. The function of the profit and loss account is to show to the vendor the net profit or Loss resulting from his transaction during a certain period.

2.1.2 PREPARATION OF FINAL ACCOUNTS

Section 129 has been made it obligatory for every company to prepare and present the balance sheet and Profit and loss account, at every annual general meeting. If company is not trading for profits, it will present Income and Expenditure Account in place of profit and loss account. A new sub-section 210(A) was added by Companies (Amendenent) Ordinance, 1999, which provided for establishment of an Advisory Committee on Accounting Standards.

According to company Act, 2013 the Company's annual accounts must be prepared in accordance with the provisions of Schedule III of the Act. This Schedule can be divided into three parts : (i) Part I : First part present the form of balance sheet. The Company's balance sheet must be prepared strictly according to the prescribed form ; (ii) Part II : Second part of the Schedule presents the form of profit and loss account ; and (iii) Part III : Third part explains the provisions regarding provisions and funds etc.

2.1.2.1 Profit and Loss Account

The Profit and Loss Account starts with credit balance from the Trading Account in respect of gross profit and with debit balance in case of gross loss. Thereafter, all those expenses or losses which have not been debited to the Trading Account are debited to Profit and Loss Account. If there is any income besides the gross profit, it will also be transferred to the credit of the profit and loss account. The profit and loss account is closed by transfer of the resultant net profit or loss to the Capital Account. If the result shows net profit then the entry would be to debit the Profit and Loss Account and credit the capital Account. If there is net Loss, the entry would be to debit the Capital Account and credit the Profit and Loss Account. The result of such an entry would be to close the profit and loss account on the one hand, and on the other hand to indicate the fact of the capital having increased as a result of profit or having, diminished as a result of loss.

2.1.2.2 Profit and Loss Appropriation Account

For a company, it is not obligatory to split the profit and loss account, into three sections i.e. trading account, profit and loss account and profit and loss appropriation account. Only profit and loss account may be prepared which may cover the items appearing in Trading Account and Profit and Loss Appropriation Account. The Profit

and Loss Appropriation section of the Profit and loss account shows the appropriations of profit and prepared in the following manner :

Dr. Profit and Loss Appropriation Account Cr.

To transfer of Reserves	XXX	By Balance b/d (Previous year's Profits)	XXX
To provision for Income tax	XXX	By Net Profits for the current year	XXX
To transfer to sinking fund	XXX		
To transfer to dividend	XXX	By General reserves or	
equalisation fund	XXX	Any other reserves	XXX
To Interin Dividend			
To proposed dividend on preference and equity shares	XXX	By provisions for income tax	XXX
To corporate dividend tax on dividends			
To balance c/d (carried forward to balance sheet)			
	XXXX		XXXX

2.1.3 SOME TYPICAL ADJUSTMENTS

It must be noted that the balances standing on Nominal Account as appearing in the Trial Balance are not transferred to the Profit and Loss Account without due scrutiny to ascertain that they are properly related to the period of Trading.

It frequently happens that certain expenses relating to a trading period do not appear in the books of that period, simply because they have not been paid or demand notes in respect of them have not been received. On the other hand it happens that, expenses under certain heads, such as Fire Insurance premium, Telephone Subscription etc. are paid for a year in advance ,and it may be that the period for which these services are to be received in return for these payments extend far beyond the close of the financial period. It will be necessary therefore, to carefully examine all items of expenditure to ascertain that all expenses paid or unpaid but relating to the period of Trading are brought into account. In addition, if any item of expenditure is paid for in advance, the same must be properly appropriated between the period that has yet to expire, so that proper adjustment may be made in this

behalf. All items of gain will also have to be similarly scrutinised to see that all gains relating to the period whether received or not are brought into account.

The following adjustments are thus usually made in Nominal Account balance before they are transferred to Profit and Loss Account. These adjustments are important in view of the fact that in order to arrive at an accurate figure of the actual net profit made or net loss sustained, during any particular period, it is necessary to see that only items of expenses of gains relating to that same period are brought into the Profit and Loss Account.

2.1.3.1 Outstanding Expenses or Expenses due but not paid :

Generally, in the business, it is usual to pay items of expenses such as rent, salaries, wages etc. of each month in the subsequent month if the trading period of such a business ends on 31st December, it would follow that the office rent, staff salaries and wages etc., for the month of December, not having been paid in that month, will not appear in the books for the period ended 31st December. It is necessary that Outstanding Expenses be charged to the profit and loss account of the period.

Such an adjustment is made by means of a journal entry debiting the various nominal accounts concerned with the amounts due and crediting an account called "Outstanding liabilities". The latter account will appear as a liability in the Balance Sheet, and will be carried forward in the next year's books. At the comencement of the next period a reverse entry will be to lose the outstanding creditor's Account.

Example : Harish e Co. on balancing their books on 31st December 2007 found that the following expenses incurred during the trading period had not been brought into a account Rent for November and December Rs. 100 per month : A bill for Legal charges incurred in October Rs. 450; Salaries to staff for December Rs. 600 and Bill for Electric Lighting Rs. 50. Pass the necessary Journal Entry to bring these items into account.

Date	Particulars		Dr.	Cr.
2007				
December 31	Rent account	Dr.	200	
	Legal Charges account	Dr.	450	
	Electric Lighting account	Dr.	50	
	Salaries account	Dr.	600	
	To Outstanding Liability for Expenses			1,300

(Being the outstandng expenses for the period brought into Account)

The effect of this entry is to bring the expenses Account concerned to their proper level representing the total Expenditure under each head for the trading period under review and at the same to disclose the fact that on the close of the financial period there was a liability for expenses incurred and unpaid amounting to Rs. 1,300.

2.1.3.2 Prepaid Expenses or Unexpired Expenses :

There are, however, several items of expenses that are usually paid for in

advance, such as fire insurance, telephone charges, rent and taxes, etc. and at the time of balancing it happens that the whole of the period to be covered by the amount already spent has not yet expired. The proportion of the amount paid with relates to the unexpired period has, therefore, to be carried forward to the next year. This is done by

Expenses Prepaid A/c Dr.
To Particular Nominal A/c
(Being amount paid in advance)

Expenses Prepaid Account being a debit balance will appear as an asset in the Balance Sheet, and will be carried forward in the next year's book. At the next commencement of the next period, the Expenses prepaid Account will be closed by means of reverse journal entry.

Various Nominal A/c Dr.
To Expense Prepaid A/c
(Being expenses paid in advance)

Advertisements are sometimes paid for two or three years in advance under a contract. And in such a case, it should be seen that while preparing profit and loss Account of any given period, only the proportionate amount representing that period is brought into account and the unexpired balance is carried forward as above. On 30th September 2007 a tax of Rs. 1000 may be paid in advance for six months ending 31st March 2008. If the accounts are made up to 31st December 2007, taxes for three months (from 1st January to 31st March, 2008) Rs. 500 will be treated as prepaid or paid in advance. Since the benefit of this amount will accrue next year, this year's account should not be burdened with the expenses. To put matters right the following entry should be passed :

Prepaid Expenss A/c ....Dr. 500
To Municipal Taxes A/c 500

Municipal taxes will be now less by Rs. 500 and a "Prepaid Expenses" Account debited, which will go to Balance Sheet. The amount will be charged to revenue next year. This applies to all prepaid expenses.

2.1.3.3 Bad Debts

Some people fail to pay their dues. They are known as Bad Debts and the amount which is irrecoverable is a loss. If a person files a petition for bankruptcy, the creditor will general treat his debt as a bad debt. The entry in the books of creditors :

Bad Debts Account ..Dr.
To Debtors (by name) A/c

The debtor's account is then closed and the Bad Debt Account is transferred

at the end of year, to the profit and Loss Account (debit side).

Sometimes, the amount later on is recovered wholly or partially. In that case the account to be credited with Bad Debts Recovered Account.

2.1.3.4 Provision for Bad Debts :

Suppose a person owes Rs. 500 and he is doubtful regarding his ability to pay but one also does not want to write it off yet. Next year the amount actually turns out to be bad and has to be written off. So, one should provide for the loss of this year not knowing the actual amount that will have to be written off next year. One can only consider an appropriate figure. This year's profit are reduced by this figure and the amount is treated as a provision. Any amount that may have to be written off next year will be met out of the provision thus created. The entry for certain of the provision is :

Profit and Loss Account Dr.

To Provision for Bad and Doubtful Debts

The provision for bad and doubtful debts will appear in the Balance Sheet. Next year the actual amount of bad debts will be debited not to the Profit and Loss Account but for the provision for Bad and Doubtful Debts Accounts which will then stand reduced. The provision can be brought up to required amount by again debiting the Profit and Loss account and crediting the Provision for Bad and Doubtful Account.

Example I

On Ist January, 2006, Premier Enginering Co. had a bad Debts Provision of Rs. 650/-. On 31st December, 2006 the total debts amounted to Rs. 18,400 out of which Rs. 400 were bad and had to be written off. The firm wants to maintain the Bad Debts provision at 5% of the debtors.

On 31st December, 2007 total debts amounted to Rs. 10,320 out of which Rs. 320 had to be written off as Bad Debts. Provision is to be maintained at 5% of the debtors. Show the Bad Debts Account and the Bad debts Provision Account for 2006 and 2007.

Solution :

Dr. Bad Debts Account Cr.

2006		Rs.	2006		Rs.
Dec. 31	To Sundry Debtors A/c	400	Dec. 31	By Bad Debts Provision Account	400
		---------------			-----------
2007	To Sundry Debtors A/c	320	2007	By Bad Debts	320
		--------	Dec. 31	Provision Account	

Provision for Bad Debts Account

Dr. Cr.

		Rs.			Rs.
2006	To Bad Debts A/c	400	2006	By Balance b/d	650
Dec. 31	To Bal. c/d	900	Jan. 1	By P & L A/c	650
	(5% on 18000)	--------		(B/F)	--------
		1300			1300
2007	To Bad Debts A/c	320	2007	By Balance b/d	900
			Jan. 1		
	To P & L A/c	80			
Dec. 31	To Bal. c/d	500			
	(5% on 10,000)	--------			--------
		900			900
			2008	By Bal. b/d	500
			Jan. 1		

Note : The balance to be carried forward is 5% of the debtor after writing off bad debts e.g. in 2006 it is 5% of 18,000. The amount to be transferred to profit and loss account is what remains in the Bad Debts Provision afer leaving the desired balances.

2.1.3.5 Provision for Discount :

Some firms also maintain a provision for Discount, that is, a provision to meet discount which may have to be allowed to present debtors. The procedure is the same as for provision for bad debts. First the Profit and Loss Account is debited and Provision for Discount Account credited. This account is carried forward to the next year. Next year the actual discount allowed will be debited to the account not to the profit and Loss Account. The Profit and Loss Account will be debited to make up the required balance each year. If, after providing the required balance, a surplus is left in the Provision for Discount A/c. It should be transferred to the credit of Profit and Loss Account, just like the Provision for Bad Debts Account. But the provision required to be maintained for discounts should be calculated on total debtors minus the provision for bad debts, since those who turn bad will not earn discount.

Example : A company may maintain a provision for bad debts at 5% of debtors and 2% provision for discounts. If at the end of a year debtors amount to Rs. 20,000 the provision for Bad Debts will be Rs. 1000 (5% of 20,000) and the provision required for discounts will be 2% of 19,000 (i.e. 20,000-1,000) of Rs. 475.

2.1.3.6 Income Received in Advance :

If a trader finds at the end of the financial period that he had received money on some account in respect of which the full service has not been rendered by him,

it becomes necessary for him to treat it as income only, such portion thereof in respect of which the service has been rendered and to treat the balance as Liability. This is brought about by ascertaining the proportion of the amount received in respect of which the service still remains to be rendered and passing a journal entry there with debiting the Nominal Account concerned and crediting an account styled "Income Received in Advance."

The credit balance on the latter account will be shown as liability on the Balance Sheet. At the commencement of the succeeding period, the above entry would be reversed.

2.1.3.7 Accrued Income :

It may happen that Income such as interest or dividend on investment held by the company, or rent from a sub-tenant for commission may have accrued but may not have received. At the time of balancing such items of accrued income belonging to the period must be brought into account by :

Outstanding debtors A/c .. Dr.

To particular Nominal A/c

Outstanding debtors account will appear as an asset in the Balance Sheet, and will be carried forward in the next year's books. At the commencement of the next period, journal entry will be passed.

Particular Nominal A/c .. Dr.

To Outstanding Debt A/c

With this entry the latter account will be closed.

2.1.3.8 Depreciation :

The term Depreciation as applied to the assets of a business means permanent decline in value of the assets due to wear and tear or from any other cause.

It is a matter of common knowledge that all assets have either a definite or an estimated period of utility to the business in which they are employed and as the years roll by their sphere of usefulness diminishes with the result that they have to be discarded when eventually the proprietors find them useless. This diminution in value of the assets however, takes place from year to year, as much as it results from the use of these assets for and brought into the accounts of each year. This loss is known as depreciation.

If the loss sustained by way of depreciation in the value of assets not charged off to Profit and Loss Account each, the annual final accounts will fail to show the true facts. The depreciation arising from the use to assets is properly chargeable in the period in which it relates, irrespective of whether a Profit and Loss Account has been made.

The method of providing for depreciation is to estimate how long the assets

in question will be used in the busines and then to charge off a proportionate amount to the profit and loss account each year, So that while the assets become useless, their book value may also be brought down to their residual of scrap value.

The journal entry to write off a depreciation on any assets is to :

Depreciation Account.............................. Dr.

To Assets A/C

The entry will be passed with the amount of each year's depreciation. The effect of such an entry would be to reduce the book value of the assets from year to year and also to enable such a loss to be charged to the Profit and Loss Account of each year.

2.1.3.9 Interest on Capital :

Interest on Capital at a nominal rate is soemtimes calculated on the traders capital and charged to the business for the purpose of ascertaining what extra profits are derived from the undertaking over and above the usual rate of interest which the capital employed therein would have earned, if invested in gilt-edged security. The entry for adjusting interest on capital is :

Interest A/c....................Dr. (with the amount of interest as calculated on

To Capital A/c the capital)

2.1.3.10 Interest on Drawings :

As a business is charged on the one hand with interest on the capital employed therein it should also be given net benefit of the interest on the sums withdrawn by the proprietor on his Personal Account. This is done by calculating the same rate of interest on the various sums withdrawn from the dates of their withdrawal to the date of balancing and with the total amount of interest thus arrived at. The entry will be passed as under :

Capital A/C......................Dr.

To Interest A/C

Points to be considered while preparing Profit and Loss Account :

By considering all necessary adjustments for example, expenses prepaid, outstanding expenses, bad and doubtfull debts, depreciation and interest on capital as above explained. The steps would be as under :

1. To transfer the gross profit as shown by the trading account to the credit of the Profit and Loss Account.
2. To transfer all Debit balances of the Nominal Accounts from the trial balance (after adjustment) to the Debit side of Profit and Loss Account.
3. To transfer all Credit balances of the Nominal Accounts from the trial balance (after adjustment) to the Credit of Profit and Loss Account.
4. To close profit and loss account by transferring the net Profit or Net Loss to the Capital Account of the company.

In connection with the preparation of final accounts of companies, the following Indian accounting standards are relevant :

AS-1	:	Disclosure of accounting policies
AS-3	:	Cash Flow Statement
AS-4	:	Contingencies and events occuring after balance sheet date
AS-5	:	Prior period and extraordinary items and changes in accounting policies
AS-7	:	Accounting for construction contracts
AS-8	:	Accounting for research and development
AS-9	:	Revenue Recognition
AS-10	:	Accounting for fixed assets
AS-11	:	Accounting for the effect of changes in foreign exchange rates
AS-22	:	Accounting for taxes on Income

2.1.4 BALANCE SHEET

A Balance sheet may, therefore, be defined as a statement prepared with a view to measure the exact financial position of a business on a certain fixed date. It is prepared from the Trial Balance, after all the balances of Nominal Accounts are transferred to the Trading and Profit and Loss Account and the Corresponding Accounts in the Ledger closed. In other words, they represent either Assets or Liabilities existing at the date of the financial close.

All such Assets and Liabilities are set out in the Balance Sheet in a classified form. On the right hand side, the various liabilities i.e. the amount owing by the business. The excess of Assets over Liabilities then represents the capital of the owner. This figure of capital must tally with the closing Balance of the Capital Account in the ledger after the net profit or net loss has been transferred there to.

The information conveyed by the Trading and Profit and Loss Account is no doubt very valuable to the owner of a business as it enables him to determine the gross net profits resulting from his dealing during a certain period. This, however, is not the only point on which as businessman wants to be enlightened. As his Assets and Liabilities change from day to day, as a result of business transaction he also wants to find out what true financial position is at the end of each trading period. In the first place, the management would like to know whether the net profit as is disclosed by the Profit and Loss Account is correctly arrived at for, if so, the companies' capital at the period must necessarily increase by that amount. The management is equally anxious to see for istself as to how such capital is looked up i.e. What (the component-assets and Liabilities are of which) this capital is made up. In order, therefore, to obtain this information at the end of trading period he has to see his several Assets and Liabilities as at that date in shape of a statement and this statement is called Balance Sheet.

Example-II

The following is the Trial balance of Baghdad Ltd. as at 31st March, 2008:

Particulars	Dr.	Cr.	Particulars	Dr.	Cr.
Stock 1st April 2007	75,000	—	Purchases returns	—	10,000
Purchases and sales	2,45,000	3,40,000	Wages	30,000	—
Discount	—	3,000	Carriage inwards	950	—
Furniture and fittings	17,000	—	Salaries	7,500	—
Rent	4,000	—	Sundry expenses	7,050	—
Profit and loss a/c	—		Dividend paid for 2002-03	9,000	—
31st March 2007	—	15,000	Debtors and creditors	27,500	17,500
Share capital	—	1,00,000	Cash at bank	46,200	—
Plant and machinery	29,000	—	Patents and trade		
General reserve	—	15,500	marks	4,800	—
Bills receivable and					
bills payable	5,000	7,000	TOTAL	5,08,000	5,08,000

Prepare profit and loss account for the year ended 31st March, 2008 and balance sheet as at that date. Take into consideration the following adjustments :

(i) Stock on 31st March, 2008 was valued at Rs. 88,000.

(ii) Make a provision for income tax @ 50%.

(iii) Depreciate plant and machinery @ 15%, furniture and fittings @ 10%, and patents and trade mark @ 5%.

(iv) On 31st March, 2008 outstanding rent amounted to Rs. 800 while oustanding salaries totalled Rs. 900.

(v) The directors proposed a dividend @ 15% per annum for the year ended 31st March, 2008 after the minimum transfer to General Reserve.

(vi) Make a provision for doubtful debts amounting to Rs. 510.

(vii) Provide for managerial remuneration @ 10% of the profit, profits before tax.

Solution :

PROFIT AND LOSS ACCOUNT OF BAGHDAD LTD.

Dr. *for the year ended 31st March, 2008* Cr.

Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
To Opening stock		75,000	By Sales		3,40,000
To Purcahses	2,45,000		By Closing Stock		88,000
Less : Returns	10,000	2,35,000			
To Wages		30,000			
To Carriage inwards		950			
To Gross profit c/d		87,050			
		4,28,000			4,28,000
To Salaries	7,500		By Gorss profit b/d		87,050
Add : Outstanding Salary	900	8,400	By Discounts		3,000
To Rent	4,000				
Add : Outstanding Rent	800	4,800			
To Sundry expenses		7,050			
To provision for doubtful debts		510			
To Provision for depreciation :					
plant and machinery	4,350				
Furniture and fittings	1,700				
Patent and trademarks	240	6,290			
Managerial remuneration (10% of Rs. 63,000)		6,300			
To Provision for taxation		28,350			
To net profit c/d		28,350			
		90,050		90,050	
To Dividends (for 2001-02)		9,000	By Previous year's profit	15,000	
To General reserve (5% of Rs. 28,350)		1,418	By Net Profit b/d	28,350	
To Proposed dividend (for 2002-03)		15,000			
To Coporate dividend tax (@ 20% of (9,000 + 15,000)		4,800			
To Balance transferred to Balance Sheet		13,132			
		43,350		43,350	

BALANCE SHEET OF BAGHDAD LTD.
as at 31st March, 2008

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Share capital :			Fixed Assets :		
Authorised, issued			Plant and machinery		
and subscribed,			(at cost)	29,000	
Equity shares each fully paid			Less : Provision for		
		1,00,000	depreciation	4,350	24,650
Reserves and Surplus :			Furniture and fittings	17,000	
General reserve	15,500		Less : provision for		
during the year	1,418	16,918	depreciation	1,700	15,300
Profit and loss A/c		13,132			
Secured Loans :		NIL	Patents and trademarks	4,800	
Un-Secured Loans		NIL	Less : Provision for		
Current Liabilities and			depreciation	240	4,560
Provisions :			Investments :		NIL
Current liabilities :			Current Assets, Loans		
			and Advances :		
Creditors		17,500			
Bills payable		7,000	A. Current Assets :		
outstanding rent		800	Stock-in-trade		88,000
Outstanding salaries		900	Debtors		
Oustanding managerial			(a) Debts outstanding for		
Renuneration		6,300	more than 6 months	——	
Provisions			(b) Others	27,500	
Provision for taxation		28,350		27,500	
Proposed dividend		15,000	Less : Provision for		
Corporate Dividend Tax @ 20%		4,800	doubtful debts	510	26,990
			Cash at bank		46,200
			B. Loans and Advances :		
			Bills receivables		5,000
			Miscellaneous Expenditures		NIL
		2,10,700			2,10,700

Note: Where the proposed dividend exceed 12.5% but does not exceed 15% of paid-up capital the amount to be transferred to reserve must not be less than 5% of the current profit, As per companies (Transfer of profits to Reserves) Rules.

Dividend out of Capital Profit : A Company can declare dividend out of capital profit, but not out of capital reserve, if

(i) It is realised in cash;

(ii) It exists after revaluation of all assets and liabilities, and

(iii) Its distribution is allowed as per Articles of Association of the company.

Capital Profit on its transfer to capital reserve is not available for distribution. Securities premium, Capital redemption reserve etc. are legally not available for distribution.

Dividend out of subsidy by the governmnt :

If payment of dividend is guaranteed by the Government, dividend may be paid out of money given by the government.

Declaration of dividend out of reserves :

In case of inadequate current year profits, the utilisation of accumulated reserves for distribution of dividend is governed by the companies. Rule 3 of the companies (Declaration and Payment of Dividend Rules, 2014) framed by the central government, These rules are as under :

(a) the rate of dividend declared shall not exceed the average rate of dividend of lastest preceding five years or 10% of its paid up capital, whichever is less.

(b) the total amount to be drawn from the reserves created out of profits earned shall not exceed 1/10 of its paid up capital and free reserves and the amount so drawn shall be first utilised to set off the losses incurred in the financial year.

(c) the balance of reserves after such withdrawal shall not fall below 15% of its paid up share capital.

2.1.5 Self Check Exercises

Ques1: What will be the adjustment entry for prepaid expenses?

Ques2: Write down the journal entry for provision for bad debt?

Ques3: Write down the Indian accounting standard for Revenue Recognition?

2.1.16 Summary

After preparing the trial balance next step is to prepare profit and loss of the company which Is divided into two parts , first part is called Trading Account and second part is called profit and loss account. After preparing the profit and loss account, balance sheet is prepared, the main aim of preparing balance sheet is to know the exact financial position of the company that is balance sheet is prepared on a particular date.

2.1.7 Glossary

1. Gross Profit: Gross Profit is the result of difference between net sales and cost of goods sold.
2. Outstanding Expenses: Outstanding Expenses are those which are due but not paid yet. These expenses belong to the category of representative personal account.
3. Prepaid expenses: Prepaid expenses are those which are paid but not due yet. These are the advance payment and it comes into the category of assets. These expenses also belong to representative personal account.

2.1.8 Short Questions

Ques1: Write down the formula of Gross Profit?

Ques2: What do you mean by outstanding expenses?

Ques3: What do you mean by prepaid expenses?

2.1.9 Long Questions

1. Give a specimen form of the Balance Sheet and Profit & Loss Account of a company, according to Companies Act, 2013.

2. Write notes : (i) Reserves and Provisions
(ii) Unclaimed dividend
(iii) Interim dividend
(iv) Contingent liabilities

3. A limited company was registered with an authorised capital of Rs. 30,00,000 is equity shares of Rs. 100 each. The following is the list of balances extracted from its books on 31-03-2008.

	Rs.		
Rs.			
Purchases	9,25,000	General Expenses	84,175
Wage	4,24,325	Stock on 1-4-2007	3,75,000
S			
Manufacturing		Goodwill	1,00,000
Expenses	65,575	Cash in hand	28,000
Salaries	70,000	Cash at bank	1,99,500
Bad Debts	10,000	Subscribed & Fully	
Directors Fees	31,125	Paid capital	20,00,000
Debentures Interest		Profit & Loss Account	
Paid	45,000	(credit balance)	72,500
Preliminary Expenses	25,000	6% Debentures	15,00,000
Calls in Arrear	37,500	Sundry Creditors	2,90,000
Plant & Machinery	15,00,000	Bills Payable	1,67,500
Premises	16,50,000	Sales	20,75,000
Interim Dividend Paid	1,87,500	General Reserve	1,25,000
Furniture & Fixtures	35,000		
Sundry Debtors	4,36,000		

You are required to prepare Trading and Profit & Loss Account for the year ended 31st March, 2008 and the Balance Sheet on that date after making the following adjustments :

Depreciate Plant and Machinery by 10%. Provide half years interest on debentures. Also write off Rs. 2,500 from preliminary expenses and make the provision for bad and doubtful debts Rs. 4,250 on sundry debtors stock on 31st March, 2008 was Rs. 4,55,000. Corporate dividend tax is to be ignored.

Ques.4 Determine the maximum remuneration available to the managing director of B Ltd. (a manufacturing company) from the following particulars : Before charging any such remuneration, Profit and loss account showed a credit balance

of Rs. 2,31,000 for the year ended 31st March, 2008 after taking into account the following matters :

1.	Capital expenditure	52,500	6.	Subsidy from Government	42,000
2.	Special depreciation	7,000	7.	Multipleship allowance	10,500
3.	Bonus to foreign technicians	31,500	8.	Provision for taxation	2,80,000
4.	Compensation paid to injured workman	7,000	9.	Ex-gratia to an Employee	3,500
5.	Loss on sale of fixed Assets	7,000	10.	profit on sale of Investment	21,000

Company is providing depreciation as per Companies Act, 2013.

2.1.10 SUGGESTED READINGS

1. Corporate Accounting
   By : C. Mohan Juneja
   B.K. Sachdeva
   Inderjit Singh
   Rakesh Katyal
2. Company Accounts
   By : Jain and Narang

LESSON NO. 2.2

Appointment and Remuneration of Managerial Personnel under the Companies Act, 2013

Structure of the lesson

2.2.0 Objective

2.2.1 Introduction

2.2.2 Definitions

2.2.2.1 Key Managerial Personnel

2.2.2.2 Directors/ Board of Directors

2.2.2.3 Managing Director/Manager

2.2.2.4 Whole-time Director/CEO/CFO

2.2.3 Number of Directors

2.2.4 Appointment of Managing Director, Whole-Time Director or Manager

2.2.4.1 Appointment with the Approval of Central Government

2.2.5 Disqualifications

2.2.6 Reappointment of Managing Director

2.2.7 Appointment of Key Managerial Personnel

2.2.8 Remuneration

2.2.9 Self Check Exercises

2.2.10 Summary

2.2.11 Glossary

2.2.12 Short Questions

2.2.13 Long Questions

2.2.14 Suggested Readings

2.2.0 Objective

The main objective of this chapter are as follows:

1. To understand the meaning of Key Managerial Personnel, Directors, Managing Directors, Whole time Directors.
2. To understand the provisions regarding Managerial Remuneration.

2.2.1 Introduction

The executive management of a company is responsible for the day to day management of a company. The companies Act, 2013 has used the term key management personnel to define the executive management. The key management personnel are the point of first

contact between the company and its stakeholders. While the Board of Directors is responsible for providing the oversight, it is the key management personnel who are responsible for not just laying down the strategies as well as its implementation.

Chapter XIII of the Companies Act, 2013 read with Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014 deal with the legal and procedural aspects of appointment of Key Managerial Personnel including Managing Director, Whole-time Director or Manager, managerial remuneration, secretarial audit etc.

2.2.2 Definitions:

2.2.2.1 Key Managerial Personnel

Sec.2 (51) – Key Managerial Personnel in relation to a company means-(i)
The Chief Executive Officer or the Managing Director or the Manager; (ii)
The Company Secretary;
(iii) The whole-time director;
(iv) The Chief financial Officer; and
(v) Such other officer as may be prescribed

2.2.2.2 Directors/Board of Directors

- ❖ Sec. 2(34) – Director means a director appointed to the Board of a company ❖ Sec.2(10) – Board of Directors or Board, in relation to a company, means the collective body of directors of the company;

2.2.2.3 Managing Director/Manager

- ❖ Sec.2(53) – "Manager" means an individual who, subject to the superintendence, control and direction of the Board of Directors, has the management of the whole or substantially the whole, of the affairs of a company, and includes a director or any other person occupying the position of a manager, by whatever name called, whether under a contract of service or not;
- ❖ Sec. 2(54) – "managing director" means a director, who, by virtue of the articles of the company or an agreement with the company or a resolution passed in its

general meeting, or by its Board of Directors, is entrusted with substantial powers of management of the affairs of a company, and includes a director occupying the position of managing director, by whatever name called.

2.2.2.4 Whole-time Director/CEO/CFO

- Sec.2(94) – "whole-time director" includes a director in the whole-time employment of the Company
- Sec.2(18) "Chief Executive Officer" means an officer of a company, who has been designated as such by it;
- Sec.2(19) – "Chief Financial Officer" means a person appointed as the Chief Financial officer of a company.

2.2.3 Number of Directors: Sec.149 (1)

- Public company – minimum three directors
- Private company – minimum two directors ➢

One person Company – minimum one director ➢

Maximum 15 directors (increased from 12)

This can be increased by passing a special resolution. No need to go to Central Government.

2.2.4 Appointment of Managing Director, Whole-Time Director or Manager

Section 196 of the Companies Act, 2013 provides that no company shall appoint or employ at the same time a Managing Director and a Manager. Further, a company shall not appoint or reappoint any person as its Managing Director, Whole Time Director or manager for a term exceeding five years at a time and no reappointment shall be made earlier than one year before the expiry of his term.

Section 196(4) of the Companies Act, 2013 provides that subject to the provisions of section 197 and Schedule V, a managing director, whole-time director or manager shall be appointed and the terms and conditions of such appointment and remuneration payable be approved by the Board of Directors at a meeting which shall be subject to approval by a

resolution at the next general meeting of the company and by the Central Government in case such appointment is at variance to the conditions specified in Schedule V. Approval of the Central Government is not necessary if the appointment is made in accordance with the conditions specified in Schedule V to the Act.

Therefore, the appointment of a managing director or whole-time director or manager and the terms and conditions of such appointment and remuneration payable thereon must be first approved by the Board of directors at a meeting and then by an ordinary resolution passed at a general meeting of the company.

A notice convening Board or general meeting for considering such appointment shall include the terms and conditions of such appointment, remuneration payable and such other matters including interest, of a director or directors in such appointments, if any.

A return in the prescribed form viz. MR.1 is required to be filed with Registrar within 60 days from the date of such appointment.

Section 196(5) provides that subject to the provisions of this Act, where an appointment of a managing director, whole-time director or manager is not approved by the company at a general meeting, any act done by him before such approval shall not be deemed to be invalid.

2.2.4.1 Appointment with the Approval of Central Government

In case the provisions of Schedule V of the Companies Act, 2013 are not fulfilled by company, an application seeking approval to the appointment of a managing director (Whole-time director or manager) shall be made to the Central Government, in e-Form No. MR.2.

As per section 200, the Central Government or a company may, while according its approval under section 196, to any appointment of a managing director, whole-time director or manager, the Central Government or the company shall have regard to—

(a) The financial position of the company;

(b) The remuneration or commission drawn by the individual concerned in any other capacity; (c) The remuneration or commission drawn by him from any other company;
(d) Professional qualifications and experience of the individual concerned;
(e) Such other matters as may be prescribed.

As per Rule 6 for the purposes of item (e) of section 200, the Central Government or the company shall have regard to the following matters while granting approval to the appointment of managing director under section 196:
(1) Financial and operating performance of the company during the three preceding financial years.
(2) Relationship between remuneration and performance.
(3) The principle of proportionality of remuneration within the company, ideally by a rating methodology which compares the remuneration of directors to that of other executive directors on the board and employees or executives of the company.
(4) Whether remuneration policy for directors differs from remuneration policy for other employees and if so, an explanation for the difference.
(5) The securities held by the director, including options and details of the shares pledged as at the end of the preceding financial year.

2.2.5 Disqualifications

Section 196(3) of the Act makes a specific prohibitory provision with regard to the appointment of managing director, whole time director or manager. The section lays down that no company shall appoint or continue the employment of any person as its managing director, whole time director or manager who—

(a) is below the age of twenty-one years or has attained the age of seventy years:
Provided that appointment of a person who has attained the age of seventy years may be made by passing a special resolution in which case the explanatory

statement annexed to the notice for such motion shall indicate the justification for appointing such person;

(b) is an undischarged insolvent or has at anytime been adjudged as an insolvent;

(c) has at any time suspended payment to his creditors, or makes, or has at any time made, a composition with them; or

(d) has at any time been, convicted by a court of an offence and sentenced for a period of more than six months.

Apart from this, Part I of Schedule V contains five conditions which must be satisfied by a person to be eligible for appointment as managing director, whole-time director or manager without the approval of the Central Government. These conditions are as below:

(a) he had not been sentenced to imprisonment for any period, or to a fine exceeding one thousand rupees, for the conviction of an offence under any of the following Acts, namely:-

(i) the Indian Stamp Act, 1899,

(ii) the Central Excise Act, 1944,

(iii) the Industries (Development and Regulation) Act, 1951,

(iv) the Prevention of Food Adulteration Act, 1954 ,

(v) the Essential Commodities Act, 1955,

(vi) the Companies Act, 2013,

(vii) the Securities Contracts (Regulation) Act, 1956,

(viii) the Wealth-tax Act, 1957,

(ix) the Income-tax Act, 1961,

(x) the Customs Act, 1962,

(xi) the Competition Act, 2002,

(xii) the Foreign Exchange Management Act, 1999,

(xiii) the Sick Industrial Companies (Special Provisions) Act, 1985,

(xiv) the Securities and Exchange Board of India Act, 1992,

(xv) the Foreign Trade (Development and Regulation) Act, 1992;

(xvi) the Prevention of Money Laundering Act, 2002;

(b) he had not been detained for any period under the Conservation of Foreign Exchange and Prevention of Smuggling Activities Act, 1974;

(c) he has completed the age of 21 years and has not attained the age of 70 years;

(d) where he is a managerial person in more than one company, he draws remuneration from one or more companies subject to the ceiling provided in section V of Part II;

(e) he is resident in India

2.2.6 Reappointment of Managing Director

Under sections 196 and 203 of the Companies Act, 2013, appointment includes reappointment. Reappointment of a managing director of a company must be taken for consideration before the expiry of his term of office. If the reappointment of the managing director is approved and if it is not in accordance with the conditions specified in Schedule V then the approval of the Central Government must be obtained for such reappointment. Rests of the provisions for reappointment of a managing director are same as in the case of appointment of a managing director.

2.2.7 Appointment of Key Managerial Personnel

Section 203 of the Companies Act, 2013 read with Rule 8 mandates the appointment of Key Managerial Personnel and makes it obligatory for a listed company and every other public company having a paidup share capital of rupees ten crores or more, to appoint following whole-time key managerial personnel:

(i) managing director, or Chief Executive Officer or manager and in their absence, a whole-time director;

(ii) company secretary; and

(iii) Chief Financial Officer:

Every whole-time key managerial personnel of a company shall be appointed by means of a resolution of the Board containing the terms and conditions of the appointment including the remuneration.

An individual shall not be appointed or reappointed as the chairperson of the company, as well as the managing director or Chief Executive Officer of the company at the same time unless the articles of such a company provide otherwise; or the company does not carry multiple businesses. However, such class of companies engaged in multiple businesses and which has appointed one or more Chief Executive Officers for each such business as may be notified by the Central Government are exempted from the above.

A whole-time key managerial personnel shall not hold office in more than one company except in its subsidiary company at the same time. However, he can hold such other directorship with the permission of the Board.

A whole-time key managerial personnel holding office in more than one company at the same time, shall, within a period of six months from such commencement, choose one company, in which he wishes to continue to hold the office of key managerial personnel.

A company may appoint or employ a person as its managing director, if he is the managing director or manager of one, and of not more than one, other company and such appointment or employment is made or approved by a resolution passed at a meeting of the Board with the consent of all the directors present at the meeting and of which meeting, and of the resolution to be moved thereat, specific notice has been given to all the directors then in India.

If the office of any whole-time key managerial personnel is vacated, the resulting vacancy shall be filled-up by the Board at a meeting of the Board within a period of six months from the date of such vacancy.

2.2.8 REMUNERATION

According to companies Act, 2013 the manager of a company may, subject the provisions of section 197, receive a remuneration, which shall not exceed in the aggregate 11% of the net profits of the company. The company can pay higher remuneration subject to the prior approval of the Central Government. Under section 197, a company may pay to its directors and manager in respect of any financial year remuneration not more than 11% of its net profits of that year.

Net profit for determining directors' remuneration shall be computed according

to the provisions of sections 198 of Companies Act, 2013. In such calculation, the remuneration of the directors shall not be deducted from the gross profit but income tax paid/payable shall be deducted.

Meaning of the term 'remuneration'

Remuneration shall include

(a) Any expenditure incurred by the company for providing rent-free accommodation or any amenity in respect of an accomodation free of charge.

(b) Any expenditure incurred by a company in providing any other amenity either free of charge or at a concessional rate.

(c) Any expenditure incurred by the company in respect of any obligation or service which otherwise would have been incurred by the directors/managers.

(d) Any expenditure incurred by the company to effect any insurance on the life of the person, or his spouse or in providing any pension, annuity or gratuity.

The remuneration payable to manager, managing director (s), whole time director (s) and part time director (s) is known as managerial remuneration.

Section I-- Remuneration payable by companies having profits:

Total managerial remuneration payable by a public company, to its directors, managing director and whole-time director and its manager in respect of any financial year:

Condition	Max Remuneration in any financial year
Company with one Managing director/whole time director/manager	5% of the net profits of the company
Company with more than one Managing director/whole time director/manager	10% of the net profits of the company
Overall Limit on Managerial Remuneration	11% of the net profits of the company
Remuneration payable to directors who are neither managing directors nor whole-time directors	
For directors who are neither managing director nor whole-time directors	1% of the net profits of the company if there is a managing director/whole time director
If there is a director who is neither a Managing director nor whole time director	3% of the net profits of the company if there is no managing director/whole time director

Section II-- Remuneration payable by companies having no profit or inadequate profit:

It may, pay remuneration to the managerial person not exceeding, the limits under given below:-

(1)	(2)	(3)

Sr.No.	Where the effective capital (in rupees) is	Limit of yearly remuneration payable shall not exceed (in Rupess) in case of a managerial person	Limit of yearly remuneration payable shall not exceed (in rupees) in case of other director
(i)	Negative or less than 5 crores.	60 lakhs	12 lakhs
(ii)	5 crores and above but less than 100 crores.	84 lakhs	17 lakhs
(iii)	100 crores and above but less than 250 crores.	120 lakhs	24 lakhs
(iv)	250 crores and above.	120 lakhs plus 0.01% of the effective capital in excess of Rs.250 crores:	24 Lakhs plus 0.01% of the effective capital in excess of Rs.250 crores:]"

Effective capital means aggregate of paid up share capital, reserves and surplus, long term loans and deposits as reduced by aggregate of any investments, accumulated losses and preliminary expenses.

2.2.9 Self Check Exercises

Ques1: How many minimum directors are needed for public companies?

Ques2: How many minimum directors are needed for private companies?

2.2.10 Summary

The management of a company is responsible for day to day affairs of the company. Public company requires minimum three directors, private company requires minimum two directors, one person company require minimum one director, maximum number of directors require fifteen.

2.2.11 Glossary

1. Director: Director means a director appointed to the Board of a company.
2. Board of Directors: Board of Directors, in relation to a company, means the collective body of directors of the company.

2.2.12 Short Questions

Ques1: Explain the meaning of key managerial personnel?

Ques2: What do you understand by the term Directors and Board of Directors?

Ques3: How many minimum directors are needed for one person company?

2.2.13 Long Questions

Ques1: Explain the managerial remuneration payable by a public company having profits to its directors, managing directors, whole time directors and its manager in respect of financial year according to Companies Act, 2013?

Ques2: Explain the maximum limit of managerial remuneration payable by a company not having profits or inadequate profits based on effective capital?

Ques3: Explain the maximum limit of Director's remuneration payable by a company not having profits or inadequate profits based on effective capital?

2.2.14 SUGGESTED READINGS

1. Corporate Accounting

- C. Mohan Juneja
- B.K. Sachdeva
- Inderjit Singh
- RakeshKatyal

2. Company Accounts

- Jain and Narang

LESSON NO. 2.3 AUTHOR : SUKHDEEP SINGH

PROFIT PRIOR TO INCORPORATION

Structure of the Lesson :

2.3.0 Objectives
2.3.1 Introduction
2.3.2 Ascertainment of Profit or Loss prior to Incorporation
2.3.3 Illustration-I
2.3.4 Calculation of Sales Ratio
2.3.5 Illustration-II
2.3.6 Calculation of Weighted Ratio
2.3.7 Illustration-III
2.3.8 Treatment of Loss prior to Incorporation
2.3.9 Illustration IV and V
2.3.10 Self Check Exercises
2.3.11 Summary
2.3.12 Glossary
2.3.13 Short Questions
2.3.14 Long Questions
2.3.15 Recommended Readings

2.3.0 OBJECTIVES

The main objective of this lesson is to introduce the students with the accounting treatment of pre-incorporation profit or loss. For this the lesson describes methods for the (1) Calculation of sale ratio and (2) Calculation of Weighted Ratio.

2.3.1 INTRODUCTION

Sometimes a company purchases a running business from a date prior to its incorporation. Generally the business is purchased from vendor on the last date of the vendor starts. Assets and liabilities are taken over on the basis of the figures given in the Balance sheet. If the company has earned any profit prior to incorporation, such profit cannot be said to have been earned by the company as it is not available for distribution as dividend to the shareholders. Such profit is treated as capital profit and is transferred to capital reserve account. If there is any loss prior to incorporation such loss is in the nature of capital loss and is debited to Goodwill Account. It should be noted carefully that it is the date of incorporation and not date of commencement of business which is taken into consideration for calculating profit or loss prior to incorporation.

2.3.2 ASCERTAINMENT OF PROFIT OR LOSS PRIOR TO INCORPORATION

Profit or loss prior to incorporation can be ascertained only when fresh stock

taking and balancing of accounts is done on this date it will involve a great deal of inconvenience. In order to avoid this inconvenience, and to calculate profit or loss prior to incorporation, the following steps may be taken :

1. Prepare the trading account for the whole period i.e., from the date of purchase of business to the last date of accounts closing in order to calculate the gross profit. Date of incorporation will not affect the calculation of gross profit.
2. Calculate time ratio and sales ratio. Time ratio is calculated by taking into consideration the time falling from the last date of balance sheet to the date of incorporation and the period between the date of incorporation to the last date of presenting final accounts. For example, if the business is purcahsed on 1st January, 2007 and certificate of incorporation is granted on 1st May, 2005 and final accounts are being prepared on 31st December, 2007, then the time ratio is 4 months : 8 months or 1:2. Sales ratio is calculated taking into consideration the sales of pre-incorporation period to that of sales of post-incorporation period. For example if sales of pre-incorporation period are Rs. 1,00,000 and the post-incorporation of Rs. 3,00,000 then the sales ratio is 1:3.
3. Prepare the profit and loss account for the pre-incorporation and post-incorporation periods separately. This is done on the following basis:
   - (i) Gross profit should be apportioned between the two periods on the basis of their respective sales ratio.
   - (ii) Such expenses which are directly related on sales such as commission on sales, discount allowed, debts and advertising etc. should be apportioned on the basis of sales ratio of the two periods.
   - (iii) Fixed expenses such as salaries, rent, audit fees, insurance, depreciation, etc. should be allocated on the basis of time ratio as these expenses are incurred on the basis of time.
   - (iv) Expenses which are incurred after the incorporation of the company such as directors fees, preliminary expenses, interest on debentures etc. should be charged wholly to the period after incorporation. Similarly expenses as salary of partners is debited to the pre-incorporation period.

2.3.3 ILLUSTRATION-I

Subhash Ltd. was incorporated on 1st July, 2007 and received its certificate of commencement of business of 1st August, 2007. The company bought the 'business of M/s Small & Co. with effect from 1st March, 2007. From the following figures relating to the year ending February 2008, find out the profits available for dividends.

- Sales for the year were Rs. 6,00,000 out of which sales upto 1st July were Rs. 2,50,000.
- Gross Profit for the year was Rs. 1,80,000.
- The expenses debited to the Profit and Loss Account were

	Rs.		Rs.
Rent	9,000	Advertising	18,000
Salaries	15,000	Stationery and Printing	3,600
Director's fees	4,800	Commission on sales	6,000
Interest on debentures	5,000	Bad debts (Rs. 500 relate to period prior to incorporation)	1,500
Audit fees	1,500	Interest to vendor on purchase consideration upto 1st Sept., 2001	3,000
Discount on sales	3,600		
Depreciation	24,000		
General expenses	4,800		

Solution :

PROFIT AND LOSS ACCOUNT

For the year ending March 31, 2008

	Basis of alloc-ation	Prior to Incor-poration	After Incor-poration		Basis of alloc-ation	Prior to Incor-poration	After Incor-poration
		Rs.	Rs.			Rs.	Rs.
To Rent	Time (1:2)	3,000	6,000	By Gross Profit	Sales (5:7)	75,000	1,05,000
To Salaries	Time	5,000	10,000				
To Director's Fees	-	-	4,800				
To Interest on Debentures	-	-	5,000				
To Audit fees	Time	500	1,000				
To Discount on sales	Sales	1,500	2,100				
To Depreciation	Time	8,000	16,000				
To General Expenses	Time	1,600	3,200				
To Advertising	Sales	7,500	10,500				
To Stationery & Printing	Time	1,200	2,400				
Commission on Sales	Sales	2,500	3,500				
To Bad Debts	Actual	500	1,000				
To Interest on Vendor (See W.Note-III)	Time (2:1)	2,000	1,000				
Capital Profit		41,700	___				
To Net Profit			38,500				
		75,000	1,05,000			75,000	1,05,000

Working Notes :

- Sales ratio is 2,50,000 : 3,50,000 or 5:7.
- Time ratio (except for interest to vendors) 4 months 8 months or 1:2.
- Time ratio for interest on vendors, 4 months 2 months or 2:1.
- Directors' fees and interest on debentures relate to post incorporation period.

2.3.4 CALCULATION OF SALES RATIO

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

2.3.5 ILLUSTRATION-II

Delhi Company, incorporated on 1st April, 2007, took over running business from 1st January, 2007. The company prepares its first final accounts on 31st December, 2007. From the following information, you are required to calculate the sales ratio of pre-incorporation and post-incorporation periods.

(a) Sales of January, 2007 to December, 2007 Rs. 4,80,000, (1). The sales for the month of January twice of the average sales for the month of February equal to average sales, sales for four months May to August–1/4 of the average of each month; and sales for October and November three times the average sales.

Solution :

Calculation of Average Sales per month = $\frac{\text{Rs. } 4{,}80{,}000}{12}$ = Rs. 40,000

Sales for the months of		Rs.
January	(2 × Rs. 40,000)	80,000
February	(1 × Rs. 40,000)	40,000
May	(¼ × Rs. 40,000)	10,000
June	(¼ × Rs. 40,000)	10,000
July	(¼ × Rs. 40,000)	10,000
August	(¼ × Rs. 40,000)	10,000
October	(3 × Rs. 40,000)	1,20,000
November	(3 × Rs. 40,000)	1,20,000
Total Sales for 8 months		4,00,000

Sales for the remaining 4 months = Rs. 4,80,000 – Rs. 4,00,000
= Rs. 80,000

Average sales for the remaning months = $\frac{80\,000}{}$ = Rs. 20,000

Sales for Pre-incorporation period:

January Rs. 80,000

February Rs. 40,000

March Rs. 20,000

1,40,000

Sales for post-incorporation period = 4,80,000 – 1,40,000

= Rs. 3,40,000

Sales Ratio of Pre-incorporation to Post-incorporation Period = 1,40,000 : 3,40,000, 14:34, 7:17.

2.3.6 CALCULATION OF WEIGHTED TIME RATIO

The total amount of certain expenses such as salary, wages etc. does not remain the same throughout the year. If the expenses remain the same throughout the year these can be easily divided in the time ratio. But if the expenses change as salary due to more number of workers employed because of conversion of partnership business into a limited company then weighted time ratio is to be calculated by taking into consideration time and the number of workers in pre and post-incorporation periods. For example, a company is incorporated on 1st May, 2007. The total amount of wages paid is Rs. 90,000. Number of workers employed on pre-incorporation period 6, post-corporation period 24. The wages for pre-incorporation period will be 90,000 × 1/9 = Rs. 10,000 and post-incorporation wages are 90,000 × 8/9 Rs. 80,000. The ratio is calculated as under :

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

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

2.3.7 ILLUSTRATION-III

III New Ventures Ltd. was incorporated on 1st January, 2007 with an authorised capital of 5000 equity shares of Rs. 10 each to take over the running business of Rundown Brothers as from 1st October, 2006.

The following is the summarised Profit and Loss Account for the year ended 30th September, 2007.

Sales	Rs.	Rs.
1st October, 2006 to 31st December, 2007	6,000	
1st January, 2007 to 30th September, 2007	19,000	
		25,000
Cost of sale for the year	16,000	
Administrative expenses	1,768	
Selling commission	875	
Goodwill written off	200	
Interest paid to vendors (Loan repaid on 1st		

February, 2007)	373	
Distribution expenses (60 per cent variable)	1,250	
Preliminary expenses written off	330	
Debenture interest	320	
Depreciation	444	
Director's fees	100	
		21,660
Net Profit		3,340

The company deals in one type of product. The unit cost of sales was reduced by 10 percent in the post incorporation period as compared to the pre-incorporation period in the year.

You are required to apportion the net profit amount between pre-incorporation and post-incorporation period showing the basis of apportionment.

PROFIT AND LOSS ACCOUNT

For the year ending 30th September, 2007

	Pre Incorpo-ration Profit	Post Inrocp-oration Profit		Pre Incorp-oration Profit	Post Incorp-oration Profit
	Rs.	Rs.		Rs.	Rs.
To cost of Sales (60:171)	4,156	11,844	By Sales (Actual)	6,000	19,000
To Administrative Expenses (Time i.e. 1:3)	442	1,326			
To Selling Commission (Sales 6:19)	210	665			
To Goodwill written off	-	200			
To Interest paid to Vendors (Time i.e. 3:1)	280	93			
To Distribution Expenses :					
Fixed 40%	125	375			
Variable 60%	180	570			
To Preliminary Expenses	-	330			
To Debenture Interest	-	320			
To Depreciation (time 1:3)	111	333			
To Director's fees	-	100			
To Profit	-	2,844			
To Capital Profit	496	-			
	6,000	19,000		6,000	19,000

Working Note :

Cost of sales ratio is calculated as under :

Suppose the sale price is Rs. 1 per unit

Pre-incorporation sales : Post-incorporation sales

$6,000 : 19,000 \times \frac{90}{100} = 6,000 : 17,100$ or $60 : 171$.

2.3.8 TREATMENT OF LOSS PRIOR TO INCORPORATION

Loss prior to incorporation being of capital nature shall be debited to separate account called "Loss Prior to Incorporation Account" and shown under miscellaneous Expenditure on the assets side of the Balance Sheet to the extent not written off.

Loss prior to incorporation can be dealt with in any of the following manner:

1. Write off against the profits of the company.
2. Treated as Goodwill and debited to Goodwill Account.
3. Such loss can be treated as deferred revenue expenditure and written off out of profits of the company over a period of years.

2.3.9 Illustration-IV and V : The partners of Mairti Agencies decided to convert the partnership into private limited company called MA (P) Ltd. with effect from 1st January, 2007. The consideration was agreed at Rs. 1,17,00,000 based on the firm's balance sheet as at 31st December, 2006. However, due to some procedural difficulties, the company could be incorporated only on 1st April, 2007. Meanwhile, the business was continued on behalf of the company and the consideration was settled on that day with interest at 12% per annum. The same books of accounts were continued by the company which closed its accounts for the first time on 31st March, 2008 and prepared following summarised profit and loss account.

	Rs.
Sales	2,34,00,000
Cost of goods sold	1,63,80,000
Salaries	11,70,000
Depreciation	1,80,000
Advertisements	7,02,000
Discounts	11,70,000
Managing Director's remuneration	90,000
Miscellaneous office expenses	1,20,000
Office-cum-show room rent	7,20,000
Interest	9,51,000
	2,14,83,000
Profit	19,17,000

The company's only borrowing was a loan of Rs. 50,00,000 at 12% p.a. to pay the purcahse consideration due to the firm and for working capital requirements.

The company was able to double the average monthly sales of the firm from 1st April, 2007 but the salaries trebled from that date. It had to occupy additional space from 1st July, 2007 for which rent was Rs. 30,000 per month.

Prepare a profit and loss account in columnar from apportioning costs and revenue between pre-incorporation and post-incorporation periods. Also suggest how the pre-incorporation profits are to be dealt with.

Solution :

MA (P) ltd.

Profit and Loss Account

Dr. For 15 months ended 31st March 2008 Cr.

	Pre Incorpo-ration	Post Incorpo-ration		Pre Incorpo ration	Post Incorpo ration
	Rs.	Rs.		Rs.	Rs.
To cost of goods (1:8)	18,20,000	1,45,60,000	By Sales (1:8)	26,00,000	2,08,00,000
To Salaries (1:12)	90,000	10,80,000	By Loss	19,000	
To Depreciation (1:4)	36,000	1,44,000			
To Advertisement (1:8)	78,000	6,24,000			
To Discount (1:8)	1,30,000	10,40,000			
To M.D.'s Remuneration	-	90,000			
To Misc. Office expenses (1:4)	24,000	96,000			
To Rent	90,000	6,30,000			
To Interest	3,51,000	6,00,000			
To Net Profit	-	19,36,000			
	26,19,000	2,08,00,000		26,19,000	2,08,00,000

As the profit prior to incorporation are in the negative so they would either be treated as a reduction from any capital reserve accruing in relation to acquisition transaction or be treated as goodwill.

Working Notes :

1. Calculation of Sales Ratio :

Sales from 1st January to 1st April = 3

Sales from 1st April 2007 to March, 2008 = 2 × 12 = 24

Ratio will be 3:24 or 1:8

Cost of goods sold, advertisement and discounts are apportioned on turnover ratio basis, i.e. 1:8.

2. Time Ratio = 3:12 = 1:4

Depreciation and Misc. Office Expenses are apportioned on time basis.

3. Ratio for Apportionment of Salaries :

From Jan. 1 to 31st March 2007 = 3×1 = 3

From April, 2007 to 31st March 2008 = 12×3 36 or 1:12

4. Apportionment of Rent :

	Rs.	
Total Rent		7,20,000
Less : Additional Rent for nine months @ Rs. 30,000		2,70,000
Rent of old premises for 15 months	4,50,000	
Monthly rent (Rs. 4,50,000 ÷ 15)	30,000	

	Pre-incorporation Rs.	Post-incorporation Rs.
Old Premises @ Rs. 30,000 per month	90,000	3,60,000
Additional premises @ Rs. 30,000 per month for 9 months from 1st July, 2007 to 31st March, 2008	—	—
	90,000	6,30,000

Illustration-V : Ashok Company Limited was incorporated on 1st April 2007 to take over as from 1st January, 2007, in the same year the existing business of Bijoy Brothers. Under the take over agreement all profits made from 1st January, 2007 are to belong to the Company. The purchase consideration was Rs. 70,00,000. The Vendors received half of it in cash on 1st July in the same year together with interest at 10 per cent annum. For other half of the purchase consideration, they were allotted 3,500 fully paid up shares of Rs. 100 each in the Company. The following balances appeared in the Company's Ledger as at 31st December, 2007.

	Rs.		Rs.
Shares capital 4,500 shares Of Rs. 100 each fully paid (including vendors' shares)	4,50,000	Preliminary expenses (These are to be fully written off)	8,000
		Salaries and Wages	48,000
Bank Overdraft	1,65,000	Rent received	13,000
Sundry Creditors	65,000	Rates and Taxes	7,000
Fixed deposits received	35,000	Repairs to Building	3,000
Freehold Land at Cost	50,000	Miscellaneous Expenses	22,000
Building at cost	1,30,000	Director's fees	2,400
Furniture and Fixtures at Cost	15,000	Interest of vendors	17,500
		Purchase	7,70,000
Transport Vehicles at cost	35,000	Sales	9,10,000

Stock-in-trade on 1-1-07	4,20,000	Goodwill	3,100
Book Debts	95,000		
Cash in Hand	12,000		

The stock-in-trade as at 31st December 2007 amounted to Rs. 4,80,000. Bad debts amounting to Rs. 1,000 out of which Rs. 500 related to book debts taken over by the Company, have to be written off and a provision of Rs. 5,000 to be made for doubtful debtors as at 31st December, 2007.

Depreciation has to be written off : Building at 5% Furniture and Fixtures at 10 percent and Transport Vehicles at 20 percent.

You are required to prepare (a) a profit and loss account for the period from 1st January to 31st December 2007 and to compute the profit prior to incorporation. For the purpose of determining the profit prior to incorporation you should assume the turnover to be spread evenly over the year and (b) Balance Sheet as on 31st December 2007.

Solution :

Trading and Profit and Loss Account of Ashok Co. Ltd.
For the year ending 31st December 2007

	Rs.		Rs.
To Stock 1st January	4,20,000	By Sales	9,10,000
To Purchases	7,700,00	By Stock,31st December	4,80,000
To Gross Profit	2,00,000		
	13,90,000		13,90,000

	Prior to Incorp-oration	After Incorp-oration		Prior to Incorp-oration	After Incorp-oration
	Rs.	Rs.	By Gross	Rs.	Rs.
To Salaries and Wages	12,000	36,000	Profit b/d (1:3)	50,000	1,50,000
To Miscellaneous Exp.	5,500	16,500	By Rent Received	3,250	9,750
To Rates and Taxes	1,750	5,250	(1:3)		
To Repair to building	750	2,250			
To Preliminary Expenses	-	8,000			
To Bad Debts	500	500			
To Provision for Doubtful Debts	-	5,000			
To Director's Fees	-	2,400			
To Interest to Vendors	8,750	8,750			
To Depreciation : Rs.					

Building @ 5% 6,500					
Furniture @ 10% 1,500					
Vehicles @ 20% 7,000	3,750	11,250			
15,000					
	20,250	-—			
To capital	—	63,850			
To Net profit	53,250	1,59,750			
				53,250	1,59,750

Balance Sheet of Ashok Company Ltd.
As on 31st December 2007

Liabilities	Rs.	Assets	Rs.
Share Capital :		Fixed Assets :	
Authorised		Goodwill	3,100
Subscribed & issued		Freehold land at cost	50,000
4,500 shares of Rs. 100 each		Building at cost 1,30,000	
Fully paid	4,50,000	Less Depreciation 6,500	1,23,500
(of the above, 4,500 shares		Furniture &	
were allotted as fully paid to		Fixtures 15,000	
vendors in pursuance of		Less : Depreciation 1,500	13,500
contract consideration		Transport Vehicles	
other than cash)		at cost 35,000	
		Less : Depreciation 7,000	28,000
Reserve & Surplus :			
Capital Reserve	20,250	Investments	NIL
Profit & Loss Account	63,850	Current Assets, loans &	
Secured loans	Nil	Advances	
Unsecured Loans :		(A) Current Assets	
Bank Overdraft	1,65,000	Stock	4,80,000
Fixed Deposits	35,000	Sundry Debtors 94,000	
Current Liabilities &		Less : Provision for	
Provision :		D/D 5,000	
(A) Current Liabilities :			89,000
Sundry Creditors	65,000	Cash in hand	12,000
Provisions	Nil	(B) Loans & Advances	Nil
(B) Contingent Liabilities	Nil	Miscellaneous Expenditure	Nil
	7,99,100		7,99,100

2.3.10 SELF CHECK EXERCISE

Ques. 1. Fill in the blanks

(a) Profit prior to incorporation is a .... profit.

(b) Profit earned after incorporation is ....profit.

Ques . 2. State whether the following statements are true or false :

(a) Loss prior to incorporation is a capital loss and debited to Goodwill account.

(b) Gross profit should be apportioned between prior to incorporation period and after incorporation period on the basis of time ratio of the two periods.

(c) Expenses such as preliminary expenses, interest on debentures and directors fees which are incurred after the incorporation of the company should be charged wholly to post incorporation period.

ANSWER TO SELF CHECK EXERCISE

Answer to		
Ques.1.	(a)	Capital
	(b)	Revenue
Answer to	(a)	True
Ques.2.	(b)	False
	(c)	True

2.3.11 Summary

Whenever a company purchases a running business from a date prior to its incorporation. If a company has earned any profit prior to its incorporation, then such profit would be treated as capital profit and it would be transferred to capital reserve account as it is of capital nature and this profit cannot be used for the distribution of dividend to the shareholders as such profit has not been earned by the company. If there is a loss, then it would be transferred to goodwill account.

2.3.12 Glossary

1. Loss prior to incorporation: Loss prior to incorporation being of capital nature debited to a account called loss prior to incorporation account.
2. Incorporation date of business: Incorporation date is that date when a company get itself registered with Registrar of Company. Private company can commence their business after getting incorporation certificate from Registrar of Company.

2.3.13 Short Questions :

Ques1: What do you understand by the term incorporation of Business?

Ques2: Loss prior to incorporation would be transferred to which accout?

Ques3: Profit prior to incorporation would be transferred to which account?

2.3.14 Long Questions :

Ques. RJ & Co. Pvt. Ltd. was incorporated on 1st July, 2007 to take over the business carried on by RJ & Bros. as a going concern with effect from 1st April, 2007. The following is the profit and loss account for the year ended 31st March, 2008 of RJ &

Co. Pvt. Ltd.

	Rs.		Rs.
To opening stock	1,20,000	By Sales (Upto 30th June,	
To Purchase	1,75,000	2007 Rs. 1,00,000	3,00,000
To Gross Profit c/d	75,000	By closing stock	70,000
	3,70,000		3,70,000
To Administration Expenses	18,000	By Gross Profit b/d	75,000
To Directors' fees	3,000		
To Selling expenses	36,000		
To Audit fees	1,000		
To Preliminary expenses	3,000		
To net profit	14,000		
	75,000		75,000

You are required to prepare a statement showing the profit earned, profit prior to and after incorporation and state how the profit earned during the respective periods may be dealt with in accounts.

Ques.2. A company incorporated on 1st November, 2007 acquires a business as from 1st July, 2007. The first accounts are drawn up upto 31st March, 2008. The

gross profit for this period of 9 months was Rs. 56,000, the general expenses Rs. 14,220, the director's fee Rs. 12,000 per annum, formation expenses Rs. 1,500.

Rent to 31st December was Rs. 1,200 per annum, after which it was increased to Rs. 3,000 per annum. Salary of the manager who upon incorporation of the company became a director was Rs. 6,000 per annum (since incorporation included in directors' fees mentioned above.)

Show Profit and Loss Account assuming that the net sales were Rs. 8,20,000 the monthly average of which for the first four months of 2007 being one half of that of remaning period. The Profit was earned uniformly on sales.

Ques 3. X Company was incorporated on 1st August, 2007 to take over a business from 1st April, 2007. The Trading and Profit and Loss Account for the year ending 31st March, 2008 showed the following results :

	Rs.		Rs.
To Opening Stock	28,000	By Sales	2,80,000
To Purchases	1,82,000	By Closing Stock	14,000
To Gross Profit C/d	84,000		
	2,94,000		2,94,000
To Rent, Rates and Insurance	3,600	By Gross Profit b/d	84,000
To Director's Fees	4,000		
To Salaries	12,000		
To Office Expenses	9,000		
To Traveling Commission	2,800		
To Discount	3,500		
To Bad Debts	700		
To Auditor's Fees	500		
To Depreciation	1,200		
To Debenture Interst	900		
To Interest on Purchase Consideration to 30th November	3,200		
To Net Profit	42,600		
	84,000		84,000

It is ascertained that the sales for April, June and December are one and half times the average of those for theyear, while those for March 2008 are twice the average andthose for May only half the average.

Apportion the year's profit between pre-incorporation period and post-incorporation period.

Ques 4. Rajasthan Udyog Limited, incorporated on August, 2006, received the certificate to commence business on August 31, 2006. It had acquired a running business from M/s Gupta & Co. witheffect from April 1, 2006. Thepurchaseconsiderationwas Rs. 5,00,000 of which Rs. 1,00,000 was to be paid in cash and Rs. 4,00,000 in the form of fully paid shares. The company also issued shares for Rs. 4,00,000 for cash. Machinery costing Rs. 2,50,000 was then installed. Assets acquired from the vendors were Machinery Rs. 3,00,000, Stock Rs. 60,000. Patents Rs.

40,000.

During the year 2007-08, the total sales were Rs. 18,00,000 the sales per month in the first half-year were one-half of what they were in the later half year. The net profit of the company after charging the following expenses was Rs. 1,00,000 Depreciation Rs. 54,000. Audit fees Rs. 7,500, Directors' fees Rs. 25,000, Preliminary expenses Rs. 6,000. Office expenses
Rs. 39,000. Selling expenses Rs. 36,000, Interest to vendors upto August 31, 2007, Rs. 2,5000.

Ascertain the pre-incorporation and post-incorporation amount of profit, and prepare the Balance Sheet of the company as on 31st March, 2008. Closing stock was valued at Rs. 70,000.

Ques 5. What do you mean by Profit prior to incorporation ? How is this profit treated in the books of accounts ?

Answer to Ques.1. Profit Prior to incorporation Rs, 8,250

Answer to Ques.2. Profit prior to incorporation Rs. 7,280
Profit after incorporation Rs. 24,650

Answer to Ques.3. Pre-incorporation Profit Rs. 14,383
Post-Incorporation Profit Rs. 28,217

Answer to Ques.4. Profit prior to incorporation Rs. 16,500
Post-incorporation profit Rs. 83,500
Balance Sheet total Rs. 9,00,000

2.3.15 RECOMMENDED READINGS

1. Corporate Accounting
By : S.R. Jain & K.L. Narang
2. Corporate Accounting
By : Mohan Juneja
B.K. Sachdeva
Inderjeet Singh
Rakesh Katyal
3. Advanced Accounting (Corporate Accounting)
By : Ashok Sehgal
Deepak Sehgal

LESSON NO. 2.4 AUTHOR : DR. SHALINDER SAINI

CONSOLIDATED FINANCIAL STATEMENTS

Structure of the Lesson

2.4.1 Objectives
2.4.2 Introduction
2.4.3 Definitions
2.4.4 Status of Consolidated Financial Statements in India
2.4.4.1 Rights of Holding company's Representatives and members
2.4.5 Preparation of conslidated balance sheet of holding company with one subsidiary
2.4.5.1 Minority Interests
2.4.5.2 Equity of the subsidiary on the date of Acquisition of Shares
2.4.5.3 Goodwill and Capital Reserve
2.4.5.4 Calculation of Reserves and Surplus on the Date of Acquisition and since the date of Acquisition
2.4.5.5 Elimination of Post-Acquisition Reserves and Surplus
2.4.5.6 Elimination of Intra group Balances
2.4.5.7 Contingent Liability
2.4.5.8 Elimination of Unrealised Profits.
2.4.5.9 Revaluation of assets of subsidiary
2.4.5.10 Unclaimed dividend and dividend received
2.4.6 Illustration-I and II
2.4.7 Consolidated Profit and Loss Account
2.4.8 Self Check Questions
2.4.9 Answer to self check questions
2.4.10 Summary
2.4.11 Glossary
2.4.12 Short Question
2.4.13 Long Question
2.4.14 Suggested Readings

2.4.1 OBJECTIVES

The main objective of this lesson is to introduce the students with the latest and relevant provisions of the Companies Act, 2013 and the Accounting Standard-21 on "Consolidated Financial Statements", issued by the Council of the Institute of Chartered Accountants of India.

2.4.2 INTRODUCTION

Users of the financial statements of a parent entrprise are usually concerned with and need to be informed about, the financial position and results of operations of

not only the enterprise itself but also of the group as a whole. For this purpose, consolidated financial statements are prepared and presented by a parent/holding enterprise to provide financial information about a parent and its subsidiary(ies) as a single economic entity without regard to the boundaries of the separate legal entities.

2.4.3 DEFINITIONS

1. Parent (or Holding) and its Subsidiary

Section 2(46) of the Companies Act, 2013 defines, "a company shall be deemed to be the holding company of the another, if that other is its subsidiary."

Accounting Standard-21, states that "a subsidiary is an enterprise that is controlled by another enterprise (known as the parent) and a parent is an enterprise that has one or more subsidiaries." It further define "Control" for this purpose as :

(a) The ownership, directly or indirectly through subsidiary(ies), of more than one half of the voting power of an enterprise; or

(b) Control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities.

2. Rationale for holding companies

1. It allows better quality decisions to be taken at all levels. In case of Public enteprises, the government can concentrate on macro policy the holding company on corporate policies and strategies and the operating levels on implementation within the framework of established strategies.
2. It leads to a better utilisation of financial and other reserves by pooling the reserves of group of enterprises like finance, R&D, marketing and human resources.
3. The management of holding company could promote commercial and managerial culture rather than bureaucratic systems.

2.4.4 STATUS OF CONSOLIDATED FINANCIAL STATEMENTS IN INDIA

Section 129(3) of the Companies Act, 2013 requires that if a company has one or more subsidiaries then it shall in addition to financial statement of its own also be required to prepare the consolidated fincial statement of the company and all its subsidaries.

Besides, a statement showing the holding company's interest in the subsidiary company on the date of balance sheet of the subsidiary and another statement showing change in interest, if any of the holding company in the subsidiary company from the date of recent balance sheet of the subsidiary to the date of balance sheet of the parent company, is to be attached to the published accounts of the parent company.

As per accounting standard-21 conslidated financial statements normally include consolidated balance sheet, conslidated statement of profit and loss, consolidated cash flow statement and notes, other statements and explanatory

material that form an integral part thereof.

2.4.4.1 Rights of Holding Company's Representatives and members

Sub Section 3 of section 128 of the companies Act, 2013 states that

1. A holding company may, by resolution, authorise representatives named in the resolution to inspect the books of accounts kept by any of its subsidiareis, and the books of accounts of any such subsidiary shall be open to inspection by those representatives at any time during business hours.
2. The rights conferred by section 235 upon members of a company may be exercised, in respect of any subsidiary by members of the holding company as if they alone were members of the subsidiary.

2.4.5 PREPARATION OF CONSOLIDATED BALANCE SHEET OF HOLDING COMPANY WITH ONE SUBSIDIARY

Net Assets (Assets less liabilities) of a company belong to its shareholders. As more than 50% of the equity shares of the subsidiary company are held by holding company, the proportionate amount of assets and liabilities of subsidiary company belong to the parent company and these are to be incorporated by the parent company to present the consolidated picture.

In case of Partly owned subsidiary in which holding company holds less than 100% shares of B Ltd., the balance of shares is held by outside shareholders. And if number of shares is less than 50% then they are termed as minority shareholders. In this case, equity assets less liabilities of subsidiary company belong to holding and minority in the ratio of equity shares held by these parties.

2.4.5.1 Minority Interests

According to AS-21, minority interest consists of :

1. the amount of equity attributable to minorities at the date on which investment in a subsidiary is made; and
2. the minorities share of movements in equity since the date the parent subsidiary relationship came into existence.

2.4.5.2 Equity of the Subsidiary on the date of Acquisition of Shares

Beside share capital, reserves and surplus of the subsidiary on the date of acquisition of shares become part of the equity of the subsidiary on the date of acquisition of shares which is shared by the parent and the minority shareholders in the ratio of equity holding.

2.4.5.3 Goodwill and Capital Reserve

The share of holding company in profit and loss account on the date of acquisition is a capital profit/receipt, and not a revenue profit/receipt. Thus, the cost to the parent of its investment in subsidiary and the parent's portion of equity of subsidiary at the date on which investment is made should be eliminated. But, if cost of investment and parent's share of equity of subsidiary are different, the

difference is treated as under :

1. Excess of the cost to the parent of its investment over the parent's portion of equity of the subsidiary at the date of investment should be described as goodwill.
2. When the cost to the parent of its investment in a subsidiary is less than the parent's portion of equity of the subsidiary, at the date of investment is made, the difference should be treated as a capital reserve.

Movement of Reserve and Surplus sicne the date of Acquisition of Shares

As per AS-21, minority interest consists of share in equity on the date of acquisiton and share in movement in equity since the date of acquisition, share of minority should be separately calculated for pre-acquisition and post-acquistion period. But from accounting point of view, distinction between reserves and surplus on the date of acquisition and accumulation during post-acquisition period is not significant as both become part of the minority interest. And, from holding company's point view, it is of significance because share in reserves on the date of acquisition affects calculation of goodwill/capital reserve and share in movement since the date of acquisition affects consolidated reserve and surplus balance.

2.4.5.4 Calculation of Reserves and Surplus on the Date of Acquisition and since the Date of Acquisition

If controlling shares are acquired at accounting date, the information about reserves and surplus on the date of acquisition (pre-acquisition) can be ascertained from the balance sheet on the date of acquisition and any change thereafter is taken as movement since the date of acquisition (post-acquisition).

The Journal entry may be recorded as follows :

Share Capital A/c	Dr. (with paid up capital of subsidiary)
Reserves and Surplus A/c	Dr. (with reserves and surplus of subsidiary)
Goodwill A/c	Dr. (excess of cost, of cost of shares held in subsidiary by the parent over the interest of holding in equity of subsidiary on the date of acquisition of shares)
To Minority interest A/c	(Interest of outsiders in equity)
To Investment in Shares A/c	(Cost of shares held by parent)
To Profit & Loss A/c	(Share of parent in post-acquisition profit of subsidiary)
To Capital Reserve A/c	(excess if any, of interest of holding in equity of subsidiary on the date of acquisition over cost of shares held by parent enterprises).

To conclude, at the time of consolidation, share capital of subsidiary, reserves and surplus of subsidiary any cost of investment in shares of subsidiary are analysed

to determine minority interest, goodwill/capital reserve and parent's share of movement of profit since the date of acquisition. Minority interest is shown as a separate item on liabilities side, goodwill apears on asset side and share of holding in post-acquisition reserves and surplus is added to the respective reserves and surplus of the parent company.

2.4.5.5 Estimation of Post-Acquisition Reserves and Surplus

When shares are acquired during the year, information about reserves and surplus in the beginning and reserves and surplus at the end of the year is to be analysed, to find out reserves and surplus on the date of acquisition by comparing balance in the beginning with the balance at the end of the year, profit/loss for the year is calculated. If no information is given, profit for the year are evenly distributed throughout the year on the basis of time. However, if information is given about sales pattern in pre and post acquisition period then profit should be apportioned on sales basis.

2.4.5.6 Elimination of Intra-group Balances

AS-21 requires that intra-group balances and intra-group transactions should be eliminated which may take the following forms :

1. Loans and Advances
2. Debentures and Investment in Debentures] Investment Transactions
3. Interest Outstanding and Accrued Interest] Trading Transactions
4. Debtors and Creditors
5. Bills Payable and Bills Receivable

In case of interest outstanding, it is subtracted from interest outstanding on the liabilities side and accrued interest on the assets side. In case of bills of exchange issued within the group, the amount of common debt is restricted to the amount of bills drawn and retained.

2.4.5.7 Contingent Liability

At the time of consolidation, contingent liabilities with parties outside the group are recorded. But contingent liability within the group will appear as actual liability in the consolidated balance sheet.

The treatment of contingent liabilities for bills discounted is as follows :

Accepted by Outsiders : Recorded as contingent liabilities in consolidated balance sheet.

Accepted within the Group : Will appear as actual liability and not as contingent liability.

The journal entry for elimination of intra company balances is as follows :

Debit : Creditors / Bills Payable / Loan / Debentures / Interest Outstanding

Credit : Debtors / Bills Receivable / Advances / Investment in Debentures / Accrued Interest

2.4.5.8 Elimination of Unrealised Profit

AS-21, states that unrealised profit resulting from intra-group transactions should be eliminted in full. The amount of unrealised profit should be subtracted out of closing stock of the subsidiary and profit and loss account balance of holding company, if goods were supplied by parent to its subsidiary.

If goods were sold by subsidiary to its holding company, the amount of unrealised profit should be subtracted out of closing stock of holding company and holding company share in profits of subsidiary company.

The rule is to subtract the full amount of unrealised profit from aggregate stock on the assets side and consolidated profit and loss account on the liabilities side of the consolidated balance sheet.

Miscellaneous Expenditure of Subsidiary Enterprise

If miscellaneous expenditure such as preliminary expenses, discount, commission/brokerage on issue of securities etc. appear in the balance sheet of the subsidiary on the date of consolidation, these should be eliminated while calculating the equity of the subsidiary on the date of acquisition.

2.4.5.9 Revaluation of Assets of Subsidiary

Revaluation of assets results in profit/loss on revaluation and affects not assets (or equity of subsidiary) on the date of acquisition of controlling shares. It also requires adjustment for additional/excess depreciation during the post-acquisition which affects post-acquisition profits of the subsidiary.

2.4.5.10 Unclaimed Dividend and Dividend Received

Unclaimed dividend appearing in the balance sheet of the subsidiary is taken as payable to minority shareholders only and added to minority interest.

Dividend Received by parent from the Subsidiary Company

1. When dividend is received

Bank A/c Dr.

To Dividend Received A/c

If dividend has been declared by the subsidiary out of profits on the date of acquisition it is treated as capital receipt and credited to investment in shares of subsidiary company as under :

Dividend Received A/c Dr.

To Investment in Shares of Subsidiary Company A/c

Thus, receipt of dividend declared out of pre-acquisition profits reduces the cost of investment in shares of subsidiary. But, if dividend is declared out of post-acquisition profit, it is treated as income from investment and credited to profit and loss account as under :

Dividend Received A/c Dr.

To Profit & Loss A/c

2.4.6 ILLUSTRATION - I AND II

Illustration-I : The Balance Sheets of A Ltd. and B. Ltd. as on 31-03-2007 were as follows :

Balance Sheet as on 31-03-2007

Liabilities	A Ltd.	B Ltd.	Assets	A Ltd.	B Ltd.
Share Capital (Rs. 20)	4,00,000	1,00,000	Land and Building	2,00,000	50,000
Profit and Loss A/c	1,00,000	-	Plant and Machinery	2,00,000	80,000
General Reserve	80,000	-	Investment in		
Securities Premium	40,000	-	5000 Shares	1,00,000	-
Secured Loan	1,00,000	80,000	Stock of S. Ltd.	1,00,000	70,000
Unsecured Loan	-	70,000	Debtors	1,20,000	70,000
Creditors	50,000	50,000	Cash and Bank	50,000	30,000
	7,70,000	3,00,000		7,70,000	3,00,000

Prepare the consoldiated Balance sheet as on 31-03-2007.

consolidated Balance Sheet of A Ltd. and its Subsidiary B Ltd. as on 31-03-2007

Liabilities	Amount	Assets		Amount
Share Capital :		Fixed Assets :		
Shares of Rs. 20 each	4,00,000	Land Building	A= 2,00,000	
Reserve and Surplus :			B= 50,000	2,50,000
Profit & Loss Ac/	1,00,000	Plant &		
General Reserve	80,000	Machinery	A= 2,00,000	
Securities Premium	40,000		B= 80,000	2,80,000
Secured Loans : A= 1,00,000		Current Assets :		
B= 80,000	1,80,000	Stock	A= 1,00,000	
Unsecured Loans: A= Nil			B= 70,000	1,70,000
B= 70,000	70,000	Debtors	A= 1,20,000	
Current Liabilities :			B= 70,000	1,90,000
Creditors : A= 50,000		Cash	A= 50,000	
B= 50,000	1,00,000		B= 30,000	80,000
	9,70,000			9,70,000

In the given balance sheet, in place of investment in shares of B. Ltd., assets and liabilities of B. Ltd. are taken as 100% shares of B Ltd. are held by A Ltd. It is known as wholly owned subsidiary.

Illustration-II : The following are the abridged balance sheets of H Ltd. and S Ltd. as on 31st March, 2007 :

Liabilities	H Ltd.	S Ltd.	Assets	H Ltd.	S Ltd.
Equity Shares of Rs. 100 each, fully paid up	10,00,000	5,00,000	Fixed Assets	4,80,000	2,50,000
Capital Reserve	1,00,000	1,70,000	Investment in Shares of S Ltd.	5,00,000	-
Profit & Loss A/c	1,60,000	1,30,000	Current Assets	7,20,000	7,50,000
Current Liabilities	4,40,000	2,00,000			
	17,00,000	10,00,000		17,00,000	10,00,000

The following additional inforamation is provided :

1. H Ltd. acquired 3000 shares in S Ltd. on 1st July, 2006. The reserves and surplus position of S Ltd. as on 1st April, 2006 was as under :

   General Reserve Rs. 2,50,000

   P&L A/c (Credit) Rs. 1,20,000

2. On 1st October, 2006 S Ltd. issued, one equity share for every four shares held as Bonus Shares out of the general reserve. No entry has been made in the books of H Ltd., for the receipt of these Bonus Shares. However, entry has been made in the books of S Ltd. for the issue of Bonus shares.

3. On 30th September, 2006, S Ltd. declared a dividend out of pre-acquired profits @ 25% on Rs. 4,00,000, its capital on that date. H Ltd. credited the dividend to its profit and loss account.

4. S Ltd. owned H Ltd. Rs. 50,000 for purchase of stock from H Ltd. The entire stock is held by S Ltd. on 31st March, 2007. H Ltd. made a profit of 25% on cost.

Prepare a consolidated Balance Sheet of H Ltd. and its subsidiary S Ltd. as on 31st March, 2007.

Solution :

Working Notes :

1. Share Capital as on March 31, 2007 = 5,00,000
   (after bonus issue)
   Ratio of Bonus Issue = One Share for Four Shares 5,
   Original Share Capital = 00,000 × 4/5 = Rs. 4,00,000
   Bonus Share Capital = 5,00,000 1/5 = Rs/ 1,00,000

Consolidated Balance Sheet of H Ltd. and its subsidiary S Ltd. as on 31st March, 2007

Liabilities		Amount	Assets		Amount
Share Capital :			Fixed Assets :		
10,000 Equity Shares of Rs.100			H Ltd.	4,80,000	
each, fully paid-up		10,00,000	S Ltd.	2,50,000	7,30,000
Reserves and Surplus			Current Assets :		
Capital Reserve		1,01,875	H Ltd.	7,20,000	
General Reserve		1,00,000	S Ltd.	7,50,000	
Profit & Loss A/c		1,48,125		14,70,000	
Minority Interest		2,00,000	Less : Mutual		
			Owing	50,000	
Current Liabilities :				14,20,000	
H Ltd.	4,40,000		Less : Unrealised		
S Ltd.	2,00,000		Profit	10,000	14,10,000
	6,40,000				
Less Mutual Owing	50,000	5,90,000			
		21,40,000			21,40,000

2. Calcualtion of Post-acquisition Reserves & Surplus :

General Reserve on 01-04-2006	2,50,000
Less : Bonus Issue	1,00,000
	1,50,000
Transfer to General Reserve (B/F)	20,000
General Reserves on 01-04-2006	1,70,000
Profit and Loss A/c on 01-04-2006	1,20,000
Less : Dividend	1,00,000
	20,000
Profit after transfer to general reserve (Balance/Figure)	1,10,000
Profit and Loss A/c on 31-03-2007	1,30,000

Profit before transfer to general Reserve = 1,10,000 + 20,000 = 1,30,000

Profit prior to acquisition = 1,30,000 × 3/12 = 32,500

Profit after acquisition of shares = 1,30,000 – 32,500 = 97,500

H Ltd.'s share of revenue profits = 97,500 × 75/100 = 73,125

Minority Shareholder's Share = 97,500 – 73,125 = Rs. 24,375

3. Calculation of Capital Profit :

General Reserve after issue of Bonus Shares =	1,50,000	
(Rs. 2,50,000 – Rs. 1,00,000)		
Profit & Loss A/c (Opening Balance less Dividend =	20,000	
(Rs. 1,20,000 – Rs. 1,00,000)	32,500	
Profit from 1st April, 2006 to the date of acquisition	2,02,500	
H Ltd.'s Share : Rs, 2,02,500 × 75/100	=Rs. 1,51,875	
Minority Shareholder's Share : Rs, 2,02,500 × 25/100 = Rs. 50,625		

4. Calculation of Capital Reserve/Goodwill on Acquisition :

Paid up value of 3,750 (3,000 + 750) Shares	= 3,75,000	
H Ltd.'s Share in Capital Profit	= 1,51,875	
		5,26,875
Parent Share in Equity of Subsidiary		
Payments for Investments	5,00,000	
Less : Dividend out of pre-acquisition profits	75,000	4,25,000
Capital Reserve		1,01,875

5. Calculation of Minority Interest :

Paid-up value of 1,250 (1,000 + 250) Shares	1,25,000
Share in post acquisition reserves & profits	24,375
Share in profits on the date of acquisition	50,625
	2,00,000

6. Unrealised Profits = Rs. 50,000 × 25/125 = Rs. 10,000

As per AS-21, on consolidated financial statement total unrealised profit is to be considered for consideration.

7. H Ltd.'s Profit and Loss Account

Balance as given		1,60,000	
Less : Dividend wrongly credited	75,000		
Unrealised Profit	10,000	85,000	75,000 73,125
		1,48,125	

Add : Share in S Ltd.'s post acquisition profits

2.4.7 CONSOLIDATED PROFIT AND LOSS ACCOUNT

Preparation of consolidated profit and loss account requires simple aggregation of the items appearing in the profit and loss accounts of the holding company and its subsidiaries subject to the following adjustments :

1. Inter-Company Sales are eliminated from purchases and sales appearing in the consolidated profit and loss account. If at the time of consolidation, some goods remain unsold, profit unrealised from the group point of view is eliminated with this entry :

Profit and Loss Account Dr.

To Stock A/c

However, the share of minority shareholders in the profits of the subsidiary company is not affected by this.

2. Revaluation of Assets of the Subsidiary Company : Additional or excess on revaluation is adjusted as follows :

Profit & Loss A/c Dr. (reverse in case of excess

To Asset A/c depreciation)

Share of minority shareholders in the profits of the subsidiary is calculated after adjustment of additional or excess depreciation due to increase or decrease in the value of assets.

3. Minority Interest : Share of minority shareholders in the profits/loss of the subsidiary company is transferred from consolidated profit and loss account to minority interest account.

4. Holding Company's Share in pre-acquisition profit/loss is transferred from consolidated profit and loss account to goodwill/capital reserve, as the case may be.

5. Income from inter-company investment such as interest, dividend received as well as receivable is eliminated from both the sides of the consolidated profit and loss account. If the holding company, has not passed entries for share in the proposed dividend of the subsidiary company, proposed dividend will be reduced by the share of the holding company in such porposed dividend.

6. Arrears of Preference Dividend on shares held by minority shareholders appear as contingent liability in the consolidated balance sheet.

2.4.8 SELF CHECK QUESTIONS

Q.1 Define parent enterprise and subsidiary enterprise.

Q.2. Define 'Minority Interest'. Discuss its constituents as per AS-21.

Q.2 The balance sheet of H Ltd. and its subsidiary S Ltd. on 31-12-2007 were as follows :

Liabilities	H Ltd.	S Ltd.	Assets	H Ltd.	S Ltd.
Equity Shares of Rs. 20 each	5,00,000	1,00,000	4,000 Shares in S Ltd. on 31-01-2007	1,20,000	-
Profit and Loss A/c	1,00,000	-	Sundry Assets	9,30,000	2,62,000
General Reserve	50,000	-	Profit & Loss A/c of S Ltd. 38,000 Less General 10,000 Reserve	-	28,000
Liabilities	4,00,000	1,90,000			
	10,50,000	2,90,000		10,50,000	2,90,000

Profit and Loss Account of S Ltd. on 01-01-2007 was Rs. 10,000 (credit).
Prepare consolidated balance sheet as on 31-12-2007.

2.4.9 ANSWER TO SELF CHECK QUESTIONS

Answer to Question No. 1 :

Parent Enterprise : A parent is an entrprise that has control over other enterprise(s).

Subsidiary Enterprise : A subsidiary is an enterprise that is controlled by another enterprise (i.e. a parent co.).

Answer to Question No. 2 :

Minority Interest : Minority Interest consists of the amount of equity attributable to minorities and the minorities share of movements in equity.

Answer to Question No. 3 :

Goodwill = Rs. 27,200

Minority Interest = Rs. 14,400

Balance Sheet = Rs. 64,00,000

2.4.10 Summary

When a company acquires the control on other company, then the company which gets the control on other company is called parent or holding company and the company which is acquired is called subsidiary company. So, a parent company is not only interested in knowing the financial position of its own but also interested in knowing the consolidated financial position. So, for this purpose consolidated financial statements are prepared. Profit and loss earned earned by subsidiary company before the acquisition is treated as capital nature by the holding company and profit and loss earned by subsidiary company after its acquisition is treated as revenue nature by the holding company.

2.4.11 Glossary

1. Parent Company: As per section 2(46) of the Companies Act, 2013, a company shall be deemed to be the holding company of the another, if that other is its subsidiary.
2. Subsidiary Company: As per Accounting Standard -21, " a subsidiary is an enterprise that is controlled by another enterprise (known as parent).

2.4.12 Short Questions

Ques1: Who are minority shareholders?

Ques2: What is pre acquisition profits and post acquisition profits?

2.4.13 Long Questions

1. Define minority interest discuss its contituents under AS-21.
2. The Balance sheet of X Ltd. and its subsidiary Y Ltd. on 31-12-2007 were as follows :

Liabilities	X Ltd.	Y Ltd.	Assets	X Ltd.	Y Ltd.
Equity Shares of Rs. 20 each	6,00,000	2,00,000	4,000 Shares in Y Ltd. on 31-01-2007	1,20,000	-
Profit and Loss A/c	2,00,000	-	Sundry Assets	10,30,000	3,22,000
General Reserve	50,000	-	Profit & Loss A/c		
Liabilities	3,00,000	1,50,000	of Y Ltd. 38,00	-	28,000
			Less Gen. 10,000		

			Reserve		
	11,50,000	3,50,000		11,50,000	3,50,000

Profit and Loss Account of Y Ltd. on 01-01-2007 was Rs. 10,000 (credit).
Prepare consolidated balance sheet as on 31-12-2007.

3. H Ltd. acquired all the shares in K Ltd. on 01-01-2007 and the balance sheets of the two companies on 31-03-2007 were as follows :

Liabilities	H Ltd. Rs.	K Ltd. Rs.	Assets	H Ltd. Rs.	K Ltd. Rs.
Share Capital	50,000	30,000	Sundry Assets	65,000	70,000
Reserve on 01-04-2006	20,000	15,000	Shares in K Ltd.		
Profit & Loss A/c	25,000	10,000	at cost	50,000	–
Sundry Creditors	20,000	15,000			
	1,15,000	70,000		1,15,000	70,000

The Profit and Loss account of K Ltd. had a credit balance of Rs. 3,000 on 1st April 2006. Prepare a consolidate Balance Sheet on 31st March, 2007.

2.4.14 SUGGESTED READINGS

1. Advanced Accounting (Corporate Accounting)
By : Ashok Sehgal
: Deepak Sehgal
Published by : Taxmann Allied Services Pvt. Ltd.

2. Corporate Accounting
By : C. Mohan Juneja B. K. Sachdeva Inderjeet Singh Rakesh Katyal
Published by : Kalyani Publishers

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