FINANCIAL REPORTING

M.Com. – ACCOUNTANCY/ BANKING
SEMESTER- III, PAPER-IV

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M.Com (Accountancy/ Banking) – Financial Reporting

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FOREWORD

Since its establishment in 1976, Acharya Nagarjuna University has been forging ahead in the path of progress and dynamism, offering a variety of courses and research contributions. I am extremely happy that by gaining 'A' grade from the NAAC in the year 2016, Acharya Nagarjuna University is offering educational opportunities at the UG, PG levels apart from research degrees to students from over 443 affiliated colleges spread over the two districts of Guntur and Prakasam.

The University has also started the Centre for Distance Education in 2003-04 with the aim of taking higher education to the door step of all the sectors of the society. The centre will be a great help to those who cannot join in colleges, those who cannot afford the exorbitant fees as regular students, and even to housewives desirous of pursuing higher studies. Acharya Nagarjuna Universityhas started offering B.A., and B.Com courses at the Degree level and M.A., M.Com., M.Sc., M.B.A., and L.L.M., courses at the PG level from the academic year 2003-2004 onwards.

To facilitate easier understanding by students studying through the distance mode, these self-instruction materials have been prepared by eminent and experienced teachers. The lessons have been drafted with great care and expertise in the stipulated time by these teachers. Constructive ideas and scholarly suggestions are welcome from students and teachers involved respectively. Such ideas will be incorporated for the greater efficacy of this distance mode of education. For clarification of doubts and feedback, weekly classes and contact classes will be arranged at the UG and PG levels respectively.

It is my aim that students getting higher education through the Centre for Distance Education should improve their qualification, have better employment opportunities and in turn be part of country's progress. It is my fond desire that in the years to come, the Centre for Distance Education will go from strength to strength in the form of new courses and by catering to larger number of people. My congratulations to all the Directors, Academic Coordinators, Editors and Lesson-writers of the Centre who have helped in these endeavours.

Prof. P. Raja Sekhar
Vice-Chancellor
Acharya Nagarjuna University

M.Com. (Accountancy/Banking)
Semester –III
304CO21- FINANCIAL REPORTING
Syllabus

Learning Outcomes:

After successful completion of this course, the students will be able to:

1. *Acquire knowledge of Overview of Corporate Financial Reporting*
2. *Know the concepts relating to Corporate Restructuring*
3. *Understand the Consolidated financial statements of Group Companies*
4. *Analyses of the Measurement of Financial instruments.*

Syllabus:

Unit –I: Corporate Financial Reporting – Issues and problems with special reference to Published financial Statements.

Unit- II: Accounting for Corporate Restructuring (including inter- company holdings)

Unit –III: Consolidated financial statements of Group Companies – Concepts of Group , Purposes of Consolidated financial statements, minority interest, goodwill, consolidation procedures - minority interest, goodwill, Treatment of pre-acquisition and post-acquisition profit.

Unit IV: Consolidation with two or more subsidiaries, Consolidation with foreign subsidiaries, consolidated profit and loss account, balance sheet, and cash flow statement.

Unit-V: Accounting and Reporting of Financial Instruments – Meaning, recognition, De-recognition and offset, compound financial instruments – Measurement of Financial instruments.

FURTHER READINGS:

1. RSN Pillai, Bagarathi & S. Uma, Fundamentals of Advanced Accounting, Vol.1, S. Chand, New Delhi.
2. Nehru J. Financial Reporting by diversified companies vision Books, New Delhi.
3. Hawkins David, Financial Statements Corporations Dow Jones – Irwin Homewood 1973.

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LESSON – 1
AN OVER VIEW OF CORPORATE FINANCIAL REPORTING

AIMS AND OBJECTIVES

After studying this lesson students should be able to

- To know the Objectives of Corporate Financial Reporting
- To understand Need for Corporate Financial Reporting
- To acquire knowledge on Steps involved in financial reporting.
- To obtain knowledge on Role of Corporate Financial Reporting in Promoting Transparency
- To learn Financial reporting and Accountability

STRUCTURE

1.1 Introduction
1.2 Definition
1.3 Growth of Corporate Financial Reporting an over view
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1.5 Need for Corporate Financial Reporting
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1.1 INTRODUCTION

Corporate financial reporting refers to the process of preparing and presenting financial information about a company's activities, performance, and financial position to various stakeholders. It involves the collection, analysis, interpretation, and communication of financial data in a structured and standardized manner.

The primary purpose of corporate financial reporting is to provide relevant and reliable information to stakeholders, enabling them to make informed decisions. Stakeholders include shareholders, investors, lenders, employees, customers, suppliers, regulators, and the general public. Financial reporting serves as a means of transparency and accountability, ensuring that stakeholders have access to accurate and timely information about a company's financial health and operations.

Corporate financial reporting encompasses several key elements, including the preparation of financial statements such as the balance sheet, income statement, cash flow statement, and statement of changes in equity. These statements provide a snapshot of a company's financial position, profitability, cash flows, and changes in equity over a specific period.

Financial reporting is guided by various regulatory frameworks and accounting standards, such as the International Financial Reporting Standards (IFRS) and the Generally Accepted Accounting Principles (GAAP). These standards provide guidelines and principles for recording, measuring, and disclosing financial information, promoting consistency, comparability, and transparency across different companies and industries.

The process of corporate financial reporting involves gathering financial data from various sources within the company, analysing and interpreting the data, and preparing the financial statements. It requires adherence to accounting principles, including concepts such as accrual accounting, going concern, materiality, and conservatism. The financial statements are then audited by external auditors to provide independent assurance on their accuracy and compliance with accounting standards.

The information presented in corporate financial reports goes beyond the financial statements. It may include footnotes, disclosures, and management discussions and analysis (MD&A), providing additional context and explanations to enhance understanding. In recent years, there has been a growing emphasis on non-financial reporting, including environmental, social, and governance (ESG) disclosures, which provide insights into a company's sustainability practices and impact.

Corporate financial reporting is a vital process that enables companies to communicate their financial performance and position to stakeholders. It promotes transparency, accountability, and informed decision-making, fostering trust and confidence in the business community. By adhering to established standards and providing accurate and relevant information, financial reporting supports effective corporate governance, capital allocation, and stakeholder engagement.

1.2 DEFINITION

Accounting Edition University defined as

“The corporate financial reporting is the system of making corporate financial reports. These corporate financial reports are income statement, balance sheet, cash flow statement, statement of retained earnings and financial policies explanation. Corporate financial reporting may be shown at the end of month or at the end of each quarter or at the end of year”.

Definition by Visier : “Corporate reporting means reporting financial and non-financial data to stakeholders. These reports can take many forms, depending on their goal, including audit reporting, financial reporting, corporate governance and responsibility reporting, and more”.

Bizfluent defined as:

“Corporate financial reporting is an essential activity for all businesses. This form of accounting should provide investors and creditors with useful information that they can employ in making lending or investment decisions. Since stockholders and lending institutions rely on income or repayment from your business to accurately run their own companies and estimate their cash flow, it’s essential that your company be able to present accurate, timely information that speaks to the overall health of your company. Failure to provide accurate information can not only lead to problems of reputation; it can cause legal difficulties”.

Meaning

Corporate financial reporting is the system of making corporate financial reports.
These corporate financial reports are income statement, balance sheet, cash flow statement, Statement of retained earning and financial policies explanation.
Corporate financial reporting is the system that builds the economic reports of a company. A corporate financial report not only shows the financial statements of a company but also aims to highlight the necessary financial data and furthermore shows the application of financial policies
Defined by Studocu:

“Corporate financial reporting is the system of making corporate financial reports. These corporate financial reports are income statement, balance sheet, cash flow statement, Statement of retained earnings and financial policies explanation and corporate financial reporting is the system that builds the economic reports of a company. It is a corporate financial report not only shows the financial statements of a company but also aims to highlight the necessary financial data and furthermore shows the application of financial policies”

Here are some quotations from familiar authors related to corporate financial reporting:

"Trust is the glue of life. It's the most essential ingredient in effective communication. It's the foundational principle that holds all relationships." - Stephen R. Covey
"Financial reporting is the window through which management communicates its financial performance and position to the outside world." - Charles W. Mulford
"The goal of financial reporting is not to disclose everything about a business, but to provide useful information that enables decision-making." - Paul Golding
These quotes offer insights into the importance of financial reporting, trust, leadership, transparency, and the role of accounting in business.

1.3 GROWTH OF CORPORATE FINANCIAL REPORTING AN OVER VIEW

The importance of corporate financial reporting has grown significantly over the years due to several key factors. Let's explore some of the reasons behind the increased significance of corporate financial reporting:

1.3.1 Globalization and Increased Complexity: As businesses expand globally and engage in complex transactions, the need for accurate and transparent financial reporting has become paramount. Companies with international operations must comply with various accounting standards and regulations, ensuring consistency in financial reporting across different jurisdictions. Transparent financial reporting facilitates cross-border investment, promotes investor confidence, and facilitates business transactions in an interconnected global economy.

1.3.2 Stakeholder Information Needs: Stakeholders, including shareholders, investors, lenders, employees, and regulatory bodies, require timely and reliable financial information to make informed decisions. Financial reports provide stakeholders with a snapshot of a company's financial performance, position, and cash flows, enabling them to assess the organization's value, risk profile, and ability to generate returns. Accessible and transparent financial reporting enhances stakeholder trust, promotes accountability, and supports efficient capital allocation.

1.3.3 Investor Protection and Regulatory Requirements: Financial reporting plays a critical role in investor protection. Regulators and standard-setting bodies, such as the Securities and Exchange Commission (SEC) and the International Accounting Standards Board (IASB), establish rules and standards to ensure transparency and reliability in financial reporting. Compliance with these regulations protects investors from fraudulent activities, misrepresentation, and manipulation of financial information. Robust financial reporting practices help maintain market integrity and foster investor confidence.

1.3.4 Corporate Governance and Accountability: Corporate financial reporting is closely tied to corporate governance practices. Transparent financial reporting enhances accountability by providing stakeholders with the necessary information to monitor and evaluate management's performance. Financial reports enable shareholders to exercise their rights, engage in shareholder activism, and influence decision-making. Effective financial reporting strengthens the checks and balances within organizations, promotes responsible business practices, and reduces the risk of corporate misconduct.

1.3.5 Impact on Capital Markets and Financing Opportunities: Accurate and transparent financial reporting has a direct impact on a company's access to capital markets and financing opportunities. Investors and lenders rely on financial statements to assess the creditworthiness and investment potential of companies. Strong financial reporting practices improve a company's credit rating, lower borrowing costs, and attract capital from investors. Access to capital markets enables companies to fund growth initiatives, invest in research and development, and enhance their competitive position.

1.3.6 Technological Advancements: Advancements in technology have revolutionized the financial reporting landscape. Automation, data analytics, and cloud-based reporting systems have improved the efficiency and accuracy of financial reporting processes. Real-time reporting capabilities and interactive data formats, such as XBRL (eXtensible Business Reporting Language), have made financial information more accessible and easier to analyse. Technological advancements have also facilitated the integration of non-financial information, such as environmental and social metrics, into corporate reporting, addressing the growing demand for sustainability reporting.

In conclusion, the importance of corporate financial reporting has grown significantly due to globalization, stakeholder information needs, regulatory requirements, corporate governance, capital market dynamics, and technological advancements. Transparent and accurate financial reporting is vital for maintaining trust, ensuring investor protection, supporting effective decision-making, and fostering sustainable business practices. As businesses continue to evolve and face new challenges, the role of financial reporting in providing reliable and timely information will remain crucial for the growth and stability of organizations.

1.4 THE GROWTH REPORT OF CORPORATE FINANCIAL REPORTING IN INDIA

Corporate financial reporting in India has undergone significant growth and evolution over the years. As the Indian economy expands and integrates into the global market, the importance of transparent and reliable financial reporting practices has become paramount. This essay explores the growth of corporate financial reporting in India, highlighting key factors contributing to its development, regulatory reforms, and the positive impact on transparency, accountability, and investor confidence.

1.4.1 Regulatory Reforms and Standards: The growth of corporate financial reporting in India can be attributed to the introduction of robust regulatory frameworks and adoption of global accounting standards. The Securities and Exchange Board of India (SEBI), Ministry of Corporate Affairs (MCA), and the Institute of Chartered Accountants of India (ICAI) play key roles in setting and enforcing reporting requirements. The implementation of Indian Accounting Standards (Ind AS), aligned with International Financial Reporting Standards (IFRS), has enhanced the comparability and quality of financial information.

1.4.2 Enhanced Disclosure Requirements: India has witnessed a significant improvement in disclosure requirements, ensuring greater transparency in financial reporting. Listed companies are now required to provide comprehensive information on financial performance, risk factors, related party transactions, corporate governance practices, and sustainability initiatives. These disclosures facilitate informed decision-making for investors, promote accountability, and deter fraudulent practices.

1.4.3 Emphasis on Corporate Governance: Corporate financial reporting is closely intertwined with corporate governance practices. The introduction of corporate governance codes, such as the SEBI's listing obligations and disclosure requirements (LODR) regulations and the Companies Act, 2013, has strengthened the governance framework. Companies are now mandated to have independent directors on boards, establish audit committees, and conduct regular internal and external audits. These measures promote transparency, accountability, and ethical practices in financial reporting.

1.4.4 Investor Protection and Stock Market Development: The growth of corporate financial reporting has played a crucial role in protecting investor interests and fostering stock market development in India. Accurate and reliable financial reporting enhances investor confidence, attracts both domestic and foreign investments, and ensures fair valuation of listed companies. The increased participation of institutional investors, such as mutual funds and foreign portfolio investors, further reinforces the need for transparent financial reporting practices.

1.4.5 Technological Advancements: Technological advancements have revolutionized corporate financial reporting in India. The adoption of digital platforms, cloud computing, and data analytics has streamlined the reporting process, improved accuracy, and reduced reporting timelines. The introduction of the extensible Business Reporting Language (XBRL) has enhanced the electronic exchange of financial information, making it more accessible, standardized, and efficient.

1.4.6 Focus on Sustainability Reporting: India has witnessed a growing emphasis on sustainability reporting, incorporating environmental, social, and governance (ESG) factors into financial reporting. This holistic approach to reporting considers the long-term impact of businesses on the environment and society. The Securities and Exchange Board of India

(SEBI) has mandated the top 1,000 listed companies to disclose their business responsibility reports, encouraging sustainable practices and responsible investing.

The growth of corporate financial reporting in India has been instrumental in enhancing transparency, accountability, and investor confidence. Regulatory reforms, adoption of global accounting standards, enhanced disclosure requirements, emphasis on corporate governance, and technological advancements have contributed to the development of a robust reporting framework. Going forward, continuous efforts to improve reporting quality, strengthen enforcement mechanisms, and align with evolving global standards will be crucial. The growth of corporate financial reporting will play a pivotal role in supporting India's economic growth, attracting investments, and maintaining its position as a dynamic and transparent market for businesses and investors alike.

1.5 NEED FOR CORPORATE FINANCIAL REPORTING

1.5.1 Stakeholder Decision Making: Corporate financial reporting addresses the information needs of various stakeholders, including shareholders, investors, lenders, employees, customers, suppliers, regulators, and the general public. Stakeholders rely on financial reports to make informed decisions about investing, lending, purchasing, and engaging with a company. Financial information helps stakeholders assess the financial health and stability of a company, evaluate its profitability and growth potential, and determine its ability to meet obligations.

1.5.2 Transparency and Accountability: Financial reporting promotes transparency and accountability in business operations. By disclosing financial information, companies provide an open view of their financial activities, ensuring that stakeholders have access to reliable and comprehensive data. Transparent reporting fosters trust and confidence among stakeholders, as it demonstrates a commitment to ethical and responsible business practices. It holds management accountable for its stewardship of company resources and enhances corporate governance.

1.5.3 Investor Protection: Financial reporting serves as a crucial mechanism for investor protection. Accurate and reliable financial information reduces information asymmetry between management and investors, minimizing the risk of fraudulent activities or misleading representations. Timely and transparent reporting helps investors assess the potential risks and rewards associated with investing in a company. It also promotes fair and efficient capital markets by ensuring the availability of accurate information to all market participants.

1.5.4 Compliance with Legal and Regulatory Requirements: Companies are subject to various legal and regulatory requirements regarding financial reporting. Governments and regulatory bodies mandate the preparation and disclosure of financial statements to ensure compliance with accounting standards and laws. Financial reporting enables companies to meet these obligations and provides regulators with the necessary information to monitor and regulate business activities effectively.

1.6 OBJECTIVES OF CORPORATE FINANCIAL REPORTING

1.6.1 Provide Useful Information: The primary objective of financial reporting is to provide useful information to stakeholders. Financial statements, including the balance sheet, income statement, cash flow statement, and statement of changes in equity, are prepared to present relevant financial data. The information should be accurate, reliable, and timely, enabling stakeholders to evaluate a company's financial performance, liquidity, solvency, and future prospects.

1.6.2 Enhance Decision Making: Financial reporting aims to facilitate informed decision making. Stakeholders rely on financial information to assess investment opportunities, make lending decisions, evaluate a company's creditworthiness, and assess its ability to generate returns. By providing clear and comprehensive financial data, financial reporting assists stakeholders in making well-informed decisions about resource allocation.

1.6.3 Facilitate Comparability and Consistency: Financial reporting promotes comparability and consistency in financial statements. Companies follow established accounting standards, such as the International Financial Reporting Standards (IFRS) or Generally Accepted Accounting Principles (GAAP), to ensure uniformity in the preparation and presentation of financial statements. Comparable financial information allows stakeholders to assess the performance of different companies within the same industry or across various time periods.

1.6.4 Support Accountability and Stewardship: Financial reporting contributes to accountability and stewardship. It enables companies to communicate their financial performance and position to stakeholders, demonstrating their responsible management of resources. Financial reports highlight how a company has utilized its assets, generated profits, and distributed dividends, thereby providing stakeholders with insights into management's stewardship.

1.6.5 Foster Trust and Confidence: Financial reporting aims to foster trust and confidence among stakeholders. Accurate and transparent financial information builds credibility, enabling stakeholders to rely on reported data for decision making. Reliable financial reporting practices contribute to a positive corporate image, strengthening relationships with investors, customers, suppliers, and other stakeholders.

1.7 BENEFITS OF CORPORATE FINANCIAL REPORTING

1.7.1. Increased transparency: Corporate transparency is a win for everyone, especially employees, customers, and stakeholders. It increases trust and accountability and helps everyone improve and make better decisions.Employees are asking for transparency right from the recruitment process. Once they start working for a company, people want that transparency to continue. Pay transparency is one key priority, but more and more people also want to understand the impact the company they work for is making on social, economic, and environmental causes.

1.7.2. Compliance with regulations: Corporate reporting is fundamental to the business, and essential in maintaining strong relationships with shareholders and stakeholders. There are myriad rules and regulations businesses must comply with, and they can vary by region, business size, and more.In the European Union, the Corporate Sustainability Responsibility Directive (CSRD) became law on November 28, 2022 and covers a wide range of reporting, including a comprehensive set of standard measures that include the key areas of Environment, Social and Governance (ESG).

1.7.3. Improved decision-making processes: Corporate reporting isn't only about presenting data. It's also about analysing it and using it to improve your decision-making processes.

Through these reports, you can see what’s working and what isn’t, and find those areas where changes must be made.

1.7.4. Improved risk management: Any business comes with risks. The key is knowing what these risks are and how to respond to them. Corporate reporting is an excellent tool for identifying risks and opportunities.

1.8 THE ROLE OF CORPORATE FINANCIAL REPORTING IN PROMOTING TRANSPARENCY AND ACCOUNTABILITY IN CORPORATES

Corporate financial reporting plays a pivotal role in promoting transparency and accountability within organizations. It serves as a mechanism through which companies communicate their financial performance, position, and stewardship to various stakeholders. This essay explores the crucial role of corporate financial reporting in enhancing transparency and accountability, emphasizing its impact on corporate governance, investor confidence, regulatory compliance, and stakeholder relationships.

1.8.1 Enhancing Transparency: Corporate financial reporting acts as a window into a company's financial activities, ensuring transparency and openness. By providing accurate and comprehensive financial information, companies enable stakeholders to assess the true financial health and performance of the organization. Transparent reporting reveals the company's sources of revenue, expenses, assets, liabilities, and cash flows, enabling stakeholders to gain insights into its operations and financial sustainability. This transparency is essential in building trust and credibility among shareholders, investors, and other stakeholders, as they can make informed decisions based on reliable information.

1.8.2 Facilitating Accountability: Financial reporting serves as a tool for holding companies accountable for their actions and financial management. By providing a clear picture of the company's financial performance, it enables stakeholders to evaluate management's effectiveness in utilizing resources, generating profits, and managing risks. Financial reports also facilitate accountability by disclosing information about executive compensation, related-party transactions, and adherence to accounting standards and regulatory requirements. When stakeholders can assess a company's financial performance and stewardship, management becomes more accountable for their decisions and actions, fostering responsible corporate governance.

1.8.3 Promoting Investor Confidence: Corporate financial reporting plays a vital role in maintaining and enhancing investor confidence. Investors require accurate and reliable financial information to assess the value and potential returns of their investments. By providing timely and transparent financial reports, companies instill confidence in investors by demonstrating their commitment to disclosure and accountability. Investor confidence is crucial for attracting capital, enabling companies to fund their operations, expand their business, and pursue investment opportunities. Reliable financial reporting practices contribute to market efficiency and investor protection, thereby attracting a broader investor base and facilitating capital formation.

1.8.4 Ensuring Regulatory Compliance: Corporate financial reporting is essential for ensuring compliance with legal and regulatory requirements. Companies are obligated to prepare financial statements according to established accounting standards, such as the International Financial Reporting Standards (IFRS) or Generally Accepted Accounting Principles (GAAP). Compliance with these standards promotes consistency, comparability, and accuracy of financial information across different companies and industries. Financial reporting also assists regulators in monitoring and overseeing business activities, identifying potential financial irregularities, and maintaining market integrity.

1.8.5 Building Stakeholder Relationships: Effective corporate financial reporting strengthens relationships with stakeholders, fostering transparent and open communication. Stakeholders, including employees, customers, suppliers, and the general public, rely on financial information to assess a company's financial stability, ethical practices, and social responsibility. Clear and comprehensive financial reporting builds trust and credibility, ensuring stakeholders feel informed and engaged. This leads to stronger relationships, increased stakeholder confidence, and a positive reputation for the company, contributing to long-term sustainability and success.

1.9 CORPORATE FINANCIAL REPORTING AND ITS IMPACT ON CORPORATE GOVERNANCE

Corporate financial reporting and corporate governance are closely intertwined concepts that play vital roles in maintaining transparency, accountability, and effective decision-making within organizations. This essay explores the relationship between corporate financial reporting and corporate governance, highlighting how financial reporting contributes to sound corporate governance practices, fosters trust among stakeholders, and enhances overall organizational performance.

1.9.1 Transparency and Accountability: Corporate financial reporting serves as a cornerstone of transparency and accountability in corporate governance. By providing accurate and timely financial information, companies enable stakeholders to assess the organization's financial performance, position, and cash flows. Transparent financial reporting helps prevent information asymmetry between management and shareholders, enhancing the accountability of corporate leaders. Stakeholders can hold management accountable for their financial decisions and actions, promoting responsible corporate governance practices.

1.9.2 Informed Decision-Making: Corporate financial reporting ensures that stakeholders have access to reliable and relevant financial information, enabling them to make informed decisions. Shareholders and investors rely on financial reports to evaluate the financial health and potential risks of investing in a company. By providing comprehensive financial information, financial reporting assists stakeholders in assessing the company's profitability, liquidity, and long-term prospects. Informed decision-making leads to more effective governance practices and helps protect the interests of shareholders.

1.9.3 Investor Confidence and Trust: Sound corporate governance is crucial for maintaining investor confidence and trust. Corporate financial reporting plays a pivotal role in instilling confidence in investors by providing transparent and reliable financial information. When companies adhere to high standards of financial reporting, they demonstrate their commitment to openness and accountability. This transparency fosters trust among stakeholders, attracting investments, and facilitating capital market efficiency. Robust financial reporting practices contribute to a positive reputation, enhancing the company's ability to attract and retain investors.

1.9.4 Compliance with Legal and Regulatory Requirements: Corporate financial reporting ensures compliance with legal and regulatory requirements. Companies are obligated to prepare financial statements in accordance with accounting standards such as the International Financial Reporting Standards (IFRS) or Generally Accepted Accounting

Principles (GAAP). Compliance with these standards promotes consistency, comparability, and transparency in financial reporting. By adhering to these guidelines, companies demonstrate their commitment to regulatory compliance and ethical practices, reinforcing effective corporate governance.

1.9.5 Stakeholder Communication and Engagement: Effective corporate governance requires open and transparent communication with stakeholders. Corporate financial reporting serves as a crucial tool for communication and engagement. Financial reports provide stakeholders, including employees, customers, suppliers, and regulators, with insights into the financial performance and sustainability of the organization. By effectively communicating financial information, companies foster stakeholder engagement and build trust. Transparent financial reporting practices enhance stakeholder relationships, promoting a collaborative and responsible approach to corporate governance.

Corporate financial reporting plays an integral role in corporate governance by fostering transparency, accountability, and informed decision-making. It serves as a foundation for building trust among stakeholders, maintaining investor confidence, and ensuring regulatory compliance. Financial reporting contributes to effective corporate governance practices by providing reliable financial information, facilitating informed decision-making, and promoting stakeholder engagement. Companies that prioritize robust financial reporting practices are more likely to establish a culture of transparency, integrity, and accountability, resulting in long-term sustainable performance and stakeholder value.

1.10 STEPS INVOLVED IN FINANCIAL REPORTING

The characteristic of comparability implies that users of financial statements must be able to compare aspects of an entity at one time and over time, and between entities at one time and over time. Therefore, the measurement and display of transactions and events should be carried out in a consistent manner throughout an entity, or fully explained if they are measured or displayed differently. The corporate financial reporting process involves several key steps to ensure the accurate and timely preparation and presentation of financial information. The following are the typical steps involved in the corporate financial reporting process:

1.10.1 Data Collection: The process begins with the collection of financial data from various sources within the organization. This includes gathering information on revenue, expenses, assets, liabilities, and cash flows from accounting records, financial systems, and other relevant sources.

1.10.2 Recording and Classifying Transactions: The collected financial data is then recorded and classified according to the applicable accounting principles and standards. This step involves applying double-entry bookkeeping to ensure that every transaction is recorded with equal debits and credits, maintaining the balance and accuracy of financial records.

1.10.3 Preparation of Financial Statements: Once the transactions are recorded and classified, the next step is to prepare the financial statements. The key financial statements include the balance sheet, income statement, cash flow statement, and statement of changes in equity. These statements present a snapshot of the company's financial position, performance, cash flows, and changes in equity over a specific period.

1.10.4 Adjustment and Reconciliation: After preparing the financial statements, adjustments and reconciliations are made to ensure the accuracy and completeness of the reported financial information. This includes reviewing and correcting any errors, reconciling balances, and making necessary adjustments for accruals, provisions, depreciation, and other accounting entries.

1.10.5 Footnotes and Disclosures: Financial statements are accompanied by footnotes and disclosures that provide additional information and explanations related to the reported financial data. Footnotes disclose significant accounting policies, contingencies, related-party transactions, and other relevant details that further enhance the transparency and clarity of the financial statements.

1.10.6 Management Discussion and Analysis (MD&A): In many cases, companies include a management discussion and analysis section in their financial reports. This section provides management's analysis and interpretation of the financial results, highlights key trends, and discusses the company's performance, risks, and future prospects. MD&A offers additional insights to stakeholders, helping them understand the financial statements in a broader context.

1.10.7 External Audit and Assurance: Companies often engage external auditors to perform an independent audit of the financial statements. The auditors examine the financial records, transactions, and supporting documentation to provide an independent opinion on the fairness, accuracy, and compliance of the financial statements with accounting standards and regulations. The audit provides stakeholders with assurance regarding the reliability and credibility of the financial information.

1.10.8 Distribution and Reporting: Once the financial statements are finalized and audited, they are distributed to various stakeholders, such as shareholders, investors, lenders, regulatory authorities, and other interested parties. This step involves publishing the financial statements in annual reports, filing them with regulatory bodies, and making them available on the company's website or other platforms.

1.10.9 Continuous Monitoring and Disclosure: Financial reporting is an ongoing process, and companies are required to provide regular updates on their financial performance and position. This involves periodic reporting, such as quarterly or interim financial statements, as well as continuous disclosure of material events, transactions, and changes that may impact the financial statements. Regular monitoring and disclosure ensure stakeholders have access to up-to-date and relevant financial information.

By following these steps, companies can ensure the accuracy, transparency, and compliance of their financial reporting, providing stakeholders with reliable information to make informed decisions and fostering trust in the organization's financial management.

1.11 WHAT ARE THE PRE REQUIREMENTS FOR STARTING OF FINANCIAL REPORTING IN A COMPANY?

To get started with corporate financial reporting in a company, several prerequisites and steps need to be taken. Here's a general outline of the key aspects involved:

1.11.1 Understand Applicable Accounting Standards and Regulations: Before commencing the financial reporting process, it is crucial to familiarize yourself with the accounting standards and regulations applicable to your company. These may include International Financial Reporting Standards (IFRS) or Generally Accepted Accounting Principles (GAAP) in your jurisdiction. Understanding the specific requirements and guidelines will help ensure compliance and consistency in your financial reporting.

1.11.2 Establish a Financial Reporting Framework: Develop a financial reporting framework that outlines the structure and processes for financial reporting within your organization. This framework should include the roles and responsibilities of key individuals involved in the reporting process, the timeline for reporting activities, and the procedures for data collection, recording, and analysis.

1.11.3 Set Up an Accounting System: Implement a robust and reliable accounting system to capture and record financial transactions accurately. This may involve selecting appropriate accounting software, setting up chart of accounts, defining accounting policies and procedures, and establishing internal controls to safeguard financial information and prevent fraud.

1.11.4 Hire or Train Competent Accounting Personnel: Ensure you have skilled accounting personnel who understand the principles of financial reporting and possess the necessary expertise to handle the reporting requirements. If needed, hire qualified accountants or provide training to existing staff to ensure they have the knowledge and skills to perform their roles effectively.

1.11.5 Establish Reporting Timelines: Develop a reporting schedule that outlines the specific deadlines for each financial reporting period, whether it's monthly, quarterly, or annually. This timeline should consider the time required for data collection, analysis, preparation, and review, allowing for sufficient time for the completion of each reporting cycle.

1.11.6 Implement Internal Controls: Implement internal control measures to ensure the accuracy and integrity of financial information. This involves segregating duties, implementing approval processes for transactions, conducting regular reconciliations, and establishing mechanisms for error detection and prevention. Internal controls help mitigate risks, enhance data reliability, and safeguard against fraudulent activities.

1.11.7 Prepare Financial Statements: Once the accounting system and internal controls are in place, prepare the required financial statements, including the balance sheet, income statement, cash flow statement, and statement of changes in equity. Follow the prescribed format and guidelines provided by the accounting standards to ensure consistency and comparability.

1.11.8 Perform Financial Analysis and Interpretation: After preparing the financial statements, analyse and interpret the data to gain insights into the company's financial performance, trends, and areas of concern. This analysis helps identify strengths, weaknesses, and potential areas for improvement. Consider using financial ratios, key performance indicators, and other analytical tools to assess the financial health and performance of the organization.

1.11.9 Conduct External Audit or Review: Consider engaging external auditors or independent accountants to perform an audit or review of your financial statements. This provides an additional level of assurance to stakeholders and demonstrates your commitment to transparency and accuracy. The external auditors will assess the financial statements for compliance, reliability, and adherence to accounting standards.

1.11.10 Communicate and Publish Financial Reports: Once the financial statements are finalized and reviewed, communicate and publish them to relevant stakeholders. This may involve creating annual reports, filing reports with regulatory authorities, and making financial information accessible to shareholders, investors, and other interested parties through various channels, such as company websites or investor portals.

By following these steps and ensuring compliance with accounting standards and regulations, your company can establish a strong foundation for corporate financial reporting, providing stakeholders with reliable and transparent financial information for decision-making and fostering trust in the organization's financial management.

1.12 FINANCIAL REPORTING AND ACCOUNTABILITY

Financial reporting plays a crucial role in promoting accountability within organizations by providing stakeholders with transparent and reliable information about a company's financial performance and position. It serves as a vital tool for teaching and reinforcing the principles of accountability and responsible business practices. This essay explores the relationship between financial reporting and accountability, emphasizing how financial reporting fosters transparency, supports ethical decision-making, and enhances overall corporate governance.
The Importance of Financial Reporting in Accountability:

1.12.1 Transparency and Disclosure: Financial reporting promotes transparency by providing stakeholders with a comprehensive view of a company's financial affairs. It ensures that relevant financial information is disclosed to shareholders, investors, lenders, employees, and other stakeholders, enabling them to assess the organization's financial health and make informed decisions. Transparent reporting practices help prevent fraudulent activities, uncover irregularities, and hold management accountable for their actions.

1.12.2 Stakeholder Trust and Confidence: Effective financial reporting builds trust and confidence among stakeholders. When companies provide accurate and reliable financial information, they demonstrate their commitment to openness, integrity, and accountability. Stakeholders, such as investors and lenders, rely on financial reports to evaluate the organization's performance, risk profile, and future prospects. Transparent financial reporting practices create a foundation of trust, attracting investments and fostering long-term relationships with stakeholders.

1.12.3 Ethical Decision-Making: Financial reporting encourages ethical decision-making by ensuring that financial information is presented in a fair and unbiased manner. It provides a framework for evaluating the financial implications of business decisions, allowing management to assess the impact on profitability, liquidity, and long-term sustainability. By considering the financial consequences of their actions, companies can make informed choices that align with ethical principles and promote responsible business practices.

1.12.4 Regulatory Compliance: Financial reporting plays a vital role in ensuring regulatory compliance. Companies are required to adhere to accounting standards, such as IFRS or GAAP, and follow specific reporting guidelines set by regulatory bodies. Compliance with these standards promotes consistency, comparability, and transparency in financial reporting. Adhering to regulatory requirements reinforces accountability and helps maintain the integrity of financial information.

1.12.5 Corporate Governance: Financial reporting is an essential component of corporate governance, which encompasses the systems and processes through which companies are directed and controlled. Transparent financial reporting practices support effective corporate governance by providing the necessary information for stakeholders to hold management accountable. Financial reports enable shareholders to exercise their voting rights, voice concerns, and influence decision-making, fostering a system of checks and balances within organizations.

1.12.6 Performance Evaluation and Improvement: Financial reporting facilitates performance evaluation and improvement. By analyzing financial statements, companies can assess their financial performance against predetermined objectives and benchmarks. This evaluation enables management to identify areas of strength and weakness, make informed decisions, and implement strategies to enhance performance. Regular reporting and analysis of financial information promote a culture of accountability and continuous improvement within organizations.

Financial reporting plays a vital role in promoting accountability and responsible business practices. It fosters transparency, builds stakeholder trust, and supports ethical decision-making. By adhering to regulatory requirements, maintaining accurate and reliable financial records, and promoting transparency in reporting, companies can reinforce accountability throughout their operations. Teaching the importance of financial reporting and accountability not only enhances financial literacy but also cultivates a culture of transparency, integrity, and responsible corporate governance. Through financial reporting, organizations can strive for sustainable growth, meet stakeholder expectations, and contribute to the long-term success of the business community as a whole.

1.13. SUMMARY

After studying this lesson students should be able to know the Objectives of Corporate Financial Reporting, To understand Need for Corporate Financial Reporting, To acquire knowledge on Steps involved in financial reporting. To obtain knowledge on Role of Corporate Financial Reporting in Promoting Transparency, To learn Financial reporting and Accountability . Further it is also revealed on Growth of Corporate Financial Reporting an over view, The Growth report of Corporate Financial Reporting in India: Benefits of Corporate financial reporting: Corporate Financial Reporting and its Impact on Corporate Governance. What are the pre requirements for starting of financial reporting in a Company? Financial reporting and Accountability

1.14. TECHNICAL TERMS

Financial Reporting: Financial reporting is the process of producing financial statements that disclose an organization's financial status to stakeholders, including management, investors, creditors and regulatory agencies.

Transparency: Transparency is the quality of being easily seen through, while transparency in a business or governance context refers to being open and honest.

Accountability: Accountability is an assurance that an individual or organization is evaluated on its performance or behavior related to something for which it is responsible. The term is related to responsibility but is regarded more from the perspective of oversight.

1.15. SELF ASSESSMENT QUESTIONS

1. What are the Objectives of Corporate Financial Reporting?
2. Need for Corporate Financial Reporting-explain.

3. What are Steps involved in financial reporting?
4. What is the Role of Corporate Financial Reporting in Promoting Transparency?
5. What is the Definition of Corporate Financial Reporting?
6. Analyze the Growth report of Corporate Financial Reporting in India:
7. What are the Benefits of Corporate financial reporting:
8. Discuss about Corporate Financial Reporting and its Impact on Corporate Governance
9. What are the pre requirements for starting of financial reporting in a Company?

1.16. SUGGESTED READINGS

1. RSN Pillai, Bagarathi & S. Uma, Fundamentals of Advanced Accounting, Vol.1, S. Chand, New Delhi.
2. Nehru J. Financial Reporting by diversified companies vision Books, New Delhi.
3. Hawkins David, Financial Statements Corporations Dow Jones – Irwin Homewood 1973.

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LESSON-2
FINANCIAL REPORTING AND ANALYSIS OF FINANCIAL STATEMENTS

AIMS AND OBJECTIVES

After studying this lesson students should be able to

- To know the Meaning of Financial Statements & Component of Financial Statements
- To understand the key elements of corporate financial reporting typically include
- To acquired knowledge on Financial reporting and Balance Sheet
- To obtain knowledge on Financial Reporting and the Importance of Cash Flow Statements.
- To learn Four types of corporate financial reporting
- To knowledge on Financial reporting and Changes in equities

STRUCTURE

2.1 Introduction
2.2 Meaning of Financial Statements
2.3 Component of Financial Statements
2.4 Sources of financial statements
2.5 Aim of financial reporting
2.6 The key elements of corporate financial reporting typically include
2.7 Four types of corporate financial reporting
2.8 Financial Reporting and Income Statement
2.9 Real-World Examples – Income statements
2.10 Financial reporting and Balance Sheet
2.11 Balance Sheet observations with Indian context
2.12 Financial Reporting and the Significance of Cash Flows
2.13 Financial Reporting and the Importance of Cash Flow Statements
2.14 Importance of Cash Flow Statements
2.15 Financial reporting and Changes in equities
2.16 Importance of Changes in Equities in Financial Reporting
2.17 Summary
2.18 Technical Terms
2.19 Self Assessment Questions
2.20 Suggested Readings

2.1 INTRODUCTION

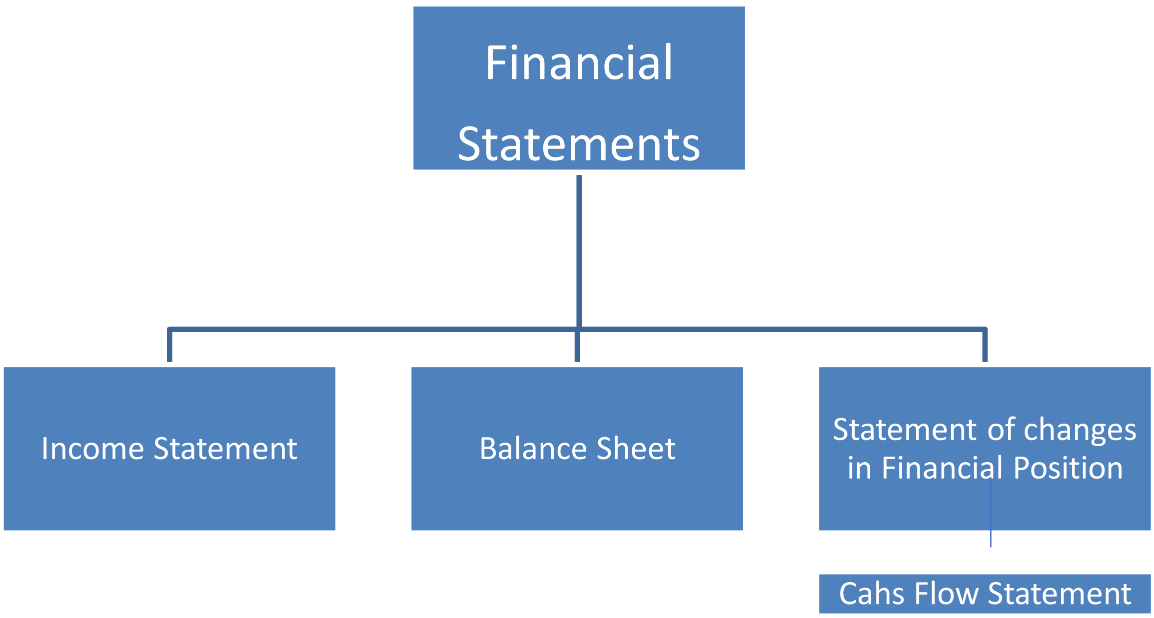
Financial statements are compilation of financial data, collected and classified in a systematic manner according to the accounting principles, to assess the financial position of an enterprise as regards to its profitability, operational efficiency, long and short – term solvency and growth potential. Financial statements are basic and formal means through which management of an enterprise make public communication of financial information along with select quantitative details. They are structured financial representation of the financial position, performance and cash flows of an enterprise. Many users are relying on the general-purpose financial statements as the major source of financial information and therefore, financial statements should be prepared and presented in accordance with their requirement. Of course, some of the users may have the power to obtain, information in addition to that contained in the financial statements. That does not undermine the dependence of the general users on the information contents of the financial statements.

2.2 MEANING OF FINANCIAL STATEMENTS

Financial statements provide information about the financial position, performance and cash flows of an enterprise that is useful to wide range of users in making economic decisions. It means to show the results of the stewardship of management, or accountability of management, or the accountability of management for the resources entrusted to it.

2.3 COMPONENT OF FINANCIAL STATEMENTS

Financial statements comprise a number of statements prepared at the end of each financial year to assess the various financial activities and strength of an enterprise.



2.4 SOURCES OF FINANCIAL STATEMENTS

Financial Statements Components	Source /Type of Companies
Profit and Loss Account Schedule and Notes Forming Part thereto	Under section 129 of the companies Act in accordance with the provisions of the Companies Act and the Indian GAAP, to be prepared by all the companies. As per section 133 all applicable accounting standards should be followed. Otherwise, reasons of departure from accounting standards and financial effect should be disclosed. Compliance with accounting standards without any deviation is mandatory for the listed companies as per clause 50 of the Listing Agreement vide SEBI Circulars SMRP/Policy/Cir-44/01, Aug 31, 2001
Cash Flow Statement	As per clause 32 of the Listing Agreement vide SEBI circular SMD-II/ Policy/cir-80/2000 February 4, 2000. Cash Flow Statement should be prepared in accordance with the requirements of AS- 3 issued by the ICAI. To be prepared by listed companies.
Consolidated Financial Statements	Applicable to listed companies as per the SEBI circular SMRP/ policy/cir-44/01, August 31, 2001 Companies Listed in a recognized stock exchange shall be mandatorily required to publish Consolidated Financial Statements in the annual report in addition to the individual financial Statements shall be mandatory. To be prepared in accordance with AS-21 and AS-23. Section 134 requires that board’s Report shall include a Director’s Responsibility Statement in which it is to be indicated that in the preparation of annual accounts, the applicable accounting standards are followed.

2.5 AIM OF FINANCIAL REPORTING

The conceptual Framework for Financial Reporting issued by the IASB has stated the following uses of the general purpose financial statements by the cross-section of users:

a. to decide when to buy, hold or sell any equity investment,
b. to assess the accountability of management,
c. to assess the ability of the entity to pay and provide other benefits to its employees,
d. to assess the security for amounts lent to the entity,
e. to determine taxation policies,
f. to determine distributable profits and dividends,
g. to prepare and use national income statistics.

Note:

1. Important shortcoming of financial statements is that they are prepared to meet the common information needs of a wide range of users. They may fall short of specific information needs of the users.
2. To meet the above – stated uses, financial statements provide information about an entity's assets, liabilities, equity, and income and expenses, including gains and losses, other changes in equity and cash flows. That information, along with other information in the notes, assists users of financial statements in predicting amount, timing and degree of certainty of the entity's future cash flows.

2.6 THE KEY ELEMENTS OF CORPORATE FINANCIAL REPORTING TYPICALLY INCLUDE

These key elements of corporate financial reporting collectively aim to provide stakeholders, including shareholders, investors, lenders, and regulatory bodies, with accurate and reliable information about a company's financial position, performance, and prospects. The information helps stakeholders make informed decisions, assess the company's value, and hold management accountable.

2.6.1 Financial Statements: Financial statements are the primary components of corporate financial reporting. They provide a summary of a company's financial performance, position, and cash flows. The key financial statements include the balance sheet, income statement, cash flow statement, and statement of changes in equity. These statements provide a snapshot of the company's financial health and are prepared in accordance with relevant accounting standards.

2.6.2 Notes to Financial Statements: The notes to the financial statements provide additional details and explanations that complement the information presented in the financial statements. They include important accounting policies, assumptions, and methods used in preparing the financial statements. The notes also disclose any contingent liabilities, related party transactions, and significant events that may impact the financial position or performance of the company.

2.6.3 Management Discussion and Analysis (MD&A): The Management Discussion and Analysis section provides a narrative explanation of the company's financial results, operations, and future prospects. It includes management's analysis of the financial statements, discussion on key performance indicators, risks, and challenges faced by the company. The MD&A provides insights into the company's strategy, market conditions, and factors influencing its financial performance.

2.6.4 Auditor's Report: The auditor's report is prepared by an independent external auditor who reviews and audits the company's financial statements. The report provides an opinion on the fairness and accuracy of the financial statements and the company's compliance with applicable accounting standards. It highlights any material misstatements or weaknesses in internal controls identified during the audit process.

2.6.5 Corporate Governance Disclosures: Corporate financial reporting often includes disclosures related to corporate governance practices. These disclosures provide information about the company's board composition, executive compensation, risk management policies, internal control mechanisms, and adherence to corporate governance codes and regulations. The goal is to promote transparency, accountability, and responsible business practices.

2.6.6 Other Supplementary Information: In addition to the above elements, corporate financial reporting may include supplementary information specific to the company or industry. This could include segment reporting, geographical analysis, non-financial performance metrics, sustainability reporting, and other relevant information that provides a comprehensive understanding of the company's operations and performance.

2.7 FOUR TYPES OF CORPORATE FINANCIAL REPORTING

When preparing corporate financial reports, there are generally four types of financial statements that can be used. These parallel the financial statements used in the accounting industry. They are:

1. income statements,
2. balance sheets,
3. statements of cash flow and
4. statements of changes in equity.

Each relies on slightly different information and provides those who review them with a different look at the financial health of the business.

An income statement is used to illustrate the financial performance of an organization over a certain period of time (the reporting period). The income statement reports all sales, and it then includes expenses incurred. By subtracting expenses from sales, it is possible to arrive at a net income or net loss. If your company deals with shareholders, you might also provide an earnings-per-share figure on your income statement. Since this type of corporate financial report speaks to a company’s overall performance, it is widely regarded as the most useful statement.

A balance sheet is used to illustrate the overall financial position of a company at a given moment in time. Information is classified into one of three categories: assets, liabilities and equity. According to Generally Accepted Accounting Principles, items within the assets and liabilities categories should be presented in order of most to least liquid. This statement is also prized by creditors and investors for its ability to speak to the overall health of a company.

Statements of cash flow are used to show the money that has come in and gone out from the business during a given period of time. Generally, this sort of financial statement is broken down into three categories: operating activities, investing activities and financing activities. This type of report is usually less widely distributed, as it does not paint as clear a picture of a company’s overall financial state. In addition, it can be difficult to decipher for the layperson.

The final type of corporate financial report is a statement of changes in equity. This document illustrates all changes during a given period to shares of stocks, dividends and profits or losses. For this type of report, the beginning equity plus net income, minus dividends and plus or minus any other changes are equal to the ending equity. Statements of changes in equity are typically only supplied to outside parties. The utility of this sort of report for management and making internal financial decisions is limited.

To get the best sense of a company’s overall financial health and well-being, the review of all four types of corporate financial reports is ideal. Doing so provides a holistic look at what is going well and what isn’t for the business, and, since it is viewed on such a large scale, can offer suggestions for improvement that might be missed if the reports are viewed independently. It is important, however, to use caution when releasing corporate financial statements to external parties. Creditors and investors should only receive information that is required by the Generally Accepted Accounting Principles or that is absolutely necessary for their decision-making.

2.8 FINANCIAL REPORTING AND INCOME STATEMENT

Financial reporting plays a crucial role in providing information about a company's financial performance and position to various stakeholders. One of the primary components of financial reporting is the income statement, also known as the profit and loss statement or statement of earnings. This essay explores the importance of financial reporting, specifically focusing on the significance of the income statement, its key components, and how it provides insights into a company's profitability and operations through real-world examples.

Financial reporting is essential for decision-making, transparency, and accountability. It enables stakeholders such as investors, creditors, employees, and regulatory bodies to assess a company's financial health, make investment decisions, and evaluate its ability to generate profits and meet obligations. Financial reporting promotes trust, enhances market efficiency, and facilitates the allocation of capital in the economy.

2.8.1 The Significance of the Income Statement: The income statement provides a comprehensive overview of a company's financial performance over a specific period. It summarizes the revenue earned, expenses incurred, and resulting net income or loss. The income statement reflects a company's ability to generate profits, indicates the effectiveness of its operations, and helps stakeholders evaluate its profitability. Key Components of the Income Statement: The income statement consists of several key components:

2.8.2 Revenue: Revenue represents the total amount of money earned from the sale of goods or services. It is a vital indicator of a company's ability to generate income and grow its business. For example, technology giant Apple Inc.'s income statement reveals its revenue streams from iPhone sales, services, and other products.

2.8.3 Cost of Goods Sold (COGS): COGS represents the direct costs incurred in producing or purchasing goods that were sold during the period. It includes costs such as raw materials, direct labor, and manufacturing overhead. The difference between revenue and COGS yields the gross profit margin, which indicates the profitability of a company's core operations.

2.8.4 Operating Expenses: Operating expenses include costs incurred in the normal course of business, such as selling, general, and administrative expenses (SG&A), research and development (R&D) expenses, and marketing costs. These expenses are deducted from the gross profit to arrive at operating income.

2.8.5 Non-Operating Income and Expenses: Non-operating income and expenses consist of revenues and expenses that are not directly related to a company's core operations. They may include gains or losses from the sale of assets, interest income, and interest expenses. These items are typically reported after operating income.

2.8.6 Income Taxes: Income taxes represent the amount of taxes payable based on the company's taxable income. The income tax expense is calculated using the applicable tax rate and is reported as a separate line item on the income statement.

2.8.7 Net Income/Loss: Net income or net loss is the final figure on the income statement, representing the company's overall profitability for the period. It is calculated by subtracting all expenses, including taxes, from total revenues. Net income is a vital measure of a company's financial performance and is often used to assess its ability to generate returns for shareholders.

2.9 REAL-WORLD EXAMPLES – INCOME STATEMENTS

Let's consider two examples to highlight the significance of the income statement:

2.9.1 Amazon.com Inc.: Amazon's income statement reflects its diverse revenue streams from e-commerce, cloud computing, and digital content. The income statement provides insights into the company's revenue growth, cost of sales, operating expenses, and net income. This information is valuable for investors assessing Amazon's profitability and the success of its various business segments.

2.9.2 Coca-Cola Company: Coca-Cola's income statement showcases its revenue from beverage sales, cost of goods sold, and operating expenses. The income statement helps stakeholders evaluate the company's ability to generate profits and its operational efficiency. It provides a clear picture of the company

2.9.3 Tata Consultancy Services (TCS): TCS is a leading global IT services and consulting company based in India. Its income statement provides valuable insights into its revenue streams, including IT services, consulting, and digital solutions. The income statement helps stakeholders assess TCS's profitability, revenue growth, and cost structure. It provides information on key financial metrics such as gross profit, operating income, and net income, enabling investors and analysts to evaluate the company's financial performance and make informed investment decisions.

2.9.4 Reliance Industries Limited: Reliance Industries is one of India's largest conglomerates, with diverse business operations in sectors such as oil and gas, petrochemicals, telecommunications, and retail. The company's income statement provides a comprehensive view of its revenue sources, including refining, petrochemicals, and retail operations. It highlights the impact of fluctuating oil prices on the company's profitability and reveals its ability to generate earnings from different business segments. The income statement also reveals operating expenses, taxes, and net income, offering insights into Reliance's financial performance and its ability to deliver value to its shareholders.

These examples demonstrate how the income statement provides crucial information about a company's revenue, expenses, and profitability, enabling stakeholders to evaluate its financial health, make investment decisions, and assess its ability to generate sustainable returns.

2.10 FINANCIAL REPORTING AND BALANCE SHEET

Financial reporting serves as a cornerstone of transparency and accountability in the corporate world. It provides stakeholders with a comprehensive understanding of a company's financial performance, position, and cash flows. The balance sheet, one of the key financial statements, plays a pivotal role in financial reporting. This essay explores the significance of financial reporting and highlights the insights gained through balance sheet analysis, with specific reference to Indian companies. Financial reporting ensures the timely and accurate disclosure of a company's financial information to shareholders, investors, lenders, and regulatory bodies. It promotes trust, facilitates informed decision-making, and fosters efficient allocation of capital. Through financial reporting, companies comply with regulatory requirements and accounting standards, while providing stakeholders with insights into their financial health and prospects.

2.10.1 The Significance of the Balance Sheet: The balance sheet, also known as the statement of financial position, provides a snapshot of a company's financial position at a specific point in time. It presents a summary of its assets, liabilities, and shareholders' equity. By analyzing the balance sheet, stakeholders gain valuable insights into a company's liquidity, solvency, and overall financial stability. Key Components of the Balance Sheet: The balance sheet comprises several key components

2.10.2 Assets: Assets represent what a company owns or controls and include current assets (cash, accounts receivable, inventory, etc.) and non-current assets (property, plant, equipment, investments, etc.). By examining the asset composition, stakeholders can assess the company's ability to generate future revenue and its investment in long-term productive resources.

2.10.3 Liabilities: Liabilities represent the company's obligations and include current liabilities (short-term debt, accounts payable, etc.) and non-current liabilities (long-term debt, leases, etc.). The analysis of liabilities helps stakeholders understand the company's financial obligations, debt levels, and ability to meet its financial commitments.

2.10.4 Shareholders' Equity: Shareholders' equity reflects the residual interest in the company's assets after deducting liabilities. It includes share capital, retained earnings, and other equity components. The analysis of shareholders' equity provides insights into a company's financial structure, capitalization, and the shareholders' stake in the business.

2.11 BALANCE SHEET OBSERVATIONS WITH INDIAN CONTEXT

Insights from Balance Sheet Analysis in Indian Companies: Examining balance sheets of Indian companies offers valuable insights into their financial health, performance, and risk profile. Here are a few notable observations:

2.11.1 Liquidity Assessment: By analyzing the current assets and liabilities of Indian companies, stakeholders can assess their short-term liquidity position. A higher ratio of current assets to current liabilities indicates better liquidity and the ability to meet short-term obligations. For example, analyzing the balance sheet of Hindustan Unilever Limited reveals its strong liquidity position with significant cash and cash equivalents to cover short-term liabilities.

2.11.2 Debt and Solvency Analysis: Balance sheet analysis helps stakeholders evaluate the level of debt and solvency of Indian companies. By examining the debt-to-equity ratio and interest coverage ratio, investors can assess the company's ability to meet long-term obligations and manage its debt burden. For instance, analyzing the balance sheet of Bharti Airtel Limited provides insights into its debt levels and the company's solvency position.

2.11.3 Asset Structure and Efficiency: The composition of assets on the balance sheet enables stakeholders to evaluate the company's asset structure and efficiency. For example, analyzing the balance sheet of Infosys Limited reveals the company's investment in intangible assets, such as software and intellectual property, which contribute to its competitive advantage and value creation.

Financial reporting and balance sheet analysis are crucial for understanding the financial performance, position, and risk profile of Indian companies. The balance sheet provides insights into a company's liquidity, solvency, asset structure

2.12 FINANCIAL REPORTING AND THE SIGNIFICANCE OF CASH FLOWS

Financial reporting plays a crucial role in providing stakeholders with comprehensive information about a company's financial performance and position. While various financial statements contribute to this reporting, cash flows hold particular importance. This essay explores the significance of cash flows in financial reporting and highlights the insights gained from analyzing different types of cash flows.

2.12.1 The Importance of Cash Flows: Financial reporting ensures the accurate and transparent communication of a company's financial information to stakeholders. It serves as a tool for decision-making, promotes accountability, and fosters trust between the company and its investors, creditors, and regulatory bodies. By adhering to accounting standards and regulations, financial reporting provides a comprehensive understanding of a company's financial health and assists stakeholders in evaluating its prospects.

Cash flows, an integral part of financial reporting, provide insights into the movement of cash within a company. They reflect the sources and uses of cash during a specified period, enabling stakeholders to assess a company's cash-generating abilities, liquidity, and financial flexibility. Cash flows are captured in the cash flow statement, which presents the net change in cash resulting from operating, investing, and financing activities.

2.12.2 Operating Cash Flows: Operating cash flows depict the cash generated or consumed from a company's core operations. They include cash receipts from sales, payments to suppliers, employee wages, and income tax payments. Positive operating cash flows indicate that a company generates sufficient cash from its primary activities, which is essential for its day-to-day operations and future growth. Conversely, negative operating cash flows may raise concerns about a company's ability to sustain its operations.

2.12.3 Investing Cash Flows: Investing cash flows represent cash flows related to the acquisition or disposal of long-term assets and investments. Examples include cash inflows from the sale of property, plant, and equipment, as well as cash outflows from capital expenditures and acquisitions. Analyzing investing cash flows helps stakeholders understand a company's investment decisions and its commitment to long-term growth. Positive investing cash flows signify a company's ability to make strategic investments and generate returns.

2.12.4 Financing Cash Flows: Financing cash flows encompass cash flows associated with raising capital and repaying debts. They include cash inflows from issuing equity or borrowing loans, as well as cash outflows from dividend payments and debt repayments. Analyzing financing cash flows provides insights into a company's capital structure, its ability to access external funding, and its commitment to returning value to shareholders. Positive financing cash flows indicate successful fundraising activities and responsible debt management.

2.12.5 Interpreting Cash Flow Patterns: Analyzing the patterns of cash flows across operating, investing, and financing activities provides valuable information about a company's financial performance and stability. For example:

a. Strong operating cash flows combined with positive investing cash flows suggest a company is generating cash from its operations and making prudent investments for future growth.
b. Positive financing cash flows may indicate that a company is effectively raising capital to fund its operations or repay debts. However, consistently relying on financing activities to generate positive cash flows may raise concerns about the company's ability to sustain itself without external funding.
c. Negative cash flows in any category requires closer examination. For instance, negative operating cash flows may indicate profitability challenges or inefficiencies in managing working capital.

Cash flows play a vital role in financial reporting as they provide insights into a company's cash-generating abilities, liquidity, and financial flexibility. By analyzing cash flows from operating, investing, and financing activities, stakeholders can gain a comprehensive understanding of a company's financial health, its ability to sustain its operations, and its prospects for future growth. Understanding the significance of cash flows enhances the evaluation of a company's overall financial performance and assists stakeholders in making informed decisions.

2.13 FINANCIAL REPORTING AND THE IMPORTANCE OF CASH FLOW STATEMENTS

Financial reporting is an essential practice that provides stakeholders with valuable information about a company's financial performance and position. One of the key components of financial reporting is the cash flow statement. This essay explores the significance of financial reporting and highlights the importance of cash flow statements in understanding a company's cash inflows, outflows, and liquidity.

2.13.1 Financial Reporting and Its Significance: Financial reporting serves as a crucial tool for stakeholders, including investors, creditors, and regulators, to assess the financial health of a company. It promotes transparency, aids in decision-making, and ensures accountability. Through financial reporting, companies present their financial information in a structured and standardized manner, complying with accounting principles and regulations.

2.13.2 The Significance of Cash Flow Statements: Cash flow statements provide a comprehensive view of a company's cash inflows and outflows during a specific period. They are essential in assessing a company's liquidity, cash-generating abilities, and its ability to meet short-term obligations. The cash flow statement complements other financial statements, such as the income statement and balance sheet, by focusing specifically on cash-related activities.The cash flow statement consists of three main components.

2.13.3 Operating Activities: Operating activities represent the cash flows directly related to a company's core operations, including cash receipts from sales, payments to suppliers, salaries, and taxes. This section of the cash flow statement provides insights into a company's ability to generate cash from its day-to-day business operations.

2.13.4 Investing Activities: Investing activities encompass cash flows related to the acquisition or disposal of long-term assets, such as property, plant, equipment, or investments. Cash inflows in this section may come from the sale of assets or investment returns, while cash outflows may result from capital expenditures or the purchase of securities. Analyzing the investing activities section helps stakeholders understand a company's capital investment decisions and its ability to generate future income.

2.13.5 Financing Activities: Financing activities include cash flows associated with raising capital or repaying debts, such as proceeds from issuing equity or borrowing loans, dividend payments, or debt repayments. This section provides insights into how a company finances its operations, expands its business, and returns value to shareholders.

2.14 IMPORTANCE OF CASH FLOW STATEMENTS

2.14.1 Liquidity Assessment: Cash flow statements are crucial in assessing a company's liquidity position. By examining the net cash flow from operating activities, stakeholders can determine if a company generates sufficient cash to meet its short-term obligations and fund its ongoing operations. Companies with positive cash flows from operating activities indicate a healthier liquidity position.

2.14.2 Cash Generating Abilities: Cash flow statements reveal a company's ability to generate cash from its core operations. Positive cash flows from operating activities indicate a company's profitability and its capability to generate cash independent of external financing. On the other hand, negative cash flows may indicate inefficiencies or challenges within the core business.

2.14.3 Investment and Financing Decision-making: Cash flow statements assist stakeholders in evaluating a company's investment and financing decisions. By analyzing the investing and financing activities sections, investors can assess the company's strategies for capital allocation, growth, and debt management. Positive cash flows from investing activities may indicate prudent investment decisions, while positive cash flows from financing activities can show the ability to raise capital or repay debts effectively.

Financial reporting plays a vital role in providing stakeholders with relevant and reliable information about a company's financial performance and position. Cash flow statements, as an integral component of financial reporting, offer insights into a company's cash inflows, outflows, and liquidity. By analyzing the cash flow statement, stakeholders can evaluate a company's ability to generate cash, its financial stability, and its effectiveness in managing cash-related activities. Understanding the significance of cash flow statements enables stakeholders to make informed decisions and assess

2.14.5 Hypothetical model for a cash flow statement:

XYZ Company
Cash Flow Statement
For the Year Ended December 31, 20XX

Operating Activities:

Net Income		Rs. XX,XXX
Adjustments:		
Depreciation and Amortization	Rs.XX,XXX	
Changes in Working Capital:		
Increase in Accounts Receivable	Rs.XX,XXX	
Decrease in Inventory	(Rs.XX,XXX)	
Increase in Accounts Payable	(Rs.XX,XXX)	
Increase in Prepaid Expenses	(Rs.XX,XXX)	
Net Cash Provided by Operating Activities	Rs.XX,XXX	
Investing Activities:		
Purchase of Property, Plant, and Equipment	(Rs.XX,XXX)	
Proceeds from Sale of Investments	Rs.XX,XXX	
Purchase of Marketable Securities	(Rs.XX,XXX)	
Net Cash Used in Investing Activities	(Rs.XX,XXX)	
Financing Activities:		
Proceeds from Issuance of Common Stock	Rs.XX,XXX	
Proceeds from Issuance of Long-Term Debt	Rs.XX,XXX	
Dividend Payments	(Rs.XX,XXX)	
Repayment of Long-Term Debt	(Rs.XX,XXX)	
Net Cash Provided by Financing Activities	Rs.XX,XXX	
Net Increase in Cash		Rs.XX,XXX
Beginning Cash Balance	Rs.XX,XXX	
Ending Cash Balance	Rs.XX,XXX	

Note:

1. No figures are provided in this example as it is a hypothetical and for illustrative purposes only. The actual amounts and categories may vary based on the specific financial transactions and circumstances of a company.
1. In this example, the cash flow statement begins with the net income figure derived from the income statement. Adjustments are made to reconcile non-cash expenses such as depreciation and amortization. The changes in working capital, including accounts receivable, inventory, accounts payable, and prepaid expenses, are factored in to determine the net cash provided by operating activities.The investing activities section reflects the cash flows associated with the purchase and sale of long-term assets and investments. It includes the purchase of property, plant, and equipment, proceeds from the sale of investments, and the purchase of marketable securities.
2. The financing activities section outlines the cash flows related to raising capital and repayment of debts. It includes proceeds from the issuance of common stock and long-term debt, dividend payments, and repayment of long-term debt.
3. The net increase in cash is calculated by summing the cash provided or used in operating, investing, and financing activities. The beginning and ending cash balances are then reported to provide a snapshot of the company's cash position at the beginning and end of the period.

4. It's important to note that the structure and categories in a cash flow statement can vary depending on the reporting standards and requirements applicable to the company.

2.15 FINANCIAL REPORTING AND CHANGES IN EQUITES

Equity, also known as shareholders' equity or owners' equity, represents the residual interest in a company's assets after deducting liabilities. It is a crucial element of the financial structure of a business, reflecting the ownership stake and the value attributable to shareholders. This essay explores the concept of changes in equities and their significance in financial reporting.

2.15.1 Changes in Equities and Financial Reporting: Financial reporting plays a vital role in providing stakeholders with information about a company's financial performance and position. Changes in equities, which encompass various transactions and events affecting shareholders' equity, are an essential component of financial reporting. These changes are reflected in the statement of changes in equity, which outlines the movement in equity accounts over a specific period. Changes in equities can arise from several sources, including the following:

2.15.2 Capital Transactions: Capital transactions involve the issuance or repurchase of shares and the payment of dividends. When a company issues new shares, it raises additional capital, resulting in an increase in shareholders' equity. Conversely, repurchasing shares reduces the number of outstanding shares and, therefore, decreases equity. Dividends paid to shareholders also reduce equity since they represent a distribution of profits to owners.

2.15.3 Comprehensive Income: Comprehensive income encompasses all changes in equity during a specific period, except those resulting from capital transactions. It includes revenues, expenses, gains, and losses that are not included in the net income figure. Examples of comprehensive income items are foreign currency translation adjustments, unrealized gains or losses on available-for-sale investments, and pension plan adjustments.

2.15.4 Changes in Accounting Policies: Changes in accounting policies can lead to adjustments in equity. When a company adopts a new accounting standard or changes its accounting treatment for certain items, it may result in restating previously reported financial information. These adjustments are reflected in the statement of changes in equity, ensuring consistency and comparability across reporting periods.

2.16 IMPORTANCE OF CHANGES IN EQUITIES IN FINANCIAL REPORTING

2.16.1 Transparency and Accountability: Changes in equities enhance transparency in financial reporting by providing stakeholders with a clear understanding of the factors impacting shareholders' equity. By disclosing the details of capital transactions, comprehensive income, and changes in accounting policies, companies demonstrate their commitment to accountability and provide a complete picture of the financial changes affecting equity.

2.16.2 Evaluation of Capital Structure: Changes in equities help stakeholders evaluate a company's capital structure and assess its financial health. Capital transactions, such as the issuance or repurchase of shares, can indicate the company's capital-raising activities and its financing strategies. Shareholders and investors can analyze these changes to assess the company's ability to fund its operations, support growth initiatives, and generate returns for shareholders.

2.16.3 Assessing Performance and Value Creation: The statement of changes in equity allows stakeholders to track the impact of comprehensive income on equity. By analyzing these changes, investors can evaluate the company's performance and its ability to create value over time. Positive changes in equity resulting from comprehensive income indicate the company's success in generating profits, managing risks, and capitalizing on investment opportunities.

Changes in equities are an integral part of financial reporting, providing stakeholders with insights into the movement and composition of shareholders' equity over a specific period. Through the statement of changes in equity, companies disclose capital transactions, comprehensive income, and changes in accounting policies, enhancing transparency, accountability, and the evaluation of a company's financial health. Understanding and analyzing changes in equities allow stakeholders to assess the company's performance, capital structure, and value creation efforts, facilitating informed decision-making.

2.16.4 Here's a hypothetical example illustrating changes in equity:

ABC Corporation - Statement of Changes in Equity
For the Year Ended December 31, 20XX

Beginning Balance of Shareholders' Equity		Rs.500,000
Capital Transactions:		
Issuance of Common Shares	Rs.200,000	
Repurchase of Treasury Shares	(Rs.50,000)	
Dividends Paid	(Rs.30,000)	
Comprehensive Income:		
Net Income	Rs.100,000	
Foreign Currency Translation Adjustment	Rs.5,000	
Unrealized Gain on Available-for-Sale Investments	Rs.7,500	
Changes in Accounting Policies:		
Adjustment for New Revenue Recognition Standard	(Rs.3,000)	
Ending Balance of Shareholders' Equity		Rs.729,500

Note: In this example, the beginning balance of shareholders' equity is Rs.500,000. Throughout the year, several transactions and events affect equity, resulting in changes outlined in the statement of changes in equity.

2.16.5 Capital Transactions:

Issuance of Common Shares: ABC Corporation issued Rs.200,000 worth of common shares, representing new capital raised from investors. This transaction increases the shareholders' equity.

1. **Repurchase of Treasury Shares:** The company repurchased Rs.50,000 worth of its own shares from the market. This action reduces the number of outstanding shares and decreases shareholders' equity.
2. **Dividends Paid:** ABC Corporation distributed Rs.30,000 to its shareholders as dividends, representing a portion of the company's profits. Dividends reduce retained earnings and, consequently, shareholders' equity.

2.16.6 Comprehensive Income:

1. **Net Income:** The company generated a net income of Rs.100,000 during the year. Net income increases retained earnings and, thereby, shareholders' equity.
2. Foreign Currency Translation Adjustment: ABC Corporation had foreign operations, and changes in exchange rates resulted in a Rs.5,000 foreign currency translation adjustment. This adjustment, classified as comprehensive income, impacts accumulated other comprehensive income and, consequently, shareholders' equity.
3. Unrealized Gain on Available-for-Sale Investments: The company had unrealized gains of Rs.7,500 on its available-for-sale investments. This gain is recognized as comprehensive income and affects accumulated other comprehensive income and shareholders' equity.

2.16.7 Changes in Accounting Policies:

1. **Adjustment for New Revenue Recognition Standard:** The company adopted a new revenue recognition standard that required a restatement of previously reported financial information. As a result, an adjustment of Rs.3,000 is made to reflect this change in equity.

The ending balance of shareholders' equity is calculated by summing up the beginning balance, capital transactions, comprehensive income, and changes in accounting policies. In this example, the ending balance of shareholders' equity is Rs.729,500.

Note: The figures provided in this example are hypothetical and for illustrative purposes only. The actual amounts and categories may vary based on the specific transactions and circumstances of a company.

2.17. SUMMARY

After studying this lesson students should be able to know the Meaning of Financial Statements & Component of Financial Statements. To understand the key elements of corporate financial reporting typically include. To acquired knowledge on financial reporting and Balance Sheet. To obtain knowledge on Financial Reporting and the Importance of Cash Flow Statements. To learn Four types of corporate financial reporting. To knowledge on financial reporting and Changes in equities. It is also revealed on the following aspects such as: Meaning of Financial Statements, Sources of financial statements, Aim of financial reporting, Financial Reporting and Income Statement, Real-World Examples – Income statements, Financial reporting and Balance Sheet, Balance Sheet observations with Indian context, Financial Reporting and the Significance of Cash Flows, Financial Reporting and the Importance of Cash Flow Statements, Importance of Cash Flow Statements, Financial reporting and Changes in equities, Importance of Changes in Equities in Financial Reporting.

2.18. TECHNICAL TERMS

Component A dynamic, functional version of React.Component , a component component if you will. Useful for inline lifecycles and state. <Component ...

Elements : An element is a substance made up of only one type of atom, each with the same number of protons. Each element cannot be broken down into simpler substances. And each element retains its basic physical properties, regardless of the number of atoms in a sample.1

Balance Sheet: A balance sheet is a statement of a business's assets, liabilities, and owner's equity as of any given date. Typically, a balance sheet is prepared at the end of set periods (e.g., every quarter; annually). A balance sheet is comprised of two columns. The column on the left lists the assets of the company.

Income Statement: An income statement is a financial statement that shows you the company's income and expenditures. It also shows whether a company is making profit or loss for a given period. The income statement, along with balance sheet and cash flow statement, helps you understand the financial health of your business.

Cash Flow Statements: The cash flow statement shows the source of cash and helps you monitor incoming and outgoing money. Incoming cash for a business comes from operating activities, investing activities and financial activities.

2.19. SELF ASSESSMENT QUESTIONS

1. What is the Meaning of Financial Statements?
2. What are the Components of Financial Statements? Explain.
3. What are the key elements of corporate financial reporting typically include
4. What is the financial reporting and Balance Sheet?
5. What is the Importance Financial Reporting and the Cash Flow Statements.
6. What are the types of corporate financial reporting? Explain.
7. Explain about Financial reporting and Changes in equities
8. What are the Sources of financial statements? Explain.
9. What is the Aim of financial reporting?
10. Explain the Financial Reporting and Income Statement.

2.20.SUGGESTED READINGS

1. RSN Pillai, Bagarathi & S. Uma, Fundamentals of Advanced Accounting, Vol.1, S. Chand, New Delhi

2. Nehru J. Financial Reporting by diversified companies vision Books, New Delhi.

3. Hawkins David, Financial Statements Corporations Dow Jones – Irwin Homewood 1973.

Dr. KRISHNA BANANA

LESSON-3
FINANCIAL REPORTING - PROBLEMS AND ISSUES AND SOME ASPECTS

AIMS AND OBJECTIVES

After studying this lesson students should be able to

- To know the scope of the problems of financial reporting.
- To understand Recent developments in Corporate Financial Reporting
- To acquired knowledge on Global Reporting Initiative (GRI).
- To obtain knowledge on International Federation of Accounts (IFAC):.

STRUCTURE

3.1 Introduction
3.2 The scope of the problems of financial reporting
3.3 Financial reporting – Some key points
3.4 Major problems and their solutions
3.5 Recent developments in Corporate Financial Reporting
3.6 Concept of Triple Bottom Line Reporting
3.7 Trend towards Triple Bottom Line Reporting
3.8 Global Reporting Initiative (GRI)
3.9 International Federation of Accounts (IFAC):
3.10 Reporting of Financial instruments and other external reporting
3.11 External Reporting under Capital Market Regulations & Disclosures
3.12 Disclosure and transparency
3.13 CEO/CFO certification
3.14 Report on Corporate Governance
3.15 Compliance
3.16 Summary
3.17 Technical Terms
3.18 Self Assessment Questions
3.19 Suggested Readings

3.1 INTRODUCTION

Today's dynamic business environment is heralding a revolution in the need for, and the way in which, accounting data is utilized. This has resulted in talk of `an accounting revolution' and the possible `redefinition of accountancy' However, it is all too easy to become caught up in this stampede for change, but how far can accounting change and for it still to be called accounting? This part seeks to explore the major issues facing contemporary financial reporting, this will include its interrelationship with external auditing and the provision of assurance to those outside the reporting entity.

3.2 THE SCOPE OF THE PROBLEMS OF FINANCIAL REPORTING

The changes taking place in the commercial environment have resulted in the accountancy profession critically reviewing its role and the relevance of its curriculum.

a. Technological developments resulting in the inexpensive preparation and dissemination of information, thus decreasing the cost and expertise necessary to produce the financial statements ·
b. The globalization of business arising from `instantaneous information' in tandem with quick and reliable methods of transportation ·
c. The growth in pension funds and other institutional investors with a resultant increase in their power to influence businesses.

The major driving forces behind the developments in contemporary financial reporting include the following:

3.2.1 Globalization: This has given rise to the push for the international harmonization of accounting standards and the resultant debate about whose standards should be adopted. In the European Union, by 2005 publicly traded EU incorporated companies will have to follow the international financial reporting standards of the International Accounting Standards Board (IASB) formerly the International Accounting Standards Committee (IASC). Over the final quarter of the twentieth century, there was increasing recognition of the politicization of the standards-setting process and the implications of the economic consequences of accounting standards and policies. Therefore, the adoption of international standards needs to be viewed as much in a political context as in an accounting one. However, `international accounting standard-setting is currently in crisis'

3.2.2 The influence of management: This is a critical constituency when it comes to developments in accounting: `Management is central to any discussion of financial reporting, whether at the statutory or regulatory level, or at the level of financial pronouncements of accounting bodies. One of the reasons for the failure of the current cost experiment in the early 1980s was the lack of support from financial statement preparers (they were not convinced of the validity of the exercise). Current values are now starting to creep into the financial statements. There is a concern that the standard setters may be requiring data for external reporting that management does not and useful for its own internal uses. The debacle regarding current cost accounting in the 1980s should not be forgotten.

3.2.3 Extreme market pressures: The pressures from the capital markets are forcing management to achieve earnings targets. These pressures are exacerbated by the unforgiving nature of the equity market as securities valuations are drastically adjusted downward whenever companies fail to meet `street' expectations. Pressures are further magnified because management's compensation often is based in large part on achieving earnings or other financial goals. One consequence of these market pressures is the danger of `aggressive earnings management' that `results in stakeholders, and the capital markets generally, being misled to some extent about an entity's performance and profitability'. Recent financial scandals may be viewed as coming about as a result of extreme disclosure and earnings management.

3.2.4 The informational perspective of the financial statements: The emphasis is now on the provision of information to enable the users of the financial statements to take decisions and to make assessments of future cash flow of the reporting entity. Since the 1960s, users have been actively involved in dialogue about accounting principles and are represented on some accounting standard-setting bodies. In 1994, the AICPA issued a report containing the findings of a special committee aimed at improving business reporting. The intention was to `influence future agendas of standard setters and regulators and the direction of their projects'.

The financial reporting process is considered by many to be the single most important function of an accounting system. However, even the best accounting system can't overcome a flawed financial reporting process.

3.3 FINANCIAL REPORTING – SOME KEY POINTS

To help you determine if your financial reporting process has a problem, start by answering these five questions:

1. Does your accounting or enterprise resource planning system produce accurate monthly financial reports on a timely basis, ideally by the tenth day of the following month?
2. Are all appropriate financial and informational reports produced on a daily, weekly, and monthly basis?
3. Are those reports distributed in a timely fashion to the appropriate personnel (either on paper or digitally)?
4. Do the appropriate personnel know how to read the reports and understand how to use the information contained within those reports?
5. Do these personnel take time to read the reports and use the information and insights derived accordingly to better perform their jobs?

Answering "no" to one or more of these questions indicates that work is needed to shore up your reporting processes. Following is a list of common mistakes companies make related to their financial and informational reporting functions, and suggestions for avoiding those mistakes in the future. While some of these steps may seem basic, many companies struggle with them, and all companies should double-check to ensure they are handling them correctly.

3.4 MAJOR PROBLEMS AND THEIR SOLUTIONS

Financial reporting involves so many ways to report. In each of the point the reporter has to face complex dimensions which create a critical situation to take decision. The following are some of the major problems and their solutions in this regard.

3**.4.1 Financial reports lack comparative data:** Some companies may produce only single-column reports, which are less informative than multi-column reports due to the absence of comparative data. The inclusion of prior-year amounts, prior-month amounts, or budgeted amounts makes it easier for the reader to ascertain whether current amounts exceed, or fall short of, expectations.

Solution: Be sure to include comparative data in your financial statements and informational reports. Rather than squeezing every possible comparative figure into a single report, which might result in too much information, consider issuing multiple reports instead. For example, you might produce two income statements — one comparing actual amounts to budget amounts and the other comparing actual amounts to prior-year amounts.

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3.4.3 Financial reports lack calculated differences: While the inclusion of comparison columns (as mentioned above) is a step in the right direction, the absence of difference calculations forces the reader to calculate those differences mentally or with a calculator — both methods of which are time-consuming and more prone to error. The more efficient approach is to provide readers with calculated column differences so they can focus more on studying the data, and less on the arithmetic.

Solution: When producing financial reports containing comparison data, include calculated differences so the reader can more easily digest the data.

3.4.4 Financial reports lack calculated percentage differences: Where difference calculations can be informative, percentage differences can be equally or more informative. For example, assume that the budgeted and actual amounts are Rs.62,000 and Rs.74,000, respectively, for salaries expense and Rs.2,800 and Rs.5,600, respectively, for utilities expense. In this simplified example, the calculated differences show that the actual salaries expense exceeded the budgeted amount by Rs.12,000, while the utilities expenses exceeded the budgeted amount by only Rs.2,800. In this situation, a casual reviewer might focus on the larger salaries difference and downplay (or overlook) the excessive utilities expenditures. However, the percentage difference calculations for these same amounts reveal that the salaries expense is over budget (or unfavourable) by 19%, while the utilities expense is over budget (or unfavourable) by 100%. These additional percentage calculations make the utilities overruns far more difficult to overlook. The table "Displaying Percentage Calculations" shows these expense amounts, including the calculated differences and percentage differences. Notice how the (12,000) and -100% difference amounts are easier to detect (or catch), as opposed to reviewing the actual and budget columns only.

Solution: When producing financial reports containing comparison data, include percentage differences with the calculated differences so the reader can more easily catch overruns that may not be as noticeable when analysed purely on calculated differences.

3.4.5 Financial statements don't reflect reality: In some cases, bookkeepers (and usually others in the organization) think it's acceptable if the financial reports don't reflect reality, so long as the relevant personnel are aware of the report's discrepancies. Unfortunately, many small business bookkeepers are not trained in proper revenue and expense recognition principles, and as a result, they don't always produce accurate financial reports. This type of situation results in inaccurate financial reporting, which, in turn, leads to management potentially making important financial decisions based on the data contained in those inaccurate reports.

Solution: Bookkeepers, managers, and company officials should be trained in proper accounting methods, including proper revenue and expense recognition. In addition, consideration should be given to training these personnel in common auditing procedures to help them better understand the goals of producing financial reports that most accurately reflect reality. Until such training is completed, proper third-party review procedures should be established to ensure that an accountant who has the right experience reviews the company's reports.

3.4.6 Failure to read/study/scrutinize financial statements: The process of producing financial reports is almost pointless if no one bothers to read or study those reports. Further, it's also rather pointless for personnel to read or study those reports if they aren't going to investigate significant deviations or suspected problems or errors.

Solution: Everyone who receives financial statements or informational reports should:

1. Be trained in how to read and understand those reports.
2. Take time to read and study those reports in a timely manner.
3. Identify discrepancies (in the report's data, amounts, or balances), if any, that deviate significantly from expectations.
4. Attempt to determine the cause of those discrepancies and address them to everyone's satisfaction.
5. If discrepancies cannot be explained, escalate those discrepancies or data anomalies to someone who can adequately address them.

3.4.7 Failure to revise procedures to prevent discrepancies from recurring: Often companies that identify an error or discrepancy appropriately take time to adjust or correct the books but then fail to implement or revise their accounting procedures to prevent the error or discrepancy from happening again. For example, if a discrepancy results from improper processing of a complicated customer deposit, the error should be corrected in the accounting system, and a second party should be assigned to review all complicated customer deposit transactions in the future until the bookkeeper who made the error is deemed proficient in this activity.

Solution: As significant deviations are identified and corrected in the system, management should implement corrective measures to ensure that the discrepancies don't recur.

3.4.8 Failure to calculate and analyse financial ratios: Analysing one's balance sheet ratios can help ferret out troubling trends that may otherwise go unnoticed. For example, if your number of days in accounts receivable grows from 26 to 28 to 34 over a three-month period, it could be a sign that some of your customers have impending cash flow problems, or perhaps it means that your accounts receivable staff are falling behind on their collection responsibilities. As a second example, if your calculated days in inventory grows significantly over a few months, it could indicate that your purchasing staff are over-ordering merchandise or, perhaps, that your production operations are slowing down. Depending upon your industry, there are myriad balance sheet ratios and calculations that, when compared to prior months or industry standards, might suggest problems that need management's attention.

Solution: Attach charts plotting relevant balance sheet and income statement ratio calculations to your monthly financial statements and reports to help readers fully understand the results of operations, as shown in the chart "Days Inventory Outstanding".

3.4.9 Failure to prepare perpetual cash flow forecasts: Because cash flow is such a vital part of a company's operations, cash flow forecasts should be prepared and updated periodically (either monthly or quarterly, for example). To prepare a proper cash flow forecast, companies must first prepare a seasonalised monthly income statement budget and a projected monthly balance sheet. Projected balance sheets can be calculated using data from the seasonalised monthly income statement budget in combination with historical balance sheet ratios (assuming those balance sheet ratios are consistent enough for such purposes). Once completed, the cash flow report should be updated each month to reflect actual values for the most recent month (or quarter), and the remaining projected cash flow values should be adjusted accordingly, if necessary. Using a proper cash flow forecast report, companies can better manage cash investments to maximise investment earnings, plan for sizeable expenditures, or anticipate cash shortfalls early enough to enable company officials to obtain working capital loans to help weather low cash flow periods.

Solution: Be sure to prepare seasonalised income statements, projected balance sheets, and projected cash flow forecasts, and then update the cash flow forecast monthly, as necessary.

3.5 RECENT DEVELOPMENTS IN CORPORATE FINANCIAL REPORTING

The following are some general trends and developments that have been observed in recent years. Here are a few examples:

Sustainability Reporting: Sustainability reporting refers to the practice of disclosing information about a company's environmental, social, and governance (ESG) performance. It goes beyond traditional financial reporting by providing stakeholders with a broader understanding of a company's impact on society and the environment. Sustainability reporting helps organizations assess and communicate their sustainability initiatives, performance, and progress towards achieving their environmental and social goals. Here are the key components of sustainability reporting:

3.5.1 Environmental Performance: This component focuses on a company's environmental impact and its efforts to address environmental challenges. It includes reporting on areas such as greenhouse gas emissions, energy consumption, water usage, waste management, biodiversity conservation, pollution prevention, and climate change mitigation strategies.

3.5.2 Social Performance: Social performance reporting addresses the company's interactions with its employees, customers, suppliers, communities, and other stakeholders. It covers topics such as labor practices, employee health and safety, diversity and inclusion, human rights, community engagement, philanthropy, product responsibility, and customer satisfaction.

3.5.3 Governance and Ethics: Governance reporting highlights the company's governance structure, practices, and ethical standards. It encompasses areas such as board composition and independence, executive compensation, risk management, anti-corruption measures, transparency, shareholder rights, and compliance with legal and regulatory requirements.

3.5.4 Stakeholder Engagement: Sustainability reporting involves actively engaging with stakeholders to identify and understand their interests, concerns, and expectations. It includes describing the company's stakeholder engagement processes, the outcomes of those engagements, and how stakeholder feedback has influenced decision-making and strategy.

3.5.5 Targets and Performance Indicators: Sustainability reports often include specific targets and performance indicators to measure progress in achieving sustainability goals. These targets may relate to reducing greenhouse gas emissions, increasing renewable energy use, improving workplace diversity, reducing waste generation, or enhancing supplier sustainability practices. Performance indicators help stakeholders assess the company's performance against these targets and benchmark it against industry peers.

3.5.6 Strategy and Governance: This component outlines the company's sustainability strategy, policies, and management systems. It explains how sustainability is integrated into the company's overall business strategy and decision-making processes. It also describes the roles and responsibilities of various stakeholders involved in driving sustainability initiatives and how the company monitors and reports on its sustainability performance.

3.5.7 Assurance and Verification: To enhance the credibility of sustainability reporting, some companies choose to obtain third-party assurance or verification of their sustainability data and reporting processes. Independent assurance provides stakeholders with confidence that the reported information is accurate, reliable, and in accordance with recognized reporting frameworks or standards.

Sustainability reporting frameworks and guidelines such as the Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB), and Task Force on Climate-related Financial Disclosures (TCFD) offer further guidance on the specific components and disclosures to include in sustainability reports.

By incorporating these components into their reporting practices, companies can demonstrate their commitment to sustainable business practices and enhance transparency and accountability to their stakeholders.

3.6 CONCEPT OF TRIPLE BOTTOM LINE REPORTING

The concept of triple bottom line (TBL) reporting is an approach to measuring and reporting an organization's performance that goes beyond financial measures. It recognizes that businesses have responsibilities not only to generate profits but also to consider their impact on people (social), the planet (environmental), and long-term sustainability (economic). TBL reporting aims to provide a comprehensive view of an organization's overall value creation by considering these three dimensions.

The three components of triple bottom line reporting are:

3.6.1 Social Dimension: The social dimension of TBL reporting focuses on the impact of an organization's activities on people, both internally (employees) and externally (communities and society at large). It includes aspects such as employee well-being, labor practices, human rights, community engagement, customer satisfaction, and contribution to local communities. Social indicators and metrics provide insights into the organization's commitment to ethical conduct, social responsibility, and stakeholder engagement.

3.6.2 Environmental Dimension: The environmental dimension of TBL reporting assesses the organization's impact on the natural environment and its efforts to promote sustainability. It encompasses areas such as energy consumption, greenhouse gas emissions, water usage, waste management, pollution prevention, biodiversity conservation, and climate change mitigation strategies. Environmental indicators and metrics help evaluate the organization's environmental performance and its commitment to environmental stewardship and resource efficiency.

3.6.3 Economic Dimension: The economic dimension of TBL reporting focuses on the financial performance and economic sustainability of the organization. It includes traditional financial measures such as revenue, profit, and return on investment. However, it also considers broader economic impacts, such as job creation, economic contributions to local economies, supply chain management, and investment in research and development. Economic indicators and metrics provide insights into the organization's ability to generate sustainable economic value while considering the interests of various stakeholders.

Triple bottom line reporting recognizes that organizations operate within a larger social and environmental context and should be accountable for their impact on all three dimensions: social, environmental, and economic. By measuring and reporting performance across these areas, TBL reporting encourages organizations to adopt more sustainable practices, make informed decisions, and strive for a balance between financial success, social well-being, and environmental stewardship.

The Global Reporting Initiative (GRI) and other sustainability reporting frameworks provide guidelines and indicators to assist organizations in implementing TBL reporting and ensuring transparency and accountability in their sustainability practices.

3.7 TREND TOWARDS TRIPLE BOTTOM LINE REPORTING

Companies are increasingly including economic, environmental and social information in their public reporting, in addition to the financial information required for statutory reporting. For some companies, this involves publication of a separate report or reports. For others, it involves including such information within their annual reporting to shareholders. A number of factors are driving this shift in public reporting, including response to mandatory requirements; consistency with emerging public commitments by business through voluntary codes of behaviour or charters and their associated business and signatory requirements; and the increasing and changing demands from stakeholders for greater transparency about operating policies and results. Stakeholders are placing increasing emphasis on understanding the approach and performance of companies in managing the environmental and social/community impact of their activities, and on obtaining a broader perspective of the economic impact of companies.

3.8 GLOBAL REPORTING INITIATIVE (GRI)

The Global Reporting Initiative's (GRI) vision is that reporting on economic, environmental, and social performance by all organizations becomes as routine and comparable as financial reporting. GRI accomplishes this vision by developing, continually improving, and building capacity around the use of its Sustainability Reporting Framework.

The GRI Guidelines contain information to assist companies seeking to enhance the credibility of their reports through independent verification and assurance. The Guidelines highlight five critical areas for consideration by those companies seeking independent assurance:

- **a. Internal information systems and processes** – investigation and evaluation of the effectiveness of internal systems and processes to provide accurate and meaningful data.
- **b. The assurance process** - in order to provide value to the reporting company, the assurance process must provide assurance in relation to subject matter, evidence, control systems, and the usefulness of reported information.
- **c. Selection of assurance providers** - the assurance provider should be independent, be able to balance stakeholder and company needs, have no conflict of interest, be able to commit sufficient time and appropriate resources.
- **d. Director's responsibilities** - recognition by the Board of the role of the assurance provider and ensuring that sufficient resources and access is made available to the assurance provider serves to enhance the process.
- **e. Assurance statements/reports -** the GRI offers guidelines on the minimum requirements for inclusion in assurance statements and reports.

In addition, the Guidelines identify several issues that companies and other organizations should consider in choosing an independent assurance provider. Some of the distinctive elements of GRI's Framework – and the activity that creates it – include:

3.8.1 multi-stakeholder input: GRI believes that multi-stakeholder engagement is the best way to produce universally applicable reporting guidance that meets the needs of report makers and users. All elements of the Reporting Framework are created and improved using a consensus-seeking approach, and considering the widest possible range of stakeholder interests. Stakeholder input to the Framework comes from business, civil society, labor, accounting, investors, academics, governments and sustainability reporting practitioners.

3.8.2 A record of use and endorsement: Every year, an increasing number of reporters adopt GRI's Guidelines. From 2006 to 2011, the yearly increase in uptake ranged from 22 to 58 percent. New audiences for sustainability information, like investors and regulators, are now calling for more and better performance data. Annual growth in the number of reporters is expected to continue, as GRI works for more reporters and better reporting.

3.8.3 Governmental references and activities. GRI was referenced in the Plan of Implementation of the UN World Summit on Sustainable Development in 2002. Use of GRI's Framework was endorsed for all participating governments. Several governments consider GRI's Framework to be an important part of their sustainable development policy, including Norway, the Netherlands, Sweden and Germany.

3.8.4 Independence. GRI's governance structure helps to maintain its independence; geographically diverse stakeholder input increases the legitimacy of the Reporting Framework. GRI's funding approach also ensures independence. GRI is a stichting – in Dutch, a non-profit foundation – with a business model that aims for a degree of self-sufficiency. Funding is secured from diverse sources; governments, companies, foundations, partner organizations and supporters.

3.8.5 Shared development costs. The expense of developing GRI's reporting guidance is shared among many users and contributors. For companies and organizations, this negates the cost of developing in-house or sector-based reporting frameworks.

3.8.6 Bridge building. GRI's basis in multi-stakeholder engagement contributes to its ability to build bridges between different actors and sectors - like business, the public sector, labor unions and civil society - and to mediate.

3.9 INTERNATIONAL FEDERATION OF ACCOUNTS (IFAC)

Investors and other stakeholders want to know what makes companies tickat the same time, regulators are increasingly requiring companies to report clearly on their business models. In response, IFAC, with the Chartered Institute of Management Accountants (CIMA) and PwC, and at the request of the International Integrated Reporting Council (IIRC), have released a background paper, which highlights the business model as being at the heart of integrated reporting.

Currently, there is wide variation in how organizations define their business models and approach to disclosure. This highlights the need for a clear, universally applicable, international definition of a business model. The proposed definition and discussion in the paper aim to bridge the varied interpretations by highlighting common areas and ensuring a consistent application across industries and sectors.

The background paper found that, in a complex financial climate that has seen investors demand greater transparency, reporting on business models is currently inconsistent, incomparable, and incomplete because of a lack of consistent guidance.

3.10 REPORTING OF FINANCIAL INSTRUMENTS AND OTHER EXTERNAL REPORTING

The following are the prime financial instruments:

(i). Applicability: this statement is applicable on enterprises which are Non-SME.

(ii). Definition of Financial Statements: Financial Instrument is a contract that gives rise to a Financial asset for one enterprise and a Financial Liability or an Equity for another enterprise. The example are investments, debtors, deposits etc.

(iii). Definition of Financial Assets: A Financial asset is an asset that is:

- Cash
- Equity Instruments of other enterprise, eg. Investment in ordinary shares.
- A contractual right to receive cash, or to exchange financial assets or liabilities with other enterprise under conditions that are potentially favourable to the enterprise.

(iv) Definition of Financial Liability: Financial Liability is a contractual obligation to deliver cash or to exchange financial assets or financial liabilities with another enterprise under conditions which are potentially unfavourable to the enterprise.

It also includes contracts which may be settled in the enterprise's equity shares. Eg. Convertible debenture, convertible Preference share.

Fixed assets, stock, pre-paid expenses are not financial assets. Deferred incomes and warranty obligation are not financial liabilities

(v) Classification of financial assets: A financial assets has four classifications

- Held for trading: Financial assets at fair value through Profit & Loss.
- They are held for trading or they are designated as such. It includes derivatives also.
- Held to maturity: Assets with fixed maturity and the entity has a positive intention and ability to hold till maturity.
- Loans & receivables: Assets with fixed payments (determinable and which are not quoted in the market
- Available for sale: These & those assets which are not classified under the above 3 categories. (residual)

(vi) Classification of Financial Liabilities: They are of two types: - (a) Financial liability at fair value through profit & loss (Held for trading liabilities.) (b) Other liabilities

(vii) Regular way of purchase or sale of financial assets: A regular way of purchase or sale is a contract that requires delivery of the assets within the stipulated time fame.

(viii) Trade date accountings & settlement date accounting: A financial asset purchased or sold is accounted for on trade date is called trade date accounting if it is accounted for on settlement date then it is called settlement date accountings.

(ix) Accountings for financial assets at fair value through profit & loss: (held for trading)

(a) On the day of acquisition, the asset is recognized at fair values.
(b) The transaction costs are directly charged to the profit & loss account. (This is also applicable for interim financial statement.)
(c) On subsequent reporting dates they are measured at fair values. The difference is transferred to P/L A/c.
(d) On Disposal the assets will be de-recognised and the difference carrying amount & fair value at the date of sale is transfer to P/c A/c.
(e) No impairment test is required.
(f) Any change in the fair value between trade date & settlement date is recognized through profit & loss A/c.

3.10.1 Example for measurement of financial instruments

With the help of the following data prepare journal Entries in the form of

1. Use normal trade date accounting and
2. Use settlement date accounting

28.03.2022 – Purchase 100 share of `600/- each
31.03.2022 – Fair value `632/- each
04.04.2022 – Settlement date – Fair value `624/-.
22.04.2022 – Sold `690/- share (settled on the same date.)

1. **Use trade date accounting.**

Date	Particulars	Debit (Rs)	Credit (Rs)
28.03.2022	Investment A/c Dr. To, Liabilities A/c	60 000	60 000
31.03.2022	Investment A/c Dr. To, P/L A/c	3200	3200
04.04.2022	P/L A/c Dr. To, investment	800	800
	Liabilities A/c Dr. To, Bank A/c	60,000	60,000
22.04.2022	Bank A/c Dr. To, Investment A/c To, P/L A/c	69,000	62,400 6,600

2. **Use settlement date accounting.**

Date	Particulars	Debit (Rs)	Credit (Rs)
31.03.2022	Faire value adjustment A/c Dr. To, P/L A/c	3200	3200
04.04.2022	Investment A/c Dr. P/L A/c Dr To Faire value adjustment A/c	800	800
22.04.2022	Bank A/c Dr. To, Investment A/c To, P/L A/c	69,000	62,400 6,600

3.11 EXTERNAL REPORTING UNDER CAPITAL MARKET REGULATIONS & DISCLOSURES

In India Capital Markets are regulated by the Securities Exchange Board of India (SEBI). In view of enhancing the Corporate Governance in Corporate in India the SEBI introduced the Clause 49 of the Listing Agreement, which deals with the Corporate Governance and its applicability in Listed companies.

3.11.1 Corporate governance of listing agreement in India: Applicability of Clause 49 –

The Clause 49 of the Listing Agreement shall be applicable to all companies whose equity shares are listed on a recognized stock exchange. However, compliance with the provisions of Clause 49 shall not be mandatory, for the time being, in respect of the following class of companies:

(a) Companies having paid up equity share capital not exceeding `10 crore and Net Worth not exceeding `25 crore, as on the last day of the previous financial year; Provided that where the provisions of Clause 49 become applicable to a company at a later date, such company shall comply with the requirements of Clause 49 within six months from the date on which the provisions became applicable to the company.

(b) Companies whose equity share capital is listed exclusively on the SME and SME-ITP Platforms. The company agrees to comply with the provisions of Clause 49 which shall be implemented in a manner so as to achieve the objectives of the principles as mentioned below. In case of any ambiguity, the said provisions shall be interpreted and applied in alignment with the principles.

1. **The Rights of Shareholders:** The company should seek to protect and facilitate the exercise of shareholders' rights. The company should provide adequate and timely information to shareholders. The company should ensure equitable treatment of all shareholders, including minority and foreign shareholders.

2. **Role of stakeholders in Corporate Governance:** The company should recognise the rights of stakeholders and encourage cooperation between company and the stakeholders

3.12 DISCLOSURE AND TRANSPARENCY

The company should ensure timely and accurate disclosure on all material matters including the financial situation, performance, ownership, and governance of the company.

3.12.1 Responsibilities of the Board: Members of the Board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the company. The Board and top management should conduct themselves so as to meet the expectations of operational transparency to stakeholders while at the same time maintaining confidentiality of information in order to foster a culture for good decision-making.

3.12.2 Composition of Board: The Board of Directors of the company shall have an optimum combination of executive and nonexecutive directors with at least one-woman director and not less than fifty percent of the Board of Directors comprising non-executive directors. Where the Chairman of the Board is a non-executive director, at least one-third of the Board should comprise independent directors and in case the company does not have a regular non-executive Chairman, at least half of the Board should comprise independent directors. Provided that where the regular non-executive Chairman is a promoter of the company or is related to any promoter or person occupying management positions at the Board level or at one level below the Board, at least one-half of the Board of the company shall consist of independent directors

3.12.3 Independent Directors: For the purpose of the clause A, the expression 'independent director' shall mean a non-executive director, other than a nominee director of the company:

(a) who, in the opinion of the Board, is a person of integrity and possesses relevant expertise and experience;

(b) (i) who is or was not a promoter of the company or its holding, subsidiary or associate company;

(ii) who is not related to promoters or directors in the company, its holding, subsidiary or associate company;

(c) apart from receiving director's remuneration, has or had no material pecuniary relationship with the company, its holding, subsidiary or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year; (d) none of whose relatives has or had pecuniary relationship or transaction with the company, its holding, subsidiary or associate company, or their promoters, or directors, amounting to two per cent. or more of its gross turnover or total income or fifty lakh rupees or such higher amount as may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year;

3.12.4 Limit on number of directorships: A person shall not serve as an independent director in more than seven listed companies. Further, any person who is serving as a whole-time director in any listed company shall serve as an independent director in not more than three listed companies.

3.12.5 Maximum tenure of Independent Directors: The maximum tenure of Independent Directors shall be in accordance with the Companies Act, 2013 and clarifications/circulars issued by the Ministry of Corporate Affairs, in this regard, from time to time.

3.12.6 Non-executive Directors' compensation and disclosures: All fees / compensation, if any paid to non-executive directors, including independent directors, shall be fixed by the Board of Directors and shall require previous approval of shareholders in general meeting. The shareholders' resolution shall specify the limits for the maximum number of stock options that can be granted to non-executive directors, in any financial year and in aggregate.

Provided that the requirement of obtaining prior approval of shareholders in general meeting shall not apply to payment of sitting fees to non-executive directors, if made within the limits prescribed under the Companies Act, 2013 for payment of sitting fees without approval of the Central Government. Provided further that independent directors shall not be entitled to any stock option.

3.12.7 Audit Committee: Qualified and Independent Audit Committee A qualified and independent audit committee shall be set up, giving the terms of reference. The Audit Committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one third of the members of the audit committee whichever is greater, but there should be a minimum of two independent members present.

3.12.8 Nomination and Remuneration Committee: The company through its Board of Directors shall constitute the nomination and remuneration committee which shall comprise at least three directors, all of whom shall be non-executive directors and at least half shall be independent. Chairman of the committee shall be an independent director. Provided that the chairperson of the company (whether executive or nonexecutive) may be appointed as a member of the Nomination and Remuneration Committee but shall not chair such Committee.

3.12.9 Subsidiary Companies: At least one independent director on the Board of Directors of the holding company shall be a director on the Board of Directors of a material non-listed Indian subsidiary company.

3.12.10 Related Party Transactions: A related party transaction is a transfer of resources, services or obligations between a company and a related party, regardless of whether a price is charged.

3.12.11 Disclosures: Disclosure relating to –

A. Related Party Transactions
B. Disclosure of Accounting Treatment
C. Remuneration of Directors
D. Management
E. Shareholders
F. Proceeds from public issues, rights issue, preferential issues, etc.

3.13. CEO/CFO CERTIFICATION

The CEO or the Managing Director or manager or in their absence, a Whole Time Director appointed in terms of Companies Act, 2013 and the CFO shall certify to the Board that:

(i) They have reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief: 1. these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading; 2. these statements together present a true and fair view of the company's affairs and are in compliance with existing accounting standards, applicable laws and regulations.
(ii) There are, to the best of their knowledge and belief, no transactions entered into by the company during the year which are fraudulent, illegal or violative of the company's code of conduct.
(iii) They accept responsibility for establishing and maintaining internal controls for financial reporting and that they have evaluated the effectiveness of internal control systems of the company pertaining to financial reporting and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of such internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.
(iv) They have indicated to the auditors and the Audit committee: 1. significant changes in internal control over financial reporting during the year; 2. significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and 3. instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system over financial reporting.

3.14 REPORT ON CORPORATE GOVERNANCE

There shall be a separate section on Corporate Governance in the Annual Reports of company, with a detailed compliance report on Corporate Governance. Non- compliance of any mandatory requirement of this clause with reasons thereof and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted.

3.15 COMPLIANCE

The company shall obtain a certificate from either the auditors or practicing company secretaries regarding compliance of conditions of corporate governance as stipulated in this clause and annex the certificate with the directors' report, which is sent annually to all the shareholders of the company. The same certificate shall also be sent to the Stock Exchanges along with the annual report filed by the company.

3.16. SUMMARY

After studying this lesson students should be able to :The scope of the problems of financial reporting-Financial reporting – Some key points-Major problems and their solutions- Recent developments in Corporate Financial Reporting-Concept of Triple Bottom Line Reporting-Trend towards Triple Bottom Line Reporting-Global Reporting Initiative (GRI)-International Federation of Accounts (IFAC):-Reporting of Financial instruments and other external reporting-External Reporting under Capital Market Regulations & Disclosures-Disclosure and transparency-CEO/CFO certification-Report on Corporate Governance-Compliance

3.17. TECHNICAL TERMS

Global Reporting Initiative: GRI (Global Reporting Initiative) is the independent, international organization that helps businesses and other organizations take responsibility for their impacts, by providing them with the global common language to communicate those impacts.

International Federation of Accounts: The International Federation of Accountants (IFAC) is the global organization for the accountancy profession.

Triple Bottom Line: Triple bottom line theory expands conventional business success metrics to include an organization's contributions to social well-being, environmental health, and a just economy. These bottom line categories are often referred to as the three “P's”: people, planet, and prosperity.

Disclosure: Disclosure is the process of making facts or information known to the public. Proper disclosure by corporations is the act of making its customers, investors, and analysts aware of pertinent information.

Corporate Governance: Corporate governance is the system of rules, practices and processes by which a company is directed and controlled. Corporate Governance refers to the way in which companies are governed and to what purpose. It identifies who has power and accountability, and who makes decisions.

Compliance: Compliance is the state of being in accordance with established guidelines or specifications, or the process of becoming so. Software, for example, may be developed in compliance with specifications created by a standards body, and then deployed by user organizations in compliance with a vendor's licensing agreement.

3.18. SELF ASSESSMENT QUESTIONS

1. What is the scope of the problems of financial reporting?
2. Financial reporting – Some key points- explain.
3. What are the Major problems and their solutions in Financial Reporting?
4. Explain the Recent developments in Corporate Financial Reporting.
5. Explain the Concept of Triple Bottom Line Reporting.
6. Trend towards Triple Bottom Line Reporting- discuss.
7. What is Global Reporting Initiative (GRI)?
8. What is International Federation of Accounts (IFAC)?
9. Explain the Reporting of Financial instruments and other external reporting.
10. External Reporting under Capital Market Regulations & Disclosures- discuss.
11. What is Disclosure and transparency?
12. What is CEO/CFO certification?
13. Explain about Report on Corporate Governance.
14. What is Compliance?

3.19. SUGGESTED READINGS

1. RSN Pillai, Bagarathi & S. Uma, Fundamentals of Advanced Accounting, Vol.1, S. Chand, New Delhi.
2. Nehru J. Financial Reporting by diversified companies vision Books, New Delhi.
3. Hawkins David, Financial Statements Corporations Dow Jones – Irwin Homewood 1973.

Dr. KRISHNA BANANA

LESSON-4
FINANCIAL REPORTING AND ANNUAL REPORTS

AIMS AND OBJECTIVES

After studying this lesson students should be able to

- To know the concept of Post-Balance Sheet Events
- To understand Accounting procedure for ESOP
- To acquired knowledge on Employees' Stock Purchase Plans (ESPP)
- To obtain knowledge on Reporting through XBRL
- To knowledge on Stock Appreciation Rights (SAR)

STRUCTURE

4.1 Introduction
4.2 Statutory requirement and External report, disclosure of post balance sheet events
4.3 Post-Balance Sheet Events
4.4 Treatment for accounting
4.5 Share based payments in IND AS
4.6 Important definitions
4.7 Accounting procedure for ESOP
4.8 Employees' Stock Purchase Plans (ESPP)
4.9 Stock Appreciation Rights (SAR)
4.10 Disclosures of employee share-based payments
4.11 Voluntary disclosures
4.12 Reporting through XBRL
4.13 XBRL solves two significant issues
4.14 Users of XBRL
4.15 Advantages of using XBRL
4.16 XBRL and India
4.17 Other Organizations in India using XBRL
4.18 Summary
4.19 Technical Terms
4.20 Self Assessment Questions
4.21 Suggested Readings

4.1 INTRODUCTION

Annual reports are essential documents in financial reporting that provide a comprehensive overview of a company's financial performance and activities. They serve as a means of transparency, allowing stakeholders to assess the company's financial health, evaluate its strategic direction, and make informed decisions. Annual reports provide a platform for companies to communicate their financial performance, governance practices, and future prospects, fostering trust and accountability in the business community.

4.2 STATUTORY REQUIREMENT AND EXTERNAL REPORT, DISCLOSURE OF POST BALANCE SHEET EVENTS

The periodic financial statements are prepared on the basis of transactions and events that have occurred during the year. However, in order that the information is complete, information regarding any significant events or material transactions beyond the traditional accounts is essential. Accounting and reporting standards ensure that the information provided in the financial statements is as complete as possible. In this section a brief introduction of the Accounting Standard 4 Contingencies and Events occurring after the Balance Sheet Date, which ensures adequate disclosure of additional evidence of conditions existing at the balance sheet date acquired up to the date of publication of the financial statements.

The preparation of the annual financial statements can be a timely process in practice and usually takes around three or four months. Company law places a maximum time limit for publication of the financial statements Six months after the year end for companies.

During the period after the balance sheet date assets such as stock will be realised into debtors or cash or, alternatively, events may occur that significantly affect the position of the company and it is only fair to inform external users of the financial statements of any further information relevant to them regarding the items in the balance sheet at the year end. The additional information may relate to actual amounts in the balance sheet or to events that have taken place since the year end. To ensure this information is disclosed, preparers of financial statements must follow the requirements of Accounting Standard 4

4.3 POST-BALANCE SHEET EVENTS

a. Post-balance sheet events are those events, both favourable and unfavourable, which occur between the balance sheet date and the date on which the financial statements are approved by the board of directors.
b. Adjusting events are post-balance sheet events which provide additional evidence of conditions existing at the balance sheet date. They include events which because of statutory or conventional requirements are reflected in financial statements.
c. Non-adjusting events are post-balance sheet events which concern conditions which did not exist at the balance sheet date.
d. The date on which the financial statements are approved by the board of directors is the date the board of directors formally approves a set of documents as the financial statements.

4.4 TREATMENT FOR ACCOUNTING

Accounting Standard 4 gives the following accounting treatment in each case.

1. Adjust the financial statements if events after the balance sheet dale provide material evidence of conditions that existed at the balance sheet dale, adjusting events.

2. A material post-balance sheet event should be disclosed (by note) where it is a non-adjusting event of such materiality that its non-disclosure would affect the ability of users of financial statements to reach a proper understanding of the financial position.

3. Disclosure is also required for the reversal or maturity after the year end of a transaction entered into before the year end, the substance of which was primarily to alter the appearance of the company's balance sheet. (If such a transaction has an income effect, adjustment would be required, for example sales returns.)

4. Certain post-balance sheet events are adjusted for because of statutory requirements to include them in the accounts; for example, proposed dividends, amounts appropriated to reserve, effects of changes in tax and dividends receivable from subsidiary and associated companies.

Some examples of adjusting and non – adjusting events:

Adjusting	**Non - adjusting**
Subsequent determination of proceeds of sale of fixed assets purchased or sold before the year end.	Mergers/acquisitions after the year end.
Property valuation that provides evidence of a permanent diminution in value.	Reconstructions after the year end
Evidence re NRV < cost of stocks.	Issue of shares/debentures after the year end.
Evidence re inaccuracy of attributable profit calculations.	Purchase/sale of fixed assets after the year end
Insolvency of a debtor	Losses re fire/flood after the year end
Dividends receivable	Extension of activities after the year end
Receipt of information re rates of tax	Significant closure if this was not anticipated at the year end
Amounts received/receivable -re insurance claims that were in the course of negotiation	Decline in asset values if demonstrated to be after the year end.
Discovery of error or fraud.	Changes in exchange rates after the year end.
	Effect of nationalisation or strikes after the year end.
	Augmentation of pension benefits after the year end.

4.5 SHARE BASED PAYMENTS IN IND AS

Share-based payments are a common form of compensation used by companies to incentivize and retain employees, directors, and other service providers. These payments involve the issuance of equity instruments, such as shares or stock options, to individuals in exchange for their services. The accounting and reporting requirements for share-based payments are outlined in the Indian Accounting Standards (IND AS), specifically IND AS 102 - Share-based Payment.

1. IND AS 102 establishes principles for recognizing, measuring, and disclosing share-based payment transactions in the financial statements of companies. It applies to both listed and unlisted companies and requires them to account for share-based payment transactions based on their fair value.
2. Under IND AS 102, companies are required to recognize the fair value of share-based payment transactions as an expense over the vesting period, which is the period during which the recipient becomes entitled to the shares or options granted. This expense is typically recognized in the income statement and allocated to the relevant cost or expense category.
3. The fair value of share-based payments is determined at the grant date and takes into consideration factors such as the market price of the company's shares, exercise price of the options, expected volatility, expected life of the options, and other relevant variables. In cases where the fair value cannot be reliably estimated at the grant date, companies may use valuation techniques to determine a reasonable estimate.
4. IND AS 102 requires companies to disclose detailed information about share-based payment transactions in their financial statements. This includes disclosing the nature and terms of the share-based payment arrangements, the amounts recognized as an expense, the method used to determine the fair value, and the impact of share-based payments on key financial measures such as earnings per share.
5. The objective of IND AS 102 is to provide users of financial statements with relevant and reliable information about the company's share-based payment transactions. By recognizing the fair value of share-based payments as an expense, companies provide a more accurate representation of their financial performance and the true cost of compensating employees and service providers.
6. It is important for companies to comply with the requirements of IND AS 102 to ensure transparency and comparability in financial reporting. Share-based payments can have a significant impact on a company's financial statements and should be properly accounted for to provide stakeholders with a comprehensive view of the company's financial position and performance.
7. Overall, IND AS 102 establishes guidelines for the accounting and reporting of share-based payment transactions in India, ensuring that companies accurately reflect the costs associated with these compensation arrangements and provide stakeholders with relevant information to assess the company's financial performance and the impact of share-based payments on its operations.

4.6 IMPORTANT DEFINITIONS

1. Share-based payment arrangement

An agreement between an entity (or another group entity or a shareholder of a group entity) and another party (including an employee) which entitles the other party to receive:

- Equity instruments (including shares or share options) of the entity (or another group entity); or
- Cash (or other assets) for amounts based on the price (or value) of equity instruments of the entity (or another group entity), Provided specified vesting conditions (if any) are met. “Vest” means to become an entitlement. A party’s right to shares of an entity may be free or at a pre - arranged exercise price.

a. Share-based payment transaction
A transaction in a share-based payment arrangement in which the entity:
- Receives goods or services from a supplier (including an employee); or
- incurs an obligation (to the supplier) when another group entity receives those goods or services.

b. Equity instrument:

A contract that gives a residual interest in the assets of an entity after deducting all its liabilities.

c. Share option:

A contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed (or determinable) price for a specified period of time.

d. Types of Transactions

The Standard identifies three types of share-based payment transactions:
- Equity-settled share-based payment transactions;
- Cash-settled share-based payment transactions; and
- Share-based payment transactions with cash alternatives.

e. Equity-settled

The entity receives services:
- As consideration for its own equity instruments; or
- Has no obligation to settle the transaction with the supplier.

f. Cash settled

The entity acquires services by incurring liabilities for amounts that are based on the price (or value) of equity instruments of the entity or another group entity. Share-based payment transactions with cash alternatives Where an entity has a choice of issuing shares or paying cash then the entity shall recognize a liability if it determines that it has an obligation to settle the liability in cash. If on settlement the entity issues share rather than paying cash then the value of the liability should be transferred to equity.

Determination of fair value of equity instruments:

5.0 Employee share-based payments

Employee share-based payments refer to compensation arrangements where companies grant their employees equity instruments, such as shares or stock options, as part of their overall remuneration package. These arrangements are designed to align the interests of employees with those of the company's shareholders, providing them with a stake in the company's success and performance.Employee share-based payments can take various forms, including:

1. **Employee Stock Options (ESOs):** ESOs grant employees the right to purchase company shares at a predetermined exercise price within a specified period. The exercise price is typically set at the market price on the grant date or a discounted

price. Employees can exercise their options and acquire shares after satisfying certain vesting conditions, such as completing a specific period of service or achieving performance targets.

2. **Restricted Stock Units (RSUs):** RSUs entitle employees to receive company shares at no cost or a discounted price after a specified vesting period. Unlike stock options, RSUs are usually settled in shares rather than cash upon vesting.

3. **Employee Stock Purchase Plans (ESPPs):** ESPPs allow employees to purchase company shares at a discounted price through regular contributions from their salary or wages. ESPPs often have defined enrolment periods and eligibility criteria.

Two principal issues involved in accounting for employee share-based payments are:

1. Problem of valuation of share-based payments before vesting date and
2. Problem of allocation of the estimated value of share-based payment to a particular accounting period during the vesting period for recognition as expense.

4.7 ACCOUNTING PROCEDURE FOR ESOP

The amount recognized as expense in a period is debited to 'Employees' Compensation A/c' with a corresponding credit to an equity account called Stock Options Outstanding A/c'. The amount recognized as expense can be either the intrinsic value or fair value. The Stock Options Outstanding A/c' is transitional in nature as it gets ultimately transferred to another equity account such as share capital, securities premium account and/or general reserve at the time of settlement. Till such transfer, the credit balance of Stock Options Outstanding A/c is shown in balance sheet under a separate heading, between 'Share Capital' and 'Reserves and Surplus'.

The balance of Employees' Compensation A/c is transferred to the Profit & Loss A/c of the period. In case capitalization is justified, the balance of Employees' Compensation A/c is transferred to the concerned Asset A/c instead of the Profit & Loss A/c.

On exercise of the option, the enterprise issues share on receipt of the exercise price. The consideration for such shares comprises of the exercise price and the aggregate value of option recognized as expense, standing to the credit of Stock Options Outstanding A/c. In a situation where the right to obtain shares or stock options expires unexercised, the balance standing to the credit of the relevant equity account should be transferred to General Reserve.

4.8 EMPLOYEES' STOCK PURCHASE PLANS (ESPP)

Under these plans, employees are given an option to subscribe to shares of employer in a public issue or otherwise. The exercise price is set at a specified rate of discount on the issue price/ market price on the date of exercise. For example, a company may offer specified number of shares to its employees at 20% discount on market price on grant date. ESPP with option features is treated as ESOP. For example, consider a case where shares are offered to employees at 80% of market price. If employees have the option to pay either 80% of market price of shares on grant date or to pay 80% of market price on date of purchase, the plan is treated as ESOP rather than ESPP. The fair value of ESPP can be less than the discount due to post-vesting restrictions on transfers and similar other factors. The fair value of ESPP is recognized over the vesting period in the same way as ESOP.

4.9 STOCK APPRECIATION RIGHTS (SAR)

Stock Appreciation Rights (SAR) entitle the employees to claim cash payment to the extent of excess of market price of underlying shares on exercise date over the exercise price. Stock Appreciation Rights are not exercised if market price of underlying shares on exercise date is less than the exercise price. SAR is therefore a call option held by employees. The employer recognizes the value of call as expense over the vesting period. The accounting procedures for ESOP and SAR are similar except that: (i) The liability for SAR is recognized as Provision instead of ESOP Outstanding and (ii) value per option is reassessed at each reporting date.

4.10 DISCLOSURES OF EMPLOYEE SHARE BASED PAYMENTS

The Guidance Note on Accounting for Employee Share-based Payments issued by The Institute of Chartered Accountants of India requires enterprises to disclose the following in respect of such payments:

1. Method used to account for the employee share-based payment plans. Where an enterprise uses the intrinsic value method, it should also disclose the impact on the net results and EPS- both basic and diluted –for the accounting period, had the fair value method been used.
2. Information that enables users of the financial statements to understand the nature and extent of employee share-based payment plans that existed during the period. In particular, it should disclose:

(a) A description of each type of employee share-based payment plan that existed at any time during the period, including the general terms and conditions of each plan, such as vesting requirement, the maximum term of options granted, and the method of settlement (e.g., whether in cash or equity).

(b) The number and weighted average exercise prices of stock options for each of the following groups of options:

(i) Outstanding at the beginning of the period:
(ii) Granted during the period;
(iii) Forfeited during the period;
(iv) Exercised during the period;
(v) Expired during the period;
(vi) Outstanding at the end of the period; and
(vii) Exercisable at the end of the period

(c) For stock options exercised during the period, the weighted average share price at the date of exercise. If options were exercised on a regular basis throughout the period, the enterprise may instead disclose the weighted average share price during the period.

(d) For stock options outstanding at the end of the period, the range of exercise prices and weighted average remaining contractual life (comprising the vesting period and the exercise period). If the range of exercise prices is wide, the outstanding options should be divided into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received upon exercise of those options.

4.11 VOLUNTARY DISCLOSURES

In today's complex and dynamic business environment, transparency and accountability have become essential for companies to gain the trust and confidence of stakeholders. Voluntary disclosures play a crucial role in enhancing transparency by providing additional information beyond what is required by mandatory reporting standards. This essay explores the concept of voluntary disclosures, their significance, and their impact on stakeholders and the overall business landscape.

Voluntary disclosures refer to the act of companies sharing information with stakeholders that is not legally mandated but is provided willingly to enhance transparency and provide a more comprehensive view of the company's operations, performance, and risks. These disclosures can take various forms, such as narrative explanations, supplementary reports, non-financial information, and forward-looking statements.

The significance of voluntary disclosures lies in their ability to provide stakeholders with a deeper understanding of a company's activities, strategies, risks, and future prospects. By going beyond the mandatory financial reporting requirements, companies demonstrate their commitment to transparency, accountability, and open communication with stakeholders. Voluntary disclosures allow companies to address issues that are not captured by traditional financial statements alone, such as environmental and social impacts, governance practices, and long-term sustainability.

There are several key benefits of voluntary disclosures. Firstly, they enable stakeholders to make informed decisions and assess the company's performance and value creation potential more accurately. Investors can gain insights into the company's strategic direction, risk management practices, and growth opportunities, leading to better investment decisions. Customers, suppliers, and employees can evaluate a company's ethical standards, social responsibility, and alignment with their own values, facilitating more informed business relationships.

Secondly, voluntary disclosures can help companies build and maintain trust with stakeholders. By voluntarily providing information, companies demonstrate transparency and a commitment to open communication. This fosters trust, as stakeholders perceive the company as proactive and responsible. Trust is particularly crucial in today's environment, where corporate scandals and ethical breaches have eroded stakeholder confidence.

Thirdly, voluntary disclosures can contribute to the overall improvement of business practices. By sharing information on environmental, social, and governance (ESG) factors, companies encourage responsible business behaviors. They also promote the adoption of best practices, as voluntary disclosures often include benchmarking against industry standards or relevant frameworks.

However, there are challenges associated with voluntary disclosures. Companies must carefully balance the need for transparency with the risk of disclosing sensitive or proprietary information that could be misused by competitors. They must also consider the costs and resources required to gather, analyze, and report additional information beyond what is legally required.

In recent years, the demand for voluntary disclosures has increased significantly. Stakeholders, including investors, customers, employees, and regulators, are increasingly demanding greater transparency and accountability from companies. They expect companies to disclose information on ESG factors, corporate governance practices, supply chain management, cybersecurity, and other non-financial risks.

Voluntary disclosure practices have also been influenced by the emergence of reporting frameworks and standards. Initiatives such as the Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB), and Task Force on Climate-related Financial Disclosures (TCFD) have provided guidance on reporting non-financial information and encouraged companies to adopt consistent and comparable reporting practices.

In conclusion, voluntary disclosures play a vital role in enhancing transparency, accountability, and trust between companies and their stakeholders. By providing additional information beyond mandatory reporting requirements, companies can address stakeholder expectations, demonstrate responsible business practices, and gain a competitive edge. Voluntary disclosures contribute to informed decision-making, improved business practices, and the overall sustainability and success of companies in today's complex and interconnected world.

4.12 REPORTING THROUGH XBRL

XBRL stands for e**x**tensible **B**usiness **R**eporting **L**anguage. It is one of a family of “XML” languages which is becoming a standard means of communicating information between businesses and on the internet. XBRL provides major benefits in the preparation, analysis and communication of business information and is fast becoming an accepted reporting language globally. It offers major benefits to all those who have to create, transmit, use or analyse such information.

4.12.1 Meaning of XBRL:

(a) **Extensible:** means the user can extend the application of a particular business data beyond its original intended purpose and the major advantage is that the extended use can be determined even by the users and not just the ones who merely prepare the business data. This is achieved by adding tags which are both human and machine readable – describing what the data is. The property of extensibility is very handy in situations when list of items reported for various elements of the financial statements are not the same across firms, industries, and countries. For example, many of item constituting non-current assets in Oil and Gas Industry (items like rigs, exploratory oil and gas wells) may not be applicable to companies in general. In a situation of this kind, XBRL may prepare a taxonomy called a ‘Global Common Document’ (GCD) for items common to all the firms, industries, and countries, and, any country specific, industry specific and firm-specific variations (extensions / limitations) can, then, be written as independent taxonomies that can be imported and incorporated with the GCD.

(b) **Business:** means relevant to the type of business transaction. XBRL focus is on describing the financial statements for both public and private companies.

(c) **Reporting:** the intention behind promoting use of XBRL is to have all companies report their financial statements in a consolidated manner using the specified formats.

(d) **Language:** XBRL is based on XML, which prescribes the manner in which the data can be "marked-up" or "tagged" to make it more meaningful to human readers as well as to computers-based system

4.12.2 Potential XBRL applications:

1. XBRL for Financial Statements - financial statements of all sorts used to exchange financial information.
2. XBRL for Taxes -specification for tax returns which are filed and information exchanged for items which end up on tax returns.
3. XBRL for Regulatory Filings – specifications for the large number of filings required by government and regulatory bodies.
4. XBRL for Accounting and Business Reports - management and accounting reporting such as all the reports that are created by your accounting system rendered in XML to make re-using them possible.
5. XBRL for Authoritative Literature - a standard way for describing accounting related authoritative literature published by the AICPA, FASB, ASB, and others to make using these resources easier, "drill downs" into literature from financials possible.

There is a dramatic improvement in processing of Financial Statements as XBRL documents can be prepared efficiently, extracted reliably, published more easily, analyzed quickly, retrieved by investors simply, and enables smarter investments.

4.13 XBRL SOLVES TWO SIGNIFICANT ISSUES

The first issue is that preparing a financial statement for printing, for a Web site, and for filing today means that a company could typically enter information three times. With XBRL, information will be entered once and the same information will be "rendered" as a printed financial statement, an HTML document for a Web site, an EDGAR (Electronic Data Gathering, Analysis, Retrieval) filing file, a raw XML file, or a specialized reporting format such as periodic banking and other regulatory reports.

The second issue is that earlier, extracting specified detailed information from a financial statement, even an electronic financial statement like a regulatory filing, was a manual process. For example, a company cannot tell a computer program to "Get the prepaid expenses for 2008" from an electronic financial statement. If a financial statement is prepared using XBRL, computer programs can easily extract every piece of information in that statement.

4.14 USERS OF XBRL

(A) Corporations: Since XBRL was designed to handle corporate financial information, it logically follows that corporations would be one of the primary users. These days most major corporations provide some sort of company financial information via the Internet. Both the corporations providing this information and the investors who are receiving it need an easy way to do so. XBRL provides a method via which financial information can be delivered to end users quickly and easily. The main benefit to the corporation is that the information can be entered once and maintained in a standard format. Required forms and documents can then be automatically generated from the XBRL formatted document.

This prevents the duplication of financial data and thereby helps prevent errors and inconsistencies.

(B) Investors, Accountants and other users of Corporate Financial Data: Having a standardized and machine-readable format is invaluable to consumers of corporate financial information. XBRL provides just such a format. Without it, consumers of the data would be stuck trying to negotiate a format for a data feed with each corporation they wished to receive data from or would be forced to manually enter data obtained from a non-machine-readable source. In addition to the lessening the time and expense involved with either of the alternatives, XBRL also helps prevent the errors they can cause. By having a standardized format, developers can share code designed to read XBRL or purchase tools with XBRL support built in. On top of preventing errors, being able to use previously tested XBRL tools also increases productivity and brings the data to those who might otherwise not have the time, money, know-how to retrieve it on their own.

4.15 ADVANTAGES OF USING XBRL

XBRL (eXtensible Business Reporting Language) is a standardized computer language designed for financial reporting and analysis. It offers numerous advantages to companies, regulators, and users of financial information. Here are some of the key advantages of using XBRL:

1. **Enhanced Accuracy and Efficiency:** XBRL improves the accuracy and efficiency of financial reporting by automating the process of data collection, analysis, and presentation. It eliminates the need for manual data entry and reduces the risk of errors and inconsistencies. By using XBRL, companies can streamline their reporting processes, save time, and allocate resources to more value-added activities.
2. **Improved Comparability and Consistency:** XBRL enables the standardized representation of financial information, making it easier to compare and analyze data across different companies, industries, and jurisdictions. It provides a common language for reporting financial data, ensuring consistency and facilitating meaningful comparisons. Users of financial information can analyze data more efficiently and make informed decisions based on reliable and comparable data.
3. **Facilitates Regulatory Compliance:** XBRL simplifies regulatory compliance by enabling companies to structure and tag financial data according to specific reporting requirements. Regulators can easily collect, validate, and analyze financial information in a consistent and efficient manner. XBRL also enhances transparency and reduces the regulatory burden by providing access to detailed and granular financial data.
4. **Enables Data Reusability:** XBRL promotes data reusability by allowing companies to tag financial information once and reuse it for multiple reporting purposes. Companies can use XBRL-tagged data for various internal and external reporting requirements, such as financial statements, tax filings, and regulatory submissions. This reduces redundancy, enhances data integrity, and improves the efficiency of data management processes.
5. **Simplifies Financial Analysis and Decision-Making:** XBRL facilitates financial analysis and decision-making by providing structured and machine-readable data. Users can import XBRL data into analysis tools and perform detailed analysis, such as ratio analysis, trend analysis, and benchmarking. XBRL also enables the integration of financial data with other systems, such as enterprise resource planning (ERP)

systems, enabling seamless data exchange and enhancing decision-making capabilities.

6. **Enhances Investor Relations and Transparency:** XBRL promotes transparency and enhances investor relations by providing more detailed and accessible financial information. Investors can access XBRL-tagged financial data and perform in-depth analysis to make informed investment decisions. XBRL also enables companies to communicate financial information more effectively, increasing stakeholder trust and confidence.
7. **Supports Emerging Technologies and Innovations:** XBRL is compatible with emerging technologies such as artificial intelligence (AI), machine learning, and big data analytics. It provides a foundation for advanced data analytics and supports the development of innovative financial reporting and analysis tools. XBRL data can be integrated with other data sources to unlock valuable insights and drive business intelligence.

In conclusion, XBRL offers numerous advantages in financial reporting and analysis. It improves accuracy, efficiency, comparability, and consistency of financial information. It simplifies regulatory compliance, enhances transparency, and supports data reusability. By using XBRL, companies can streamline their reporting processes, improve data quality, and enable more informed decision-making.

4.16 XBRL AND INDIA

The development of XBRL technology in India started mainly around the period 2005-07. India is probably the first among developing countries to introduce XBRL standard in its reporting system. XBRL India is the provisional jurisdiction of XBRL International and is facilitated by the Institute of Chartered Accountants of India (ICAI). XBRL India is governed by a Steering Committee which is headed by the President, ICAI.

4.16.1 Its objectives are:

- To promote and encourage the adoption of XBRL in India as the standard for electronic business reporting in India
- To facilitate education and marketing of XBRL
- To develop and manage XBRL taxonomies
- To keep the developed XBRL taxonomies updated with regard to international developments
- To represent Indian interests within XBRL International
- To contribute to the international development of XBRL

XBRL India has developed Draft General Purpose Financial Reporting XBRL taxonomy for Commercial and Industrial Companies. This taxonomy covers the financial statements like Balance Sheet, Statement of Profit and Loss, and Cash Flow Statement and related non-financial information. The draft taxonomy has been developed conforming to Indian Accounting Standards and Company Law. XBRL India is currently developing XBRL Taxonomy for the Banking Sector

4.17 OTHER ORGANIZATIONS IN INDIA USING XBRL

1. Members of XBRL India among others include regulators such as Reserve Bank of India (RBI), Insurance Regulatory and Development Authority (IRDA), Securities

and Exchange Board of India (SEBI), Ministry of Corporate Affairs (MCA), stock exchanges like Bombay Stock Exchange Limited (BSE) and National Stock Exchange of India Limited (NSE), and some private sector companies.

2. Both leading stock exchanges of India, BSE and NSE have migrated to XBRL from the paper-based model and offer a unified electronic platform, popularly known as ‘Corp Filing’ system, which enables the companies listed in either or both of the exchanges to electronically file their disclosures. Approximately 100 top companies of India are using Corp Filing XBRL platform for filing mandatory information. BSE has played an important role in the initiation of XBRL reporting platform in India and was the first one to formally adopt XBRL in the country.
3. To attune to the new XBRL based reporting standards, legal and regulatory changes are required. SEBI has thus issued a mandate for select companies to submit their Financial Statements through the Corporate Filing and Dissemination System (CFDS) starting in the first phase in 2008.
4. Recently, RBI has also moved to XBRL based electronic filing system for the Basel II Reporting by Banks, wherein banks are required to submit their returns for capital adequacy returns data through the existing Online Return Filing System (ORFS). Banks are now upgrading to Core.
5. Banking Solution (CBS) and also sprucing up their internal Management Information Systems (MIS), which will create a platform for the implementation of XBRL solutions.
6. Ministry of Corporate Affairs [MCA] is planning to use extensible business reporting language (XBRL) in an effort to work closely with SEBI and RBI, which are also migrating to XBRL. While MCA maintains a database of all registered companies, SEBI deals with listed firms and RBI with banks and non-banking finance companies. “Through e-filing, MCA has obtained a mass database which is available in public domain. So far, its use is restricted to getting information on companies. But this data can be productively used for examining and analysing the direction in which companies are moving. XBRL, combined with a sophisticated technology, will further support these objectives.

4.18 SUMMARY

After studying this lesson students should be able to : know the concept of Post-Balance Sheet Events-To understand Accounting procedure for ESOP-To acquired knowledge on Employees’ Stock Purchase Plans (ESPP)-To obtain knowledge on Reporting through XBRL-To knowledge on Stock Appreciation Rights (SAR). In addition to that this lesson is revealed about some more information to the student that Statutory requirement and External report, disclosure of post balance sheet events, Treatment for accounting, Share based payments in IND AS, Accounting procedure for ESOP, Disclosures of employee share-based payments, Voluntary disclosure, XBRL solves two significant issues, Users of XBRL, Advantages of using XBRL, XBRL and India and Other Organizations in India using XBRL.

4.19 TECHNICAL TERMS

Stock Appreciation Rights (SAR): Stock appreciation rights (SAR) is a method for companies to give their management or employees a bonus if the company performs well financially. Such a method is called a 'plan'. SARs resemble employee stock options in that the holder/employee benefits from an increase in stock price.

Voluntary disclosures: Voluntary disclosure is financial or operating information related to an issuer's obligations, credit, or operating conditions that an issuer chooses to provide in addition to information required by the issuer's Continuing Disclosure Agreements.

XBRL: XBRL stands for eXtensible Business Reporting Language. It is a language for the electronic communication of business and financial data worldwide. As one of the family of "XML" languages, it is becoming a standard means of communicating information between businesses and on the Internet.

ESOP: The ESOP full form is the Employee Stock Ownership Plans. It is essentially a type of incentive or compensation plan in which you, as an employee of any organization, have the option to earn equity from your company over a set period. An ESOP is an employee benefit plan that enables employees to own part or all of the company they work for. ESOPs are most commonly used to facilitate succession planning, allowing a company owner to sell his or her. Shares and transition flexibly out of the business.

4.20 SELF ASSESSMENT QUESTIONS

1. What is statutory requirement and External report, disclosure of post balance sheet events?
2. What are Post-Balance Sheet Events?
3. Explain Share based payments in IND AS.
4. What is Accounting procedure for ESOP?
5. What is Employees’ Stock Purchase Plans (ESPP)?
6. What is the meaning of Stock Appreciation Rights (SAR)?
7. Explain about Disclosures of employee share-based payments
8. What are Voluntary disclosures?
9. Explain about Reporting through XBRL.
10. XBRL solves two significant issues
11. What are the Users of XBRL? And Advantages of using XBRL?
12. XBRL and India -discuss.
13. What are the Other Organizations in India using XBRL?

4.21. SUGGESTED READINGS

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LESSON-5
CORPORATE RESTRUCTURING

AIMS AND OBJECTIVES

After studying this unit, you should be able to:

- To understanding the concept of corporate restructuring, historical background and emerging trends in corporate restructuring, etc.,
- To know the need and scope of corporate restructuring.
- To acquire knowledge of legal, procedural and practical aspects of corporate restructuring;
- To assess different modes of corporate restructuring.

STRUCTURE

5.1. Introduction
5.2. Meaning of Corporate Restructuring
5.3. Overview of Corporate Restructuring in India
5.4. Need and Scope Restructuring
5.5. Legal procedures of Corporate Restructuring
5.6. Various Modes of Restructuring
5.7. Practical Illustrations
5.8. Summary
5.9. Technical Terms
5.10. Self Assessment Question
5.11. Suggested Readings

5.1. INTRODUCTION

The business environment is rapidly changing with respect to technology, competition, products, people, geographical area, markets, and customers. It is not enough if companies keep pace with these changes but are expected to beat competition and innovate in order to continuously maximize shareholder value. Inorganic growth strategies like mergers, acquisitions, takeovers and spinoffs are regarded as important engines that help companies to enter new markets, expand customer base, cut competition, consolidate and grow in size quickly, employ new technology with respect to products, people and processes. Thus, the inorganic growth strategies are regarded as fast track corporate restructuring strategies for growth.

5.2. WHAT IS CORPORATE RESTRUCTURING?

Restructuring as per Oxford Dictionary means “to give a new structure to, rebuild or rearrange". Corporate restructuring is also referred to as business restructuring. Business restructuring is a process in which an entity changes its legal structure to ensure the seamless running of the business. This process is usually carried out when the business is facing financial or economic problems. When a company is unable to pay a corporate debt, it enters into a restructuring agreement with its lenders. In this agreement, the company's strategy to pay the corporate debt would be mentioned. Creditors and Lenders are an essential part of the corporate restructuring process.

A company's inability to not pay a corporate debt is not only reason for corporate restructuring. Other reasons can be a company entering into an acquisition agreement, or a joint venture or Merger & Acquisition process.

5.3. OVERVIEW OF CORPORATE RESTRUCTURING IN INDIA

In earlier years, India was a highly regulated economy. Though Government participation was overwhelming, the economy was controlled in a centralized way by Government participation and intervention. In other words, economy was closed as economic forces such as demand and supply were not allowed to have a full fledged liberty to rule the market. There was no scope of realignments and everything was controlled. In such a scenario, the scope and mode of Corporate Restructuring were very limited due to restrictive government policies and rigid regulatory framework. These restrictions remained in vogue, practically, for over two decades. These, however, proved incompatible with the economic system in keeping pace with the global economic developments if the objective of faster economic growth were to be achieved. The Government had to review its entire policy framework and under the economic liberalization measures removed the above restrictions by omitting the relevant sections and provisions.

The real opening up of the economy started with the Industrial Policy, 1991 whereby 'continuity with change' was emphasized and main thrust was on relaxations in industrial licensing, foreign investments, transfer of foreign technology etc. With the economic liberalization, globalization and opening up of economies, the Indian corporate sector started restructuring to meet the opportunities and challenges of competition. The economic and liberalization reforms, have transformed the business scenario all over the world. The most significant development has been the integration of national economy with 'market-oriented globalized economy'. The multilateral trade agenda and the World Trade Organization (WTO) have been facilitating easy and free flow of technology, capital and expertise across the globe. A restructuring wave is sweeping the corporate sector the world over, taking within its fold both big and small entities, comprising old economy businesses, conglomerates and new economy companies and even the infrastructure and service sector.

From banking to oil exploration and telecommunication to power generation, petrochemicals to aviation, companies are coming together as never before. Not only this new industries like e-commerce and biotechnology have been exploding and old industries are being transformed. With the increasing competition and the economy, heading towards globalisation, the corporate restructuring activities are expected to occur at a much larger scale than at any time in the past. Corporate Restructuring play a major role in enabling enterprises to achieve economies of scale, global competitiveness, right size, and a host of other benefits including reduction of cost of operations and administration.

5.4. NEED AND SCOPE OF CORPORATE RESTRUCTURING

Corporate Restructuring is carried out when a company requires restructuring its business to perform well in the market. There are specific benefits of restructuring:

- It helps the company bring out new strategies to survive in a competitive environment.
- When a company is facing financial stress, corporate restructuring procedures are used to change the financial strategy. Using this strategy, the company can reduce its financial burden.
- Cash flow is one of the major requirements for a company to survive in the market. Without cash flow, a company will not pay its employees, suppliers, and third parties. Hence a company utilizes different forms of restructuring strategies to ensure there is sufficient cash flow and does not lead to business disruption.
- Corporate Restructuring occurs when a company wants to restructure its debts and finances. When a company is being acquired or merged with another company, restructuring happens as a result of the acquisition of assets, IP, and employees of the other business. Through this process, the company can enjoy the benefits of synergies from different departments.
- The restructuring also helps in improving the economies of scale and scope for a business entity.

5.5. LEGAL PROCEDURES OF CORPORATE RESTRUCTURING

The following laws would be governing in corporate restructuring:

- Companies Act 2013 or Companies Act 1956- Section 233 (of the CA 2013) deals with the process in which companies can opt for a fast-track merger.
- Insolvency and Bankruptcy Code, 2016- When speaking about debt restructuring and financial restructuring, the IBC code deals with the aspects of resolution and liquidation.
- SEBI (Securities Exchange Board of India) Laws -When a company wants to go for a reverse merger or list its securities within a stock exchange in India.

Procedure for Restructuring

Restructuring an organization is a complex task. The form of restructuring would depend on the main aims of the organization. If the company is paying off a debt, then a different restructuring process will be used. If a company is going to be merged with another organization, then the criteria would be different. The following steps have to be followed in a restructuring process:

Determination: In this phase, the main objective of the restructuring exercise is determined. If the restructuring process involves paying a corporate debt, then the debt restructuring procedure can be used. At Enterslice, professionals will determine your business's needs and guide to carry the proper procedure to restructure your business.

Identification: To help the organization identify the strengths and weaknesses. Through thorough research, to establish the need to concentrate on improving the business's strengths.

Implementation: Once we analyze the business's strengths, to implement the procedure with the collective strengths of the business. While carrying out this process, to identify potential problems that can be addressed at an early stage in the restructuring process.

Post-Implementation Analysis: To conduct a broad-based analysis of the restructuring exercise and understand the effects.

Evaluation of Restructuring: In the last step, monitor the organization and provide post-compliance reporting.

5.6. VARIOUS TYPES OF STRATEGIC CORPORATE RESTRUCTURING

- **Financial Restructuring-** Financial restructuring is a form of corporate restructuring strategy which is usually considered when companies merge or get acquired by another company. In this form of Restructuring, often, companies do not face any financial problems. The company is restructured as a result of a share sale or an asset sale in an acquisition. In a share sale, the entire share capital of the company is acquired. In an asset sale, only a specific asset is obtained from the selling company. Financial restructuring can also occur during an M&A process.
- **Debt Restructuring-** Debt restructuring is usually used by a company to change its strategy to pay off a debt. A company may restructure its business, divest a particular subsidiary of the parent company, or raise additional capital to pay off a debt. A creditor or lender would typically allow the company to restructure itself when they have to repay a debt. In this form of restructuring, the parties would enter into an agreement that would bind the company's debtors. The amount of Non-Performing Assets (NPAs) and bad debts has made the government bring in the IBC. Due to this code, the number of bad debts has drastically reduced.

Based on the type of situation, corporate restructuring can be divided into financial restructuring and debt restructuring. However, the types of strategic corporate restructuring which companies enter into are as follows:

Mergers

Mergers are understood as a combination of two or more corporate entities. The principal reason for a merger is to enjoy economies of scale and economies of scope. In this form of corporate restructuring, the companies or organizations enter into a merger agreement, where the terms and conditions of the merger are decided. There are lots of complex formalities in the merger process. Expert advice from a transaction specialist is required in this process. At Enterslice, we have experienced M & A experts who can advise you throughout the process. A company merges with another company, just to improve its business. Apart from this, there are different forms of mergers:

a) Horizontal Merger- Horizontal merger is a process in which two companies are operating in the same levels of a production merge.

b) Vertical Merger- Vertical merger is a process where companies merge who are in different phases of the production cycle.

c) Conglomerate Merger- Conglomerate merger is a process in which companies in different business merge.

d) Cash Merger- A cash merger is a process in which one of the companies acquires the other company for a specific amount of cash.

Private Acquisitions

A private acquisition is a process when a company acquires another company. This process is also known as a takeover. A takeover process can be either a friendly takeover or a hostile takeover. In this transaction, there are three parties. The parties are the buyer, seller, and the target company. Private acquisitions normally occur due to increased benefits such as synergies, economies of scale, and economies of scope. The acquisition process is complex and requires expert advice. Our professionals at Enterslice will ensure that you face seamless corporate restructuring services in an acquisition process. There are two forms of acquisitions.

Share

This is normally referred to as a share sale. In a share sale, the buyer acquires the entire share capital or a portion of the share capital of the seller or the target company. When a company is acquired as a result of a share sale, all assets and liabilities are transferred to the buyer.

Asset

This is usually referred to as an asset sale. In an asset sale, the buyer has the advantage of acquiring a specific asset. Hence through this process, the buyer can cherry-pick the assets of a company. One of the advantages of an asset sale is the buyer can leave the liabilities with the seller and only purchase the important assets of the target company.

Divestment

Divestment is a process in which a company sells off its subsidiary. Through the process of divestment, the company can reduce the number of debts. This type of strategic corporate restructuring is used in financial restructuring processes as well as debt restructuring processes. In the divestment process, the parent company will usually liquidate or wind up the subsidiary company's operations.

Demerger

This is a form of restructuring where the company divides into two separate groups. In this process, the synergies which are earlier enjoyed by the two entities are divided. A company demerges due to restructuring, reducing the financial burden, and other factors. Optimum capacity is reduced through the demerger's process, making the company produce the required amount of profits to run the business.

Reverse Merger

In a reverse merger, the private company gets different forms of benefits. A public company acquires a private company in a reverse merger. Due to this, the private company does not need to go through the entire process for applying its shares to be listed in a stock exchange. This form of corporate restructuring is to improve the private company's business without going through the entire process of applying for an initial public offering.

Strategic Partnership/Alliance

Strategic Partnership is also known as an alliance. In a strategic partnership, the companies partner to carry out business. However, a strategic partnership is effectuated through one or more contracts. The partnership is binding on the parties. However, a strategic partnership does not have the effect of a normal partnership or a registered company. A strategic partnership must be differentiated from a joint venture. In a joint venture, two or more companies agree to share profits for a particular period or until the project's execution. Once the period is over, the parties can resume carrying out their businesses.

5.7. PRACTICAL ILLUSTRATIONS

Accounting Entries in the Books of Transferor Company:

The books of the transferor company being wound up will be closed in the same way as the books of a partnership firm being dissolved. The following entries are made:

1. For transferring assets taken over by the transferee company.

Realisation Account Dr.	XX	
To Various Assets (individually) (at book value)		XX

2. For transferring liabilities taken over by the transferee company

Various Liabilities (individually) A/c Dr.	XX	

To Realisation Account XX

3. For purchase consideration
   Transferee Company A/c Dr. XX
   To Realisation Account XX

4. For receiving purchase consideration from the transferee company
   Bank A/c Dr. XX
   Shares in Transferee Company A/c Dr. XX
   To Transferee Company's A/c XX

5. For assets sold by the transferor company which are not taken over by the transferee company
   Bank A/c Dr. XX
   Realisation A/c (if loss on sale of assets) A/c Dr. XX
   To Assets A/c XX
   To Realisation A/c (if profit on sale of assets) XX

6. For liquidation expenses
   (a) If the expenses are to be met by the transferor company
   Realisation A/c Dr. XX
   To Bank A/c XX
   (b) If the expenses are to be met by the transferee company
   Transferee Company's A/c Dr. XX
   To Bank A/c XX

   Bank A/c Dr. XX
   To Transferee Company's A/c XX

7. For liabilities not taken over by the transferee company when paid by the transferor company
   Various Liabilities A/c Dr. XX
   Realisation A/c (if excess payment is made) Dr. XX
   To Bank A/c XX
   To Shares in Transferee Company A/c XX
   To Realisation A/c (if less payment is made) XX

8. For closing Realisation Account
   (a) If profit
   Realisation A/c Dr. XX
   To Equity Shareholders A/c XX
   (b) If loss
   Equity Shareholders A/c Dr. XX
   To Realisation A/c XX

9. For transferring preference share capital
   Preference Share Capital A/c Dr. XX
   To Preference Shareholders A/c XX

10. For transferring equity share capital and accumulated profits

Equity Share Capital A/c	Dr.		XX	
General Reserve A/c	Dr.		XX	
Debentures Redemption Fund A/c	Dr.		XX	
Dividend Equalisation Reserve A/c	Dr.		XX	
Securities Premium A/c		Dr.		XX
Profit & Loss A/c	Dr.		XX	
Accident Compensation Fund A/c	Dr.		XX	
Shares Forfeited A/c	Dr.		XX	
Profit prior to incorporation A/c		Dr.		XX
Any other reserve fund A/c	Dr.		XX	
To Equity Shareholders A/c				XX

11. For transferring accumulated losses and expenses not written-off

Equity Shareholders A/c	Dr.		XX	
To Profit & Loss A/c			XX	
To Discount or Expenses on Issue of Shares/Debentures				XX
To Preliminary Expenses			XX	
To Underwriting Commission				XX

12. For paying to shareholders

Preference Shareholders A/c	Dr.		XX	
Equity Shareholders A/c		Dr.		XX
To Bank/Shares in Transferee Company				XX

Accounting Entries in the Books of Transferee Company:

Accounting in the books of the Transferee Company is to be done with reference to Accounting Standard (AS) -14. The accounting procedure will differ depending upon the type of amalgamation. There are two main methods of accounting for amalgamation in the books of the transferee company:

(a) The Pooling of Interests Method, and
(b) The Purchasing Method.

(a) **The Pooling of Interests Method**: This method is applicable in case of amalgamation in the nature of merger. In this case, the amalgamation is accounted for as if separate business of amalgamated companies were intended to be carried on by the transferee company. This is why only minimum changes are made in aggregating the individual financial statements of the transferor company.

The following journal entries are to be passed in the books of the transferee company for incorporating the financial statements of the transferor company:

(1) On amalgamation of business

Business Purchase A/c	Dr.	XX	
To Liquidators of the Transferor Co.			XX

(2) For recording assets and liabilities taken over

Sundry Assets (Individually) A/c	Dr.	XX		
To Sundry Liabilities A/c			XX	
To Reserve A/c				XX
To Business Purchase A/c			XX	

(3) For making payment to the liquidators of the transferor company

Liquidators of the Transferor Co. A/c	Dr.	XX	
To Bank/Share Capital/Securities Premium A/c			XX

(4) If liquidation expenses are paid by the transferee company

General Reserve or Profit & Loss A/c Dr. XX
To Bank A/c XX

(5) For the formation expenses of the transferee company
Preliminary Expenses A/c Dr. XX
To Bank A/c XX

Illustration-1: A Ltd. and B Ltd. were amalgamated on and from 1st April, 2019. A new company AB Ltd. was formed to take over the business of existing companies. The balance sheet of A Ltd. and B Ltd. as on 31st March, 2019 are given below:

Equity & Liabilities	A Ltd. Rs. ('000)	B Ltd. Rs. ('000)	Assets	A Ltd. Rs. ('000)	B Ltd. Rs. ('000)
Share Capital: Equity Shares of Rs.10 each	2,400	1,600	Fixed Assets **Less**: Depreciation	4,800 800	3,200 600
12% Preference Shares of Rs.100 each	1,200	800		4,000	2,600
Reserve and Surplus: Capital Reserve	800	600	Investments	1,600	600
General Reserve	1,200	600	***Current Assets***: Stock	1,200	600
Profit & Loss A/c	400	200	Debtors	1,600	800
Secured Loans	1,600	800	Cash & Bank Balance	1,200	600
Trade Creditors	1,200	400			
Tax Provisions	800	200			
	9,600	**5,200**		**9,600**	**5,200**

Other Information:

(i) Preference shareholders of the two companies are issued equivalent number of 15% preference shares of AB Ltd. at an issue price of Rs.125 per share.

(ii) AB Ltd. will issue one equity share of Rs.10 each for every share of A Ltd. and B Ltd. The shares are issued at a premium of Rs.5 per share.
Prepare the balance sheet of AB Ltd. on the assumption that the amalgamation is in the nature of merger.

Solution:

Calculation of Purchase Consideration

Particulars	A Ltd. Rs. ('000)	B Ltd. Rs. ('000)
(a) P:reference Shareholders 12,000 shares at Rs.125 each 8,000 share at Rs.125 each	1,500	1,000
(b) Equity Shareholders 2,40,000 shares of Rs.15 each 1,60,000 shares of Rs.15 each	3,600	1,000
Total Purchase Consideration	**5,100**	**3,400**

Amount to be adjusted against the Reserves

Particulars	**A Ltd. Rs. (‘000)**	**B Ltd. Rs. (‘000)**
Share Capital of transferor companies		
Equity Share Capital	2,400	1,600
Preference Share Capital	1,200	800
	3,600	2,400
Purchase Consideration (as per working (i)	5,100	3,400
Difference to be adjusted against reserves	1.500	1,000

The total difference of Rs.25,00,000 should be adjusted in the balance sheet of AB Ltd. against reserves as shown below:

	A Ltd. Rs. (‘000)	**B Ltd. Rs. (‘000)**	Total **Rs. (‘000)**	Adjustment **Rs. (‘000)**	Balance **Rs. (‘000)**
Capital Reserve	800	600	1,400	1,400	N il
General Reserve	1,200	600	1,800	1,100	700
	2,000	1,200	3,200	2,500	700

AB Ltd. Balance Sheet as on 01-04-2019

Liabilities	**Rs. (‘000)**	**Assets**	**Rs. (‘000)**
Share Capital	2,000	Fixed Assets	8,000
20,000 Preference shares of Rs.100 each		Less: Depreciation	1,400
			6,600
4,00,000 Equity Shares of Rs.10 each	4,000	Investments	2,200
Reserves & Surplus	2,500	Current Assets:	
		Stock	1,800
Securities Premium	700	Debtors	2,400
General Reserve	600	Cash & Bank Balance	1,800
Secured Loans	2,400		
Trade Creditors	1,600		
Tax Provision	1,000		
	14,800		**14,800**

(b) Purchase Method

This method of accounting is applicable for amalgamation in the nature of purchase. The following factors should be considered while making accounting entries under this method:

(i) In preparing the transferee company’s financial statements, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or, alternatively, the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation.

(ii) The reserves (whether capital or revenue or arising on revaluation) of the transferor company, other than the statutory reserves, should not be included in the financial statements of the transferee company.

(iii) An excess of the amount of the consideration over the net assets of the transferor company acquired by the transferee company should be recognised in the transferee company's financial statements as goodwill arising on amalgamation. If the amount of the consideration is lower than the value of the net assets acquired, the difference should be treated as Capital Reserve.

(iv) The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life. The amortisation period should not exceed five years unless a somewhat longer period can be justified.

(v) Where the requirements of the relevant statute for recording the statutory reserves such as Development Allowance Reserve, Investment Allowance Reserve, etc. in the books of the transferee company are compiled with, statutory reserves of the transferor company should be recorded in the financial statements of the transferee company by debiting 'Amalgamation Adjustment Account'.

(vi) The Amalgamation Adjustment Account should be disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and aforesaid account should be reserved.

The following journal entries are to be passed in the books of the transferee company for incorporation of the financial statements of the transferor company:

(1) For purchase of business from the Transferor Company:
Business Purchase A/c Dr. XX
To Liquidators of the Transferor Company XX

(2) For recording assets and liabilities taken over
Sundry Assets (Individually) A/c Dr. XX
To Sundry Liabilities A/c XX
To Business Purchase A/c XX

(3) For making payment to the liquidators of the transferor company
Liquidators of the Transferor Company A/c Dr. XX
To Bank/Share Capital/Securities Premium A/c XX

(4) When statutory reserve is maintained

Amalgamation Adjustment A/c Dr. XX
To Statutory Reserve A/c XX

(5) If liquidation expenses are paid by the transferee company:
Goodwill A/c Dr. XX
To Bank A/c XX

(6) For formation expenses of the transferee company if any:
Preliminary Expenses A/c Dr. XX
To Bank A/c XX

(7) When goodwill is written off against capital reserve:
Capital Reserve A/c Dr. XX
To Goodwill A/c XX

(8) If any liability is discharged by the transferee company
Respective Liability A/c Dr. (with amount payable) XX
To Share Capital/Debentures/Bank A/c XX

Illustration-2: A Ltd. and B Ltd., have agreed to amalgamate. A new company AB Ltd., has been formed to take over the combined concern as on 31st March 2013. After negotiations, the assets of the two companies have been agreed as shown in the following Balance Sheets:

Equity & Liabilities	**A Ltd. Rs.**	**B Ltd. Rs.**	**Assets**	**A Ltd. Rs.**	**B Ltd. Rs.**
Issue Capital: Shares of Rs.10 each	10,00,000	5,00,000	Land and Buildings	5,00,000	3,00,000
Sundry Creditors	80,000	50,000	Machinery and Plant	2,00,000	2,50,000
Reserve and Fund	---	50,000	Goodwill	---	50,000
Profit & Loss A/c	50,000	50,000	Stock	1,50,000	20,000
			Sundry Debtors	1,20,000	20,000
			Cash at Bank	50,000	10,000
			Patents	1,10,000	---
	11,30,000	**6,50,000**		**11,30,000**	**6,50,000**

Show how the amount payable to each company is arrived at and prepare the amalgamated Balance Sheet of the new company.

Solution:

Statement showing the amount payable to each of the Amalgamated Companies:

		Rs.
A Ltd.	Total Assets	11,30,000
	Less: Sundry Creditors	80,000
		10,50,000
B Ltd.	Total Assets	6,50,000
	Less: Sundry Creditors	50,000
		6,00,000

Thus the shareholders of the A Ltd. will be issued 1,05,000 share of Rs.10 each fully paid, i.e., for every 20 shares in the old company they will get 21 shares in the new company. Similarly, B ltd. will be issued 60,000 shares of Rs.10 each fully paid in the new company, the shareholders getting 6 shares in the new company for every 5 shares they held in the old company.

Balance Sheet of AB Ltd. as on 31st March, 2013

Liabilities	**Rs. ('000)**	**Assets**	**Rs. ('000)**
Share Capital-Authorized: 1,65,000 shares of Rs.10 each	16,50,000	**Fixed Assets**:	
		Goodwill	50,000
Subscribed: 1,65,000 shares of Rs.10 each issued as fully paid	16,50,000	Land & Buildings at cost	8,00,000
		Machinery & Plant	4,50,000
		Patents	1,10,000

Current Liabilities: Sundry Creditors	1,30,000	**Current Assets**: Stock Sundry Debtors Cash at Bank	 1,70,000 1,40,000 60,000
	17,80,000		**17,80,000**

Since the new company AB Ltd. is taking over all the assets and liabilities of the two existing companies A Ltd. and B Ltd. it is a case of amalgamation in the nature of a merger as per AS-14. The difference between total purchase consideration Rs.16,50,000 (i.e. Rs.10,50,000 A Ltd. + Rs.6,00,000 B Ltd.) and Equity Share Capital of A Ltd. and B Ltd. has been adjusted in the Balance Sheet of AB Ltd. against the Reserve Fund and Accumulated Surplus as per AS-14 as follows:

	Rs.	
Purchase Consideration for acquiring A Ltd. and B Ltd.		16,50,000
Less: Equity Share Capital of A Ltd., and B Ltd. (Rs.10,00,000 + Rs.5,00,000)		15,00 000
	1,50,000	
Less: Adjusted in Reserve Fund and Profit & Loss A/c Balance of A Ltd. & B Ltd.		1,50,000
Reserve Fund and Profit & Loss A/c to be shown in Balance Sheet of AB Ltd.		Nil

Illustration-3: A Ltd. acquired the undertaking of B Ltd. on 31-03-2013 for a purchase consideration of Rs.2,50,00,000 to be paid by fully paid equity shares of Rs.10 each. The balance sheet of the two companies on the date of acquisition were as follows:

Equity & Liabilities	**A Ltd. Rs.**	**B Ltd. Rs.**	**Assets**	**A Ltd. Rs.**	**B Ltd. Rs.**
Share Capital: Equity Shares of Rs.10 each fully paid up	2,50,000	1,50,000	Fixed Assets: Land & Buildings	1,20,00,00	80,00,000
Reserves & Surplus General Reserve	1,20,00,000	18,00,000	Plant & Machinery	2,00,00,000	1,80,00,000
Profit & Loss A/c	10,00,000	53,00,000	Furniture & Fixtures	10,00,000	20,00,000
Development Rebate Reserve	10,00,000	37,00,000	*Current Assets:*		
Workers' Compensation Fund	15,00,000	24,00,000	Stock	55,00,000	40,00,000
Current Liabilities	45,00,000	95,00,000	Debtors	45,00,000	40,00,000
			Bank Balance	20,00,000	17,00,000

	4,50,00,000	**3,77,00,000**		**4,50,00,000**	**3,77,00,000**

Pass the necessary journal entries in the books of A Ltd. when amalgamation is in the nature of (i) merger and (ii) by way of purchase. Also prepare the Balance Sheet of A Ltd. after amalgamation assuming that Development Rebate Reserve and Workers' Compensation Fund of B Ltd. are required to be continued in the books of A Ltd.

Solution:

(i) **When Amalgamation is in the Nature of Merger**:

Date	**Particulars**	**Dr. (Rs.)**	**Cr. (Rs.)**
31-03-2013	Business Purchase A/c Dr. To Liquidators of B Ltd. (Being purchase of business of B Ltd.)	2,50,00,000	 2,50,00,000
31-03-2013	Land & Buildings A/c Dr. Plant & Machinery A/c Dr. Furniture & Fixtures A/c Dr. Stock A/c Dr. Debtors A/c Dr. Bank A/c Dr. General Reserve A/c Dr. (Balancing Figure) To Current Liabilities To Development Rebate Reserve A/c To Workers' Compensation fund A/c To Business Purchase A/c (Being merger of assets, liabilities and reserves of B Ltd. with A Ltd. and difference transferred to General Reserve A/c)	80,00,000 1,80,00,000 20,00,000 40,00,000 40,00,000 17,00,000 29,00,000	 95,00,000 37,00,000 24,00,000 2,50,00,000
31-03-2013	Liquidators of B Ltd. A/c Dr. To Equity Share Capital A/c (Being payment of purchase price by issue of 25,00,000 equity shares of Rs.10 each)	2,50,00,000	 2,50,00,000

Balance Sheet of A Ltd. as on 31-03-2013 (After Amalgamation)

Liabilities	**Rs. ('000)**	**Assets**	**Rs. ('000)**
Share Capital	50,000	***Fixed Assets***	
50,00,000 Equity shares of Rs.10 each, fully paid up (of the above 25,00,000 shares of Rs.10 each issued for purchase of business of B Ltd.)		Land & Buildings Plant & Machinery Furniture & Fixtures	20,000 38,000 3,000
Reserves & Surplus		Current Assets:	
General Reserve	9,100	Stock	9,500
Profit & Loss A/c	1,000		

Development Rebate Reserve Workers' Compensation Fund Current Liabilities	4,700 3,900 14,000	Debtors Bank Balance	8,500 3,700
	82,700		**82,700**

(ii) **When Amalgamation is by the way of Purchase**:

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
31-03-2013	Business Purchase A/c Dr. To Liquidators of B Ltd. (Being purchase of business of B Ltd.)	2,50,00,000	 2,50,00,000
31-03-2013	Land & Buildings A/c Dr. Plant & Machinery A/c Dr. Furniture & Fixtures A/c Dr. Stock A/c Dr. Debtors A/c Dr. Bank A/c Dr. To Current Liabilities To Business Purchase A/c To Capital Reserve A/c (Balancing Figure) (Being assets and liabilities taken over)	80,00,000 1,80,00,000 20,00,000 40,00,000 40,00,000 17,00,000	 95,00,000 2,50,00,000 32,00,000
31-03-2013	Liquidators of B Ltd. A/c Dr. To Equity Share Capital A/c (Being payment of purchase price by issue of 25,00,000 equity shares of Rs.10 each)	2,50,00,000	 2,50,00,000
31-03-2013	Amalgamation Adjustment A/c Dr. To Development Rebate Reserve A/c To Workers' Compensation Fund A/c (Being carrying forward of reserve of B Ltd.)	6,10,000	 37,00,000 24,00,000

Balance Sheet of A Ltd. as on 31-03-2013 (After Amalgamation)

Liabilities	Rs. ('000)	Assets	Rs. ('000)
Share Capital 50,00,000 Equity shares of Rs.10 each, fully paid up (of the above 25,00,000 shares of Rs.10 each issued for purchase of business of B Ltd.)	50,000	***Fixed Assets*** Land & Buildings Plant & Machinery Furniture & Fixtures	 20,000 38,000 3,000

Reserves & Surplus		<u>**Current Assets**</u>:	
Capital Reserve	3,200	Stock	9,500
General Reserve	12,000		
Profit & Loss A/c	1,000		
		Debtors	8,500
Development Rebate Reserve	4,700	Bank Balance	3,700
Workers' Compensation Fund	3,900		
Current Liabilities	14,000	Amalgamation Adjustment A/c	6,100
	88,800		**88,800**

Illustration-4: A Ltd. and B Ltd. agreed to amalgamate by transferring their undertakings to a new company, AB Ltd. formed for that purpose. On the date of the amalgamation Balance Sheets of the companies were as under:

Liabilities	**A Ltd. Rs.**	**B Ltd. Rs.**	**Assets**	**A Ltd. Rs.**	**B Ltd. Rs.**
Authorised & Issued Capital			Sundry Assets	4,80,00,00	3,22,000
Equity Shares of Rs.10 each	5,00,000	3,00,000	Freehold property	2,00,000	1,00,000
			Investments	50,000	20,000
			Debtors	2,50,000	1,50,000
5% Debentures	2,00,000	1,00,000	Preliminary Expenses	20,000	8,000
Reserve Fund	----	50,000			
Profit & Loss A/c	30,000	20,000			
Mortgage Loan secured on Freehold property	50,000	---			
Sundry Creditors	2,20,000	1,30,000			
	10,00,000	**6,00,000**		**10,00,000**	**6,00,000**

The purchase consideration consisted of:

(a) The assumption of the liabilities of both companies; and

(b) The assumption of shares at a premium of Rs.2 per share of equity shares of Rs.10 each in AB Ltd.

For the purpose of the amalgamation, the assets are to be revalued as under:

	A Ltd. Rs.	B Ltd. Rs.
Goodwill	1,00,000	75,000
Sundry Assets	4,10,000	2,28,000
Freehold Property	2,60,000	1,40,000
Investments	51,000	20,000
Debtors	2,25,000	1,35,000

Journlise the above transactions in the books of A Ltd., B Ltd., and AB Ltd. Indicate the basis on which the shares in AB Ltd. will be distributed among the shareholders of A Ltd. and B Ltd. respectively.

Solution:

As per Accounting Standard-14, amalgamation is not in the nature of merger but it is in the nature of purchase because assets of the transferor companies A Ltd. and B Ltd. have not been taken over by the transferee company at their existing values.

	A Ltd.		B Ltd.	
	Rs.	Rs.	Rs.	Rs.
Assets Taken over				
Goodwill		1,00,000		75,000
Sundry Assets		4,10,000		2,28,000
Freehold Property		2,60,000		1,40,000
Investments		51,000		20,000
Debtors		2,25,000		1,35,000
		10,46,000		**6,50,000**
Less: Liabilities taken over				
5% Debentures	2,00,000		1,00,000	
Mortgage Loan	50,000		---	
Sundry Creditors	2,20,000	**4,70,000**	1,30,000	**2,30,000**
		5,76,000		**4,20,000**

Purchase consideration to be discharged by:

Issue of shares of Rs.10 each at a premium of Rs.2 per share — Rs. 5,76,000 — Rs.4,20,000

No. of shares issued — $\frac{5,76,000}{12} = 48,000$ — $\frac{4,20,000}{12} = 35,000$

Nominal value of shares issued — 48,000 X 10 = 4,80,000 — 35,000 X 10 = 3,50,000

∴ Shareholders of A Ltd. will get 48,000 shares for 50,000 shares held
Shareholders of A Ltd. will get 48 shares for every 50 shares held
∴ Shareholder of B Ltd. will get 35,000 shares for 30,000 share held
Shareholders of B Ltd. will get 7 shares for every 6 shares held

Journal Entries in the Books of A Ltd.

Date/ S. No.	Particulars	Dr. (Rs.)	Cr. (Rs.)
1.	Realisation A/c Dr.	9,80,000	
	To Sundry Assets A/c		4,80,000
	To Freehold Property A/c		2,00,000
	To Investments A/c		50,000
	To Debtors A/c		2,50,000
	(Being assets taken over by AB Ltd.		

	transferred to Realisation A/c)		
2.	Mortgage Loan A/c Dr. Sundry Creditors A/c Dr. 5% Debentues A/c Dr. To Realisation A/c (Being liabilities taken over by AB Ltd. transferred to Realisation A/c)	50,000 2,20,000 2,00,000	 4,70,000
3.	AB Ltd. A/c Dr. To Realisation A/c (Being purchase consideration agreed to be paid by AB Ltd.)	5,76,000	 5,76,000
4.	Equity Shres in AB Ltd. A/c Dr. To AB Ltd. A/c (Being the receipt of the purchase price)	5,76,000	 5,76,000
5.	Realisation A/c Dr/. To Equity Shareholders A/c (Being profit on realisation transferred)	66,000	 66,000
6.	Equity Shareholders A/c Dr. To Preliminary Expenses A/c (Being transfer of preliminary expenses)	20,000	 20,000
7.	Equity Share Capital A/c Dr. Profit & Loss A/c Dr. To Equity Shareholders A/c (Being share capital and accumulated profits transferred to equity shareholders)	5,00,000 30,000	 5,30,000
8.	Equity Shareholders A/c Dr. To Equity Shares in AB Ltd. A/c (Being payment made to equity shareholders)	5,76,000	 5,76,000

Journal Entries in the Books of B Ltd.

Date/ S. No.	Particulars	Dr. (Rs.)	Cr. (Rs.)
1.	Realisation A/c Dr. To Sundry Assets A/c To Freehold Property A/c To Investments A/c To Debtors A/c (Being assets taken over by AB Ltd. transferred to Realisation A/c)	5,92,000	 3,22,000 1,00,000 20,000 1,50,000
2.	Sundry Creditors A/c Dr. 5% Debentures A/c Dr. To Realisation A/c (Being liabilities taken over by AB Ltd. transferred to Realisation A/c)	1,30,000 1,00,000	 2,30,000

3.	AB Ltd. A/c Dr. To Realisation A/c (Being purchase consideration agreed to be paid by AB Ltd.)	4,20,000	 4,20,000
4.	Equity Shares in AB Ltd. A/c Dr. To AB Ltd. A/c (Being the receipt of the purchase price)	4,20,000	 4,20,000
5.	Realisation A/c Dr. To Equity Shareholders A/c (Being profit on realisation transferred)	58,000	 58,000
6.	Equity Shareholders A/c Dr. To Preliminary Expenses A/c (Being transfer of preliminary expenses)	8,000	 8,000
7.	Equity Share Capital A/c Dr. Profit & Loss A/c Dr. Reserve Fund A/c Dr. To Equity Shareholders A/c (Being share capital and accumulated profits transferred to equity shareholders)	3,00,000 20,000 50,000	 3,70,000
8.	Equity Shareholders A/c Dr. To Equity Shares in AB Ltd. A/c (Being payment made to equity shareholders)	4,20,000	 4,20,000

Journal Entries in the Books of AB Ltd.

Date/ S. No.	Particulars	Dr. (Rs.)	Cr. (Rs.)
1.	Business Purchase A/c Dr. To Liquidators of A Ltd. (Being purchase of business of A Ltd.)	5,76,000	 5,76,000
2.	Goodwill A/c Dr. Sundry Assets A/c Dr. Freehold Property A/c Dr. Investment A/c Dr. Debtors A/c Dr. To Mortagage Loan A/c To Sundry Creditors A/c To 5% Debentures A/c To Business Purchase A/c (Being assets and liabilities of A Ltd. taken over)	1,00,000 4,10,,000 2,60,000 51,000 2,25,000	 50,000 2,20,000 2,00,000 5,76,000
3.	Liquidators of A Ltd. A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Being issue of 48,000 equity shares of Rs.10 each at a premium of Rs.2 per share in settlement of the purchase price)	5,76,000	 4,80,000 96,000
4.	Business Purchase A/c Dr. To Liquidators of B Ltd. (Being purchase of business of B Ltd.)	4,20,000	 4,20,000

5.	Goodwill A/c Dr. Sundry Assets A/c Dr. Freehold Property A/c Dr. Investment A/c Dr. Debtors A/c Dr. To 5% Debentures A/c To Sundry Creditors A/c To Business Purchase A/c (Being assets and liabilities of B Ltd. taken over)	75,000 2,80,000 1,40,000 20,000 1,35,000	 1,00,000 1,30,000 4,20,000
6.	Liquidators of B Ltd. A/c Dr To Equity Share Capital A/c To Securities Premium A/c (Being issue of 35,000 equity shares of Rs.10 each at a premium of Rs.2 per share in settlement of the purchase price)	4,20,000	 3,50,000 70,000

5.8 SUMMARY

After studying this unit, you should be able to: understanding the concept of corporate restructuring, historical background and emerging trends in corporate restructuring, etc., To know the need and scope of corporate restructuring. To acquire knowledge of legal, procedural and practical aspects of corporate restructuring; To assess different modes of corporate restructuring. Meaning of Corporate Restructuring, Historical Background, Need and Scope Restructuring, Legal procedures of Corporate Restructuring, Various Modes of Restructuring and Practical Illustrations explained in this lesson.

5.9 TECHNICAL TERMS

Amalgamation: The noun amalgam derives, by way of Middle French, from Medieval Latin amalgama. It was first used in the 15th century with the meaning "a mixture of mercury and another metal." (Today, you are likely to encounter this sense in the field of dentistry; amalgams can be used for filling holes in teeth.) Use of amalgam broadened over time to include any mixture of elements, and by the 18th century the word was also being applied figuratively, as in "an amalgam of citizens." The verb amalgamate has been in use since the latter half of the 1500s. It too can be used either technically, implying the creation of an alloy of mercury, or more generally for the formation of any compound or combined entity.

Fixed Assets: A fixed asset, also known as a capital asset, is a tangible piece of property, plant, or equipment (PP&E) that you own or manage with expectations that it'll continuously help generate income. An asset is fixed when it's an item that your business won't consume, sell, or convert to cash within the next calendar year.

Debentures: A debenture is a type of long-term business debt not secured by any collateral. It is a funding option for companies with solid finances that want to avoid issuing shares and diluting their equity.

Current Assets: A current asset—sometimes called a liquid asset—is a short-term asset that a company expects to use up, convert into cash, or sell within one fiscal year or operating cycle. Non-current assets, on the other hand, are long-term assets that cannot be readily converted into cash within one year.

Current Liabilities: Current liabilities (also called short-term liabilities) are debts a company must pay within a normal operating cycle, usually less than 12 months (as opposed to long-term liabilities, which are payable beyond 12 months). Paying off current liabilities is mandatory.

General Reserve: General reserve is referred to as the reserve fund that is created by keeping aside a part of profit earned by the business during the course of an accounting period for fulfilling various business needs like meeting contingencies, offsetting future losses, enhancing the working capital, paying dividends to the ...

Preliminary Expenses: The expenses which are incurred before the incorporation of a company or the start of a business are known as preliminary expenses. These include expenses such as legal or professional fees, logo designing cost, printing, registration fees, stamp duty, etc.

5.10. SELF ASSESSMENT QUESTION

1. What do you know the concept of corporate restructuring? Explain its origin and growth.
2. Explain the need and scope of corporate restructuring
3. Discuss various methods of accounting for amalgamation.
4. Distinguish between amalgamation in the nature of merger and amalgamation in the nature of purchase.
5. What are the legal, procedural and practical aspects of corporate restructuring;
6. Enumerate different modes of corporate restructuring.

7. Following is the balance sheet of Neelam Ltd. as on 31-03-2015.

Liabilities	**Rs.**	**Assets**	**Rs.**
Share Capital 50,000 Equity Shares of Rs.10 each fully paid	5,00,000	Fixed Assets	5,00,000
5% Debentures	1,50,000	Investment	1,00,000
P & L A/c	20,000	Current Assets	1,80,000
General Reserve	30,000	Preliminary Expenses	20,000
Current Liabilities	1,00,000		
Total	**8,00,000**	**Total**	**8,00,000**

On the date of balance sheet, the company was taken over by Jayasree Ltd. On the following terms:

(i) Fixed assets are revalued at Rs.6,00,000.
(ii) Investments have only a market value of Rs.80,000.
(iii) Current assets are agreed at Rs.2,00,000.
(iv) All liabilities are taken over by Jayasree Ltd.

You are required to compute the purchase consideration.

8. AX Ltd. And BX Ltd. amalgamated on and from 1st January 2018. A new company ABX Ltd. was formed to take over the business of the existing companies.

Summarized Balance Sheets as on 31-12-2017

Equity & Liabilities	**AX Ltd. Rs. '000**	**BX Ltd. Rs. '000**	**Assets**	**AX Ltd. Rs. '000**	**BX Ltd. Rs. '000**
Share Capital Equity Shares of Rs.10 each	60.00	70.00	Sundry Fixed Assets	85.00	75.00
General Reserve	15.00	20.00	Investment	10.50	5.50
P & L A/c	10.00	5.00	Stock	12.50	27.50
Investment Allowance Reserve	5.00	1.00	Debtors	18.00	40.00
Export Profit Reserve	0.50	1.00	Cash & Bank	4.50	4.00
12% Debentures	30.00	40.00			
Sundry Creditors	10.00	15.00			
	130.50	**152.00**		**130.50**	**152.00**

ABX Ltd. issues requisite number of shares to discharge the claims of the equity shareholders of the
Transferor Companies.

Prepare a note showing purchase consideration and discharge thereof and the Balance Sheet of ABX Ltd.

9. A Ltd. and B Ltd. carrying on similar business decided to amalgamate and for the purpose a new company being formed to take over the assets and liabilities of both companies and it is agreed that fully paid shares of Rs.100 each shall be issued by the new company to the value of the net assets of each of the old companies.

Balance Sheets as on 31-03-2015

Liabilities	**A Ltd. Rs.**	**B Ltd. Rs.**	**Assets**	**A Ltd. Rs.**	**B Ltd. Rs.**
Share Capital Shares of Rs.50 each	50,000	40,000	Goodwill Land & Buildings	5,000 17,000	2,000 10,000
General Reserve	20,000	---	Plant & Machinery	24,000	16,000
P & L A/c	3,000	---	Furniture & Fixtures	5,000	7,500

Sundry Creditors Bills Payable Bank Overdraft	4,000 4,000 ---	8,000 8,000	Stock Debtors Cash Profit & Loss A/c	10,000 12,000 8,000 ---	7,500 7,000 300 5,700
	81,000	**56,000**		**81,000**	**56,000**

The following is the accepted scheme of valuation of the business of the two companies:

A Ltd.

(i) To provide for reserve for debts at the rate of 5% on debtors
(ii) To write off Rs.400 from stock; and
(iii) To write off 331/3% from plant and machinery.

B Ltd.

(i) To eliminate its goodwill and profit and loss account balance.
(ii) To write off bad debts to the amount of Rs.1,000 and to provide reserve of 5% on the balance of debtors.
(iii) To write down plant and machinery at the rate of 10%; and
(iv) To write off Rs.1,400 from the value of stock.

You are required to compute purchase consideration.

5.11. SUGGESTED READINGS

1. CA (Dr.) P.C. Tulsian & CA Bharat Tulsian, '***Financial Reporting'***, S. Chand & Company Pvt. Ltd., New Delhi, 2013.
2. S. N. Maheshwari & S K. Maheshwari, '***Advanced Accountancy'***, Vikas Publishing House Pvt. Ltd., New Delhi, 2009.
3. M. C. Shukla, T. S. Grewal & S. C. Gupta, '***Solutions to Problems in Advanced Accounts'***, S S. Chand & Company Pvt. Ltd., New Delhi, 2014.
4. S.P. Jain & K.L. Narang, '***Corporate Accounting'***, Kalyani Publishers, Ludhiana, 2006.

Dr. NAGARAJU

LESSON-6
INTER-COMPANY HOLDINGS

AIMS AND OBJECTIVES

After studying this unit, you should be able:

- To understand accounting treatment when the shares are held by the Transferee Company in the Transferor Company.
- To know accounting treatment when the shares are held by the Transferor Company in the Transferee Company.
- To study accounting treatment when the shares are held by the both the Companies in each other.

STRUCTURE

6.1. Introduction
6.2. Shares held by the Transferee Company in the Transferor Company
6.3. Shares held by the Transferor Company in the Transferee Company
6.4. Shares held by both companies in one another
6.5. Model Examination Questions
6.6. Summary
6.7. Technical Terms
6. 8. Self-Assessment Questions
6. 9. Suggested Readings

6.1. INTRODUCTION

There may be three situations with reference to inter-company holdings:

1. Shares held by the Transferee Company in the Transferor Company.
2. Shares held by the Transferor Company in the Transferee Company.
3. Shares held by both companies in one another.

6.2. SHARES HELD BY THE TRANSFEREE COMPANY IN THE TRANSFEROR COMPANY

The transferee company being a shareholder of the transferor company has a right to proportionate net assets of the transferor (or vendor) company. In such a case the transferee company buys only the net assets belonging to outsiders. The purchasing or transferee company usually issues its own shares for discharge of purchase consideration. Such a company cannot receive its own shares for the amount due to itself. The accounting treatment will be as under in the books of transferor (vendor) company and transferee (purchasing) company.

Books of Transferor or Vendor Company

Purchase consideration is calculated for the entire business either by the net assets or net payment method as applicable in a particular case. The purchasing or transferee company account is debited with the full price but credited with only what is received in respect of outsiders. The debit balance in this account represents the amount still receivable from the purchasing company towards purchase price. Similarly only outside shareholders are paid and debited to shareholders account. The shareholders account will show a credit balance representing the amount due to the purchasing company as a shareholder of the vendor company. This amount is neither paid by the purchasing company as the buyer of the business nor received by it as a shareholder. Rather the two accounts are closed by passing the following set-off entry:

Shareholders' A/c Dr. XX
To Transferee Co's A/c XX

Books of Purchasing or Transferee Company

In the books of Transferee Company, the first two entries are passed as usual. When the question of payment to Transferor Company's liquidator arises, payment is shown only in respect of what is due to the outsiders and for the balance shares in the vendor company are surrendered by crediting the account. The journal entry for this will be as under:

Liquidator of Transferor Company A/c Dr. XX (with full purchase price)
To Share Capital/Bank XX (Amount payable to outsiders)
To Shares in the Transferor Company XX (Amount due to purchasing company)

The difference, if any, in shares in the vendor company account will be transferred to Goodwill or Capital Reserve Account as the case may be.

Illustration-1:

Following are the Balance Sheets of A Ltd. and B Ltd. as on 31-03-2013

Liabilities	**A Ltd. Rs. in Lakh**	**B Ltd. Rs. in Lakh**	**Assets**	**A Ltd. Rs. in Lakh**	**B Ltd. Rs. in Lakh**
Issue Capital:			Goodwill	---	0.50
40,000 shares of Rs.100 each	40		Fixed Assets	30	3.50
20,000 shares of Rs.50 each		10	Investments	5	---
General Reserve	30	5	Current Assets	65	14.00
Current Liabilities	30	1			
Provision for Tax	---	1			
Proposed Dividend	---	1			
	100	**18**		**100**	**18**

B Ltd. is to be amalgamated in the nature of purchase by A Ltd. on the following terms:

(1) B Ltd. declares a dividend of 10% before absorption for the payment of which it is to retain sufficient amount of cash.

(2) The net worth of B Ltd. is valued at Rs.14.50 lakh.

(3) The purchase consideration is satisfied by the issue of fully paid-up shares of Rs.100 each in A Ltd.

Following further information is also to be taken into consideration:

(a) A Ltd. holds 5,000 shares of B Ltd. at a cost of Rs.3 lakh.

(b) The stock of B Ltd. includes items valued at Rs.1,00,000 purchased from A Ltd. (cost to A Ltd. Rs.75,000).

(c) The creditors of B Ltd. include Rs.50,000 due to A Ltd.

(d) A Ltd. takes fixed assets of B Ltd. in its books at Rs.4,50,000.

Show the ledger accounts in the books of B Ltd. to give effect to the above and make journal entries in the books of A Ltd. and also prepare Balance Sheet of A Ltd. after completion of the absorption.

Solution:

Ledger Accounts in the books of B Ltd.

Dr. RealizationAccount Cr.

Particulars	**Amount Rs.**	**Amount Rs.**	**Particulars**	**Amount Rs.**	**Amount Rs.**
To Sundry Assets:			By Sundry Liabilities:	1,00,000	
Goodwill	50,000		Provision Tax	1,00,000	2,00,000
Fixed Assets	3,50,000		By A Ltd. (purchase consideration)		14,50,000
Current Assets	13,00,000	17,00,000	By Shareholders A/c		50,000
		17,00,000			**17,00,000**

Dr. A Ltd. Account Cr.

Particulars	**Amount Rs.**	**Particulars**	**Amount Rs.**
To Realisation A/c	14,50,000	By Shares in A Ltd.	10,87,500
		By Shareholders A/c	3,62,500
	14,50,000		**14,50,000**

Dr. Shareholders Account Cr.

Particulars	**Amount Rs.**	**Particulars**	**Amount Rs.**
To Realisation A/c	50,000	By Share Capital A/c	10,00,000
To shares in A Ltd.	10,87,500	By General Reserve A/c	5,00,000
To A Ltd. (set off)	3,62,500		
	15,00,000		**15,00,000**

Dr. Proposed Dividend Account Cr.

Particulars	Amount Rs.	Particulars	Amount Rs.
To Current Assets A/c	1,00,000	By Balance b/d	1,00,000
	1,00,000		**1,00,000**

Dr. Share in A Ltd. Account Cr.

Particulars	Amount Rs.	Particulars	Amount Rs.
To A Ltd. A/c	10,87,500	By Shareholders A/c	10,87,500
	10,87,500		**10,87,500**

Dr. Current Assets Account Cr.

Particulars	Amount Rs.	Particulars	Amount Rs.
To Balance b/d	14,00,000	By Proposed Dividend A/c By Realisation A/c	1,00,000 13,00,000
	14,00,000		**14,00,000**

Journal Entries in the Books of A Ltd.

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
31-03-2013	Business Purchase A/c Dr. To Liquidators of B Ltd. (Being purchase of business of A Ltd.)	14,50,000	 14,50,000
31-03-2013	Fixed Assets A/c Dr. Current Assets A/c Dr. To Current Liabilities A/c To Provision for Tax A/c To Business Purchase A/c To Capital Reserve A/c (Being assets and liabilities of B Ltd. taken over and difference transferred to Capital Reserve A/c)	4,50,000 13,00,000	 1,00,000 1,00,000 14,50,000 1,00,000
31-03-2013	Liquidators of B Ltd. A/c Dr To Equity Share Capital A/c To Shares in B Ltd. A/c (Being settlement of the purchase consideration price)	14,50,000	 10,87,500 3,62,500
31-03-2013	Shares in B Ltd. A/c Dr. To Capital Reserve A/c (Being profit on shares in B Ltd. transferred to Capital Reserve)	62,500	 62,500

31-03-2013	Bank A/c Dr. To Profit & Loss A/c (Being the receipt of dividend from B Ltd.)	25,000	25,000
31-03-2013	Capital Reserve A/c Dr. To Stock A/c (Being stock reserve maintained on stock sold by us)	25,000	25,000
31-03-2013	Creditors A/c Dr. To Debtors A/c (Being stock reserve maintained on stock sold by us)	25,000	25,000

Balance Sheet of A Ltd. as on 31-03-2013 (After Amalgamation)

Liabilities	**Rs.**	**Assets**	**Rs.**
Share Capital: Issued and Paid up 50,875 Equity shares of Rs.10 each, fully paid (of the above 10,875 shares have been issued to vendors)	50,87,500	***Fixed Assets*** Opening Balance 30,00,000 **Add**: Purchased 4,50,000 during the Year	34,50,000
		Investments (5,00,000 – 3,00,000)	2,00,000
Reserves & Surplus:		Current Assets (65,00,000 + 13,00,000 + 25,000 – 25,000 (stock reserve) – 50,000 (sundry creditors set off)	77,50,000
Capital Reserve	1,37,500		
General Reserve	30,00,000		
Profit & Loss A/c	25,000		
Current Liabilities & Provisions:			
Current Liabilities (30,00,000 + 1,00,000 – 50,000)	30,50,000		
Provision for Taxation	1,00,000		
	1,14,00,000		**1,14,00,000**

Alternative Method:

Purchase consideration, under this alternative method, is not calculated for the entire business. In the case of ***net payment method***, purchase consideration is calculated on the basis of what is due to the outside shareholders plus creditors. Under ***net assets method***, purchase consideration is calculated for the whole business and then reduced proportionately on the basis of shares held by the purchasing or Transferee Company in the vendor or transferor company. Suppose A Ltd. acquires the business of B Ltd. on a valuation of Rs.5,00,000 and if A Ltd. is holding 30% equity shares in B Ltd. purchase consideration should be treated as only Rs.3,50,000, i.e., 70% of Rs.5,00,000 as Rs.1,50,000 already belongs to A Ltd.

No purchase consideration is to be paid by the transferee company to the transferor company for that part of share capital which is held by the transferee company. The transferor company will close the share capital to that extent by transferring to realisation account. The entry for this is:

Share Capital A/c Dr.
To Realisation A/c

The transferee company's investment in shares and debentures of the transferor company also becomes useless after the liquidation of the transferor company. So investment in shares and debentures (of the transferor company) is closed by passing the following entry:

Goodwill or Capital Reserve A/c Dr.
To Investments in Shares/Debentures A/c

This will be clearer from the following illustration:

Illustion-2:

The following is the Balance Sheet of A Ltd. as on 31st March, 2013:

Liabilities	**Rs.**	**Assets**	**Rs.**
Share Capital in Rs.10 each share fully paid	16,00,000	Fixed Assets	17,00,000
		Current Assets	10,20,000
10% Debentures	10,00,000	Profit & Loss A/c	5,00,000
Interest Outstanding	50,000		
Sundry Creditors	5,70,000		
	32,20,000		**32,20,000**

The above company is amalgamated by B Ltd. who holds ¼ of the share capital (purchased by them at Rs. 3,70,000) and all the debentures of A Ltd.

The purchase consideration being the taking over of the assets and trade liabilities of A Ltd. at book value subject to revaluation of fixed assets which were reduced by Rs. 3,00,000, payment to outside shareholders Rs. 10 shares issued at par on the basis of such shares being worth Rs. 15 each and the shares of A Ltd. being worth Rs. 5 each.

You are required to make necessary journal entries in the books of both the companies.

Solution:

Working Notes:

(i) Calculation of purchase consideration:

Assets taken over at market value (Rs. 27,20,000 - Rs. 3,00,000)	24,20,000
Less: Liabilities taken over	5,70,000
	18,50,000
Less: Debentures (including interest)	10,50,000
	8,00,000
Less: Money belonging to B Ltd. because of the shares of A Ltd. held by B. Ltd.	2,00,000
Purchase consideration	6,00,000

(ii) Payment of purchase consideration by issue of shares as under:

For Rs. 15 company issues 1 share.

For Rs. 6,00,000 company issues 40,000 shares.

As each share is to be recorded at par, so the purchase consideration for book purposes is 40,000 X 10 = Rs. 4,00,000 (though actual purchase consideration is Rs. 6,00,000).

Journal in the books of A Ltd.

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
31-03-2013	Realisation A/c Dr. To Fixed Assets A/c To Current Assets A/c (Being assets taken over by B Ltd. transferred to Realisation A/c)	27,20,000	 17,00,000 10,20,000
31-03-2013	Debentures A/c Dr. Interest Outstanding A/c Dr. Creditors A/c Dr. To Realisation A/c (Being liabilities taken over by B Ltd. transferred to Realisation A/c)	10,00,000 50,000 5,70,000	 16,20,000
31-03-2013	B Ltd. A/c Dr. To Realisation A/c (Being purchase consideration agreed to be paid by AB Ltd.)	4,00,000	 4,00,000
31-03-2013	Equity Shares in B Ltd. A/c Dr. To B Ltd. A/c (Being the receipt of the purchase price)	4,00,000	 4,00,000
31-03-2013	Share Capital A/c Dr. To Realisation A/c (Being ¼ of share capital already with B Ltd. transferred to realisation a/c)	4,00,000	 4,00,000
31-03-2013	Equity Shareholders A/c Dr/. To Realisation A/c (Being loss on realisation transferred to realisation a/c)	3,00,000	 3,00,000
31-03-2013	Equity Shareholders A/c Dr. To Profit & Loss A/c (Being transfer of profit & loss a/c balance to shareholders a/c)	5,00,000	 5,00,000
31-03-2013	Equity Share Capital A/c Dr. To Equity Shareholders A/c (Being share capital transferred to equity shareholders)	12,00,000	 12,00,000
31-03-2013	Equity Shareholders A/c Dr. To Equity Shares in B Ltd. A/c (Being payment made to equity shareholders)	4,00,000	 4,00,000

Journal in the books of B Ltd.

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
31-03-2013	Business Purchase A/c Dr. To Liquidators of A Ltd. (Being purchase of business of A Ltd.)	4,00,000	 4,00,000
31-03-2013	Fixed Assets A/c Dr. Current Assets A/c Dr. To Creditors A/c To Debentures in A Ltd. A/c To Accrued Interest A/c To Business Purchase A/c To Capital Reserve A/c (Balancing Figure) (Being assets and liabilities taken over)	14,00,000 10,20,000	 5,70,000 10,00,000 50,000 4,00,000 4,00,000
31-03-2013	Liquidators of A Ltd. A/c Dr. To Equity Share Capital A/c (Being payment of Purchase Consideration Price)	4,00,000	 4,00,000
31-03-2013	Capital Reserve A/c Dr. To Investment in shares in A Ltd. A/c (Being cancellation of investment in shares of A Ltd.)	3,70,000	 3,70,000

Illustration-2: With a view to expand business and also affect economies, the right Light Limited and Sun Light Limited decided to amalgamate and for this purpose Bright Light Limited was absorbed by Sun Light Limited. The assets and liabilities of two companies are given below:

***Bright Light Limited*.**

Cash Rs. 5,000, Investment Rs. 10,000, Reserves Rs. 10,000, Debentures Rs. 60,000, Machinery Rs. 70,000, Book Debts Rs. 45,000, Creditors Rs. 30,000, Workmen Compensation Reserve Rs. 10,000, Stock Rs. 10,000, and Goodwill Rs. 20,000.

***Sun Light Limited*.** Capital Rs. 40,000, Investments Rs. 10,000, Reserves Rs. 25,000, Debentures Rs. 50,000, Machinery Rs. 60,000, Book Debts Rs. 10,000, Creditors Rs. 20,000, Workmen Compensation Fund Rs. 5,000, Stock Rs. 5,000 and Cash Rs. 2,000.

You are given that the Capital of Bright Light Limited consisted of Rs. 100 shares, called Rs. 50 and that of Sun Light Limited Rs. 100 shares called Rs. 40.

It was agreed that the shareholders of Bright Light Limited were to be issued such number of Re. I shares of Sun Light Limited at their intrinsic value as would equal the intrinsic value of the Bright Light Limited shares. The Debtors of Sun Light Limited include Rs. 5,000 due by Bright Limited and the investments include Rs. 5,000 paid up value of shares in Bright Light Limited. The stocks of Bright Light Limited include Rs. 2,000 worth of stock bought from Sun Light Limited invoiced at 10% profit on sale price by Sun Light Limited.

Give journal entries in Sun Light's Books and also the Balance Sheet of Sun Light Limited after amalgamation taking amalgamation in the nature of purchase.

Solution:

Calculation of Intrinsic Value of Shares of Bright Ltd.

Balance sheet of Bright Light Limited is prepared to find out capital, which is not given in the question.

Balance Sheet of Bright Light Limited

Liabilities	**Rs.**	**Assets**	**Rs.**
Share Capital *(Balancing Figure)* 1,000 Equity shares of Rs.100 each, Rs.50 called up	50,000	Goodwill	20,000
		Machinery	70,000
		Investments	10,000
Reserves	10,000	Stock	10,000
Workmen's Compensation Fund	10,000	Debtors	45,000
		Cash	5,000
Debentures	60,000		
Creditors	30,000		
	1,60,000		**1,60,000**

Total Assets		Rs.1,60,000
Less: Liabilities:		
Debentures	Rs.60,000	
Creditors	Rs.30,000	Rs. 90,000
Intrinsic worth of 1,000 shares		Rs. 70,000

Therefore, intrinsic value per share (70,000/1,000) = Rs.70/-

Calculation of Intrinsic value of shares of Sun Light Limited:

Balance sheet of Sun Light Limited is prepared to find out the value of goodwill (not given in the question). There is an excess of liabilities over assets and the difference has been assumed to be goodwill.

Balance Sheet of Sun Light Limited

Liabilities	**Rs.**	**Assets**	**Rs.**
Share Capital		Goodwill *(Balancing Figure)*	53,000
1,000 Equity shares of Rs.100 each, Rs.40 called up	40,000	Machinery	60,000
		Investments (including Investments in Bright Light Ltd.100 shares @ Rs.70 per share) (7000 + 5,000)	12,000
Reserves (including Rs.2,000 resulting from the increase in the value of shares in Bright Light Ltd.)	27,000	Stock	5,000
		Book Debts	10,000
		Cash	2,000
Workmen's Compensation Fund	5,000		
Debentures	50,000		
Creditors	20,000		
	1,42,000		**1,420,000**

Note: Sun Light Ltd. as an investment of Rs.5,000 in Rs.50 paid-up shares of Bright Light Ltd. Therefore, number of shares held is 5,000/50 = 100/-. The intrinsic worth of a share of Bright Light Ltd. is Rs.70 per share, so value of 100 shares is Rs.7,000 (i.e., 100 X 70).

Total Assets		Rs.1,42,000	
Less: Liabilities:			
Debentures	Rs.50,000		
Creditors	Rs.20,000	Rs. 70,000	
Intrinsic worth of 1,000 shares			Rs. 72,000

Therefore, intrinsic value per share (72,000/1,000) = Rs.72/-

Calculation of Purchase Consideration

Purchase price of the business of Bright Light Ltd. is equal to the intrinsic value of shares held by shareholders (other than Sun Light Ltd.) of Bright Light Ltd.:

Total number of shares of Bright Light Ltd.	1,000
Less: Number of shares held by Sun Light Ltd.	100
Shares held by outsiders	900

Intrinsic worth of 900 shares @ Rs.70 is Rs.63,000.

Intrinsic value of a share of Sun Light Ltd. is Rs.72.

Hence, the number of shares to be issued by Sun Light Ltd. to pay the purchase price of Rs.63,000 is 63,000/72 = 875 shares. Therefore, purchase consideration is 875 shares of Rs.100 each, Rs.40 paid up (875 X 40) + Rs.35,000.

Note: While calculating purchase consideration, shares have been valued at their paid-up value of Rs.40 each and not at the intrinsic value of Rs.72 each.

Journal Entries in the books of Sun Light Ltd.

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
31-03-2013	Business Purchase A/c Dr. To Liquidators of Bright Light Ltd. A/c (Being the amount of purchase consideration)	35,000	 35,000
31-03-2013	Machinery A/c Dr. Investments A/c Dr. Stock A/c Dr. (Rs.10,000 less 10% on Rs.2,000) Debtors A/c Dr. Cash A/c Dr. To Debentures A/c To Creditors A/c To Business Purchase A/c To Capital Reserve A/c (Balancing Figure) (Being assets and liabilities taken over)	70,000 10,000 9,800 45,000 5,000	 60,000 30,000 35,000 14,800

31-03-2013	Liquidators of Bright Light Ltd. A/c Dr. To Equity Share Capital A/c (Being payment of Purchase Consideration Price by issue of 875 shares of Rs.100 each, Rs.40 paid-up)	35,000	35,000
31-03-2013	Sundry Creditors A/c Dr. To Sundry Debtors A/c (Being cancellation of amount due by Bright Light Limited)	5,000	5,000
31-03-2013	Capital Reserve A/c Dr. To Investment A/c (Being Investment in shares of Bright Light Ltd. eliminated on takeover of Bright Light Ltd.)	7,000	7,000

Balance Sheet of Sun Light Ltd. as on 31-03-2013 (After Amalgamation)

Liabilities	Rs.	Assets	Rs.
Authorised Capital:		Goodwill	53,000
Paid up Capital		Machinery	1,30,000
1,875 share of Rs.100 each, Rs.40 paid up	75,000	Investments	15,000
		Stock	14,800
(of the above 875 shares have been issued in pursuance of the purchase of Business of Bright Light Ltd.)		Book Debts	50,000
		Cash	7,000
Capital Reserve	7,800		
Reserves	27,000		
Workmen's Compensation Fund	5,000		
Debentures	1,10,000		
Creditors	45,000		
	2,69,800		**2,69,800**

6.3. SHARES HELD BY THE TRANSFEROR COMPANY IN THE TRANSFEREE COMPANY

In this case when the assets of the transferor company are acquired by the transferee company, the latter company cannot purchase its own shares.

Under the net payment method the purchase consideration is calculated by deducting the number of shares already held by the transferor company from the shares agreed to be issued. The shares already held by the transferor company before absorption are treated as a part of the purchase consideration. As shares in Transferor Company are not taken over by the transferee company, so investment in the shares (of the transferee company) should not be transferred to realisation account. Transferor Company is required to revalue the shares in the transferee company in view of the price of the shares now received. If there is any gain or loss, that should be transferred to realisation account.

If the purchase consideration is calculated under the net asset method, the assets in the form of the investment in shares of the purchasing company are not taken into consideration.

Accounting Treatment in the Books of Transferor Company:

<table>
<tr><td>Step-1</td><td colspan="2">Calculate the intrinsic Value of an Equity Share of Purchasing Company</td></tr>
<tr><td>Step-2</td><td colspan="2">Calculate the Total Intrinsic Value of Equity Shares held by Transferor Company in Transferee Company as follows:
= No. of Shares held by Transferor Company X Intrinsic Value of Equity Shares of Transferee Company</td></tr>
<tr><td>Step-3</td><td colspan="2">Calculate the Profit or Loss on Revaluation of Equity Shares held by Transferor Company as under:
Profit = Total Intrinsic Value (as per step-2) – Book value of such shares
Loss = Book Value of such shares - Total Intrinsic Value (as per step-2)</td></tr>
<tr><td rowspan="3">Step-4</td><td colspan="2">Transfer the Profit or Loss on revaluation to the Realisation A/c as under:</td></tr>
<tr><td>(a) In case of Profit on Revaluation</td><td>Share in Transferee Company A/c Dr.
To Realisation A/c</td></tr>
<tr><td>(b) In case of Loss on Revaluation</td><td>Realisation A/c Dr.
To Share in Transferee Company A/c</td></tr>
</table>

Note: Do not transfer the ‘Shares in Transferee Company A/c to the Realisation Account.

How to calculate No. of Shares to be issued by the Transferee Company:

The calculation of number of shares to be issued by the Transferee Company depends upon the fact whether the purchase consideration is determined under Net Payment Method or Net Assets Method. Such calculation of shares has been shown below:

Calculation of No. of Shares to be issued by the Transferee Company if the purchase consideration is determined under Net Payment Method

A.	No. of Shares in Transferor Company.	XXX
B.	No. of Shares in Transferee Company to be issued for each share in Transferor Company	XXX
C.	Total No. of share to be issued (A X B)	XXX
D.	Total No. of shares already held by Transferor Company	XXX
E.	No. of Additional Shares to be issued by Transferee Company (C – D)	XXX

Calculation of No. of Shares to be issued by the Transferee Company if the purchase consideration is determined under Net Assets Method

A.	Assets taken over at their agreed values (other than Shares)	XXX
B.	**Less**: Liabilities taken over at their agreed values	XXX
C.	Net Assets taken over at their agreed values (A - B)	XXX
D.	Agreed Price for each share of Transferee Company	XXX
E.	No. of Shares be issued (C – D)	XXX

Illustration-3: Given below are the Balance Sheets of X Ltd. and Y Ltd. as at 31st March 2022 at which date Y Ltd. was taken over by X Ltd. on the basis of their respective value of shares.

(Rs. in Lakh)

Liabilities	**X Ltd.**	**Y Ltd.**	**Assets**	**X Ltd.**	**Y Ltd.**
Equity Shares of Rs.10 each	5.00	10.00	Tangible Fixed Assets	22.00	10.00
			Investments	3.25	5.00
General Reserve	26.20	5.85	Current Assets	8.05	0.65
12% Debentures	2.20	1.10	Preliminary Expenses	1.70	1.85
Creditors for goods	1.60	0.55			
	35.00	**17.50**		**35.00**	**17.50**

Investments of Y Ltd. represent 10,000 equity shares of X Ltd. Investments of X Ltd. are considered worth of Rs.3,75,000.

Giver Journal Entries in the books of X Ltd. and Y Ltd. and prepare the Balance Sheet of X Ltd. after absorption.

Solution:
Working Notes:
Statement showing the Computation of Intrinsic Value

(Rs. in Lakh)

		X Ltd.	Y Ltd.
A.	**Total Assets at their current assets**		
	Fixed Assets	22.00	10.00
	Investments (10,000 shares @ Rs.60)	3.75	6.00
	Current Assets	8.05	0.65
		33.80	16.65
B.	Less: Outsiders Liabilities at their current values		
	12% Debentures	2.60	1.10
	Creditors for goods	1.60	0.55
		3.80	1.65
C.	Net Assets for Equity Shareholders (A – B)	30.00	15.00
D.	No. of Equity Shares	50,000	1,00,000
E.	Intrinsic Value of Equity Shares (C/D)	Rs.60	Rs.15

Statement showing the Number of Shares to be issued by the Transferee Company to the Transferor Company

		Rs.
A.	Net Assets of Transferor Company taken over by Transferee Company (15,00,000-6,00,000 (being share in Transferee Company)	9,00,000
B.	Issue Price of an Equity Share of Transferee Company	Rs.60
C.	No. of Equity Shares to be issued (9,00,000/60)	15,000
D.	Amount to be credited to share capital (15,000 X Rs.10)	1,50,000
E.	Amount to be credited to securities premium (15,000 X Rs.50)	7,50,000

Journal in the books of Y Ltd.

(Rs. in Lakh)

Date	**Particulars**	**Dr. (Rs.)**	**Cr. (Rs.)**
31-03-2022	Realisation A/c Dr. To Tangible Fixed Assets A/c To Current Assets A/c (Being assets taken over by X Ltd. transferred to Realisation A/c)	10.65	 10.00 0.65
31-03-2022	12% Debentures A/c Dr. Creditors for goods A/c Dr. To Realisation A/c (Being liabilities taken over by X Ltd. transferred to Realisation A/c)	1.10 0.55	 1.65
31-03-2022	X Ltd. A/c Dr. To Realisation A/c (Being purchase consideration agreed to be paid by AB Ltd.)	9.00	 9.00
31-03-2022	Equity Shares in X Ltd. A/c Dr. To X Ltd. A/c (Being the receipt of the purchase price)	9.00	 9.00
31-03-2022	Equity Shares in X Ltd. A/c Dr. To X Ltd. A/c (Being the transfer of profit on revaluation of shares in X Ltd. to Realisation A/c)	1.00	 1.00
31-03-2022	Realisation A/c Dr. To Equity Shareholders A/c (Being profit on realisation transferred to realisation a/c)	1.00	 1.00
31-03-2022	Equity Shareholders A/c Dr. To Profit & Loss A/c (Being transfer of profit & loss a/c balance to shareholders a/c)	5,00,000	 5,00,000
31-03-2022	Equity Share Capital A/c Dr. General Reserve A/c Dr. To Equity Shareholders A/c (Being share capital and reserves transferred to equity shareholders)	10.00 5.85	 15.85
31-03-2022	Equity Shareholders A/c Dr. To Preliminary Expenses A/c (Being the amount of preliminary expenses transferred to shareholders a/c)	1.85	 1.85
31-03-2022	Equity Shareholders A/c Dr. To Equity Shares in X Ltd. A/c (Being payment made to equity shareholders)	9.00	 9.00

Journal Entries in the books of X Ltd.

(Rs. in Lakh)

Date	**Particulars**	**Dr. (Rs.)**	**Cr. (Rs.)**
31-03-2022	Business Purchase A/c Dr. To Liquidators of Y Ltd. A/c (Being the amount of purchase consideration)	9.00	 9.00
31-03-2022	Tangible Fixed Assets A/c Dr. Current Assets A/c Dr. To 12% Debentures A/c To Creditors for goods A/c To Business Purchase A/c (Being assets and liabilities of Y Ltd. taken over)	10.00 0.65	 1.10 0.55 9.00
31-03-2022	Liquidators of Y Ltd. A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Being payment of Purchase Consideration Price by issue of 15,000 equity shares of Rs.10 each, at Rs.60 each)	9.00	 1.50 7.50
31-03-2022	Investments A/c Dr. To Revaluation Reserve A/c (Being the profit on revaluation of investments credited to Revaluation Reserve)	0.50	 0.50
31-03-2022	Profit & Loss A/c Dr. To Preliminary A/c (Being the preliminary expenses written off as per Para 56 of AS 26)	1.70	 1.70

Balance Sheet of X Ltd. as on 31-03-2022 (After Absorption)

(Rs. in Lakh)

Liabilities	**Rs.**	**Assets**	**Rs.**
Share Capital:		***Fixed Assets*:**	
65,000 equity shares of Rs.10 each (of the above 15,000 shares were issued for consideration otherwise than cash)	6.50	Tangible Fixed Assets (22 + 10)	32.00
		Investments	3.75
		***Current Assets, Loans & Advances*:**	
		Current Assets (8.05 + 0.65)	8.70
***Reserves & Surplus*:**			
Securities Premium	7.50		
General Reserve (26.20 – 1.70)	24.50		
Revaluation Reserve	0.50		
12% Debentures (2.20 + 1.10)	3.30		
Current Liabilities & Provisions:			
Creditors for Goods (1.60 – 0.55)	2.15		
	44.45		**44.45**

As per Para 56 of AS 26, 'Intangible Assets', preliminary expenses are to be recognized as expenses as and when they are incurred. Hence, Preliminary Expenses are not to appear in the Balance Sheet.

Illustration-4: Rama Ltd. and Krishna Ltd. had the following financial position as at 31st March 2022:

Liabilities	X Ltd.	Y Ltd.	Assets	X Ltd.	Y Ltd.
Equity Shares of Rs.100 each fully paid General Reserve Investment Allowance Reserve Current Liabilities	8,00,000 3,00,000 --- 4,00,000	6,00,000 2,00,000 3,00,000 1,50,000	Goodwill Tangible Fixed Assets Investments-at cost Current Assets	5,00,000 4,00,000 3,00,000 3,00,000	1,00,000 7,00,000 2,00,000 2,50,000
	15,00,000	**12,50,000**		**15,00,000**	**12,50,000**

It was decided that Rama Ltd. will take over the business of Krishna Ltd. on that date, on the basis of the respective share values adjusting, wherever necessary, the book value of assets and liabilities on the strength of information given below:

(a) Investments of Krishna Ltd. included 1,000 shares in Rama Ltd. acquired at a cost of Rs.150 per share. The other investments of Krishna Ltd. have a market value of Rs.25,000;

(b) Investment Allowance Reserve was in respect of additions made to fixed assets by Krishna Ltd. on which income tax relief has been obtained. In terms of the Income Tax Act, the company has to carry forward till 2027, reserve of Rs.1,50,000 for utilisation;

(c) Goodwill of Rama ltd. and Krishna Ltd. are to be taken at Rs.4,00,000 and Rs.2,00,000 respectively;

(d) Fixed assets of Rama Ltd. and Krishna Ltd. are valued at Rs.5,00,000 and Rs.7,50,000 respectively;

(e) The market value of investments of Rama Ltd. was Rs.2,00,000;

(f) Current assets of Rama ltd. included Rs.80,000 of stock in trade obtained from Krishna Ltd. which company normally sold its goods at a profit of 25% over cost;

Suggest the scheme of absorption and show the Journal entries necessary in the books of Rama Ltd. Also prepare the Balance Sheet of that company after takeover of the business of Krishna Ltd.

Solution:

Working Notes:

(i) Valuation of Shares of Rama Ltd. and Krishna Ltd.

		Rama Ltd.	Krishna Ltd.
A.	**Total Assets at their current assets**		
	Goodwill	4,00,000	2,00,000
	Tangible Fixed Assets	5,00,000	7,50,000
	Investments at Market Value	2,00,000	25,000
	1,000 shares in Rama Ltd. @Rs.125		1,25,000

	Current Assets	3,00,000	2,50,000
		14,00,000	13,50,000
B.	**Less**: Outsiders Liabilities taken over	4,00,000	1,50,000
C.	Net Assets at their current values (A – B)	10,00,000	12,00,000
D.	No. of Shares	8,000	6,000
E.	Intrinsic Value (C/D)	Rs.125	Rs.200

(ii) **Calculation of No. of Shares to be issued**

A. Net Assets of Vendor Company taken over ((Rs.12,00,000 – Rs.1,25,000) 10,75,000

B. Intrinsic Value of an Equity Share of Transferee Company Rs.125

C. No. of shares to be issued (A/B) 8,600 shares

Journal Entries in the books of Rama Ltd.

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
31-03-2022	Business Purchase A/c Dr. To Liquidators of Krishna Ltd. A/c (Being the amount of purchase consideration)	10,75,000	 10,75,000
31-03-2022	Goodwill A/c Dr. Tangible Fixed Assets A/c Dr. Investments A/c Dr. Current Assets A/c Dr. To Current Liabilities A/c To Business Purchase A/c (Being assets and liabilities of Krishna Ltd. taken over)	2,00,000 7,50,000 25,000 2,50,000	 1,50,000 10,75,000
31-03-2022	Liquidators of Krishna Ltd. A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Being payment of Purchase Consideration Price by issue of 8,600 equity shares of Rs.100 each, at Rs.125 each)	10,75,000	 8,60,000 2,15,000
31-03-2022	Goodwill A/c Dr. To Current Assets (Stock) A/c (Being stock purchased from Krishna Ltd. reduced to cost-reduced by 1/5 of Rs.80,000)	16,000	 16,000
31-03-2022	Amalgamation Adjustment A/c Dr. To Investment Allowance Reserve A/c (Being the Investment Allowance Reserve of Transferor Company recorded))	1,50,000	 1,50,000

Balance Sheet of Rama Ltd. as on 31-03-2022 (After Absorption)

(Rs. in Lakh)

Liabilities	Rs.	Assets	Rs.
Share Capital:		***Fixed Assets***:	
16,600 equity shares of Rs.100 each	16.60	Tangible Fixed Assets (4.00 + 7.50)	11.50
(of the above 8,600 shares were issued for consideration otherwise than cash)		Goodwill (5.00+2.00+0.16)	7.16
		Investments (3.00+0.25)	3.25
		Amalgamation Adjustment A/c	1.50
		Current Assets (3.00 + 2.50+0.16)	5.34
Reserves & Surplus:			
Securities Premium	2.15		
General Reserve	3.00		
Investment Allowance Reserve	1.50		
Current Liabilities	5.50		
	28.75		**28.75**

6.4. SHARES HELD BY BOTH COMPANIES IN EACH OTHER

As the shares are held by both companies in each other is a case of cross holdings. The calculation of purchase consideration is dependent on the method given in the problem for this purpose. The procedure is explained as under:

Practical Guidelines when the shares are held by both the companies in each other:

Step-1	Calculate the Net Assets (excluding the value of Intercompany share investments) of each company at their current values.
Step-2	Take the Total Assets (including the value of share investments) of Transferee Company and Transferor Company as 'P' and 'V' respectively.
Step-3	Express the value of shares held by Transferee Company in Transferee Company in terms of 'V' (e.g. if Transferee Company holds 20% share of Transferor Company then value of such 20% shares should be expressed as 1/5 V) and similarly express the value of shares held by Transferor Company in Transferee Company in terms of 'P'
Step-4	Now express the Total Assets (including the value of shares investments) of each company in the form of an algebraic equation as under: P = Net Assets (as per Step-1) + Value of Shares held by Transferee Company in Transferor Company (as per Step-3) V = Net Assets (as per Step-1) + Value of Shares held by Transferor Company in Transferee Company (as per Step-3)
Step-5	Solve both these algebraic equations by substituting the value of one equation in the other one. **Note**: Now we have the Total Value of Net Assets (including Intercompany share in investments) of the company.
Step-6	Calculate the intrinsic value of an equity share of Transferee Company as under: Total Value of Net Assets of Transferee Company (as per Step-5)

	Intrinsic Value = No. of Equity Shares of Transferee Company
Step-7	Calculate the share of outsiders in Transferor Company as under: A. Total value of Net Assets of Transferor Company (as per Step-5) XXX B. Less: Share of Transferee Company therein XXX C. Share of Outsiders (A – B) XX
Step-8	Calculate the No. of additional shares to be issued by Transferee Company as under: A. Shares of Outsiders in Transferor Company (as per Step-7) XXX B. Intrinsic Value of an share of Transferee Company (as per Step-6) XXX C. No. of shares to be issued (A/B) XXX D. Less: No. of shares already held by Transferor company in the Transferee Company XXX E. No. of additional shares to be issued by Transferee Company (C-D) XXX
Step-9	(a) Equity Shareholders A/c Dr. (with share of Transferee Company in the Net To Transferee Company A/c Assets of Transferor Company) (b) Investment in Shares of Transferee Company A/c Dr. (with the profit on Revaluation) To Realisation A/c (Or) Realisation A/c Dr. (with the loss on Revaluation) To Investment in Shares of Transferee Company A/c **Note:** Profit/Loss on Revaluation of Shares = (No. of such shares X Intrinsic Value of an equity share of Transferee company) – the Book value of such shares in the books of Transferor Company.
Step-10	Credit the 'Shares in Transferor Company A/c' in the Books of Transferee Company while recording the assets and liabilities taken over.

Illustration-5. X Ltd. is to absorb Y Ltd. by issuing 5 shares of Rs. 10 each at a premium of 10% for every 4 shares held in Y Ltd. On the date of absorption, the balance sheets were as under:

Liabilities	**X Ltd. Rs.**	**Y Ltd. Rs.**	**Assets**	**X Ltd. Rs.**	**Y Ltd. Rs.**
Share Capital (shares of Rs.10 each)	10,00,000	6,00,000	Fixed Assets	8,00,000	4,00,000
			Investments:		
			12,000 shares in Y Ltd.	1,60,000	
			10,000 shares		1,20,000

General Reserve Creditors	1,00,000 2,00,000	80,000 1,20,000	in X Ltd. Current Assets	3,40,000	2,80,000
	13,00,000	**8,00,000**		**13,00,000**	**8,00,000**

You are required to show (a) important ledger accounts in the books of Y Ltd. and (b) the acquisition entries in the books of X Ltd. assuming current assets of Y Ltd. are taken at Rs.1,80,000.

Solution:
Working Notes:
Calculation of Purchase Consideration:

(a) Shares of Y Ltd. held by outsiders = 60,000 – 12,000 = 48,000
Shares to be issued by X Ltd. to outsiders (48,000 X 5/4) = 60,000
(b) Shares due to X Ltd. (which however will not be issued) 12,000 X 5/4 = 15,000
(c) Total of (a) and (b) = 75,000
(d) Less: Already held by Y Ltd. =10,000
(e) Net number of shares constituting purchase consideration =65,000
(f) Therefore, purchase consideration will be 65,000 X Rs.11 (issue price) = Rs.7,15,000

Ledger Accounts in Y Ltd

Dr. Realisation Account Cr.

Particulars	Amount Rs.	Particulars	Amount Rs.
To Fixed Assets To Current Assets To Shares in X Ltd. (Rs.1,20,000 – 10,000 X Rs.11) To Shareholders A/c (profit)	4,00,000 2,80,000 10,000 1,45,000	By Sundry Creditors By X Ltd. – Purchase consideration	1,20,000 7,15,000
	8,35,000		**8,35,000**

Dr. X Ltd. Account Cr.

Particulars	Amount Rs.	Particulars	Amount Rs.
To Realisation A/c	7,15,000	By Shares in X Ltd. By Shareholders A/c (set off) (12,000 X 5/4 X Rs.11)	5,50,000 1,65,000
	7,15,000		**7,15,000**

Dr. Shares in X Ltd. Account Cr.

Particulars	**Amount Rs.**	**Particulars**	**Amount Rs.**
To Balance b/d To X Ltd. (shares received now)	1,20,000 5,50,000	By Realisation A/c (Loss on revaluation) By Shareholders A/c (distribution)	10,000 6,60,000
	6,70,000		**6,70,000**

Dr. Shareholders Account Cr.

Particulars	**Amount Rs.**	**Particulars**	**Amount Rs.**
To X Ltd. – set off To Shares in X Ltd. (distribution)	1,65,000 6,60,000	By Share Capital By General Reserve Realisation A/c	6,00,000 80,000 1,45,000
	7,15,000		**7,15,000**

Journal Entries in the books of X Ltd

Date/ S. No.	**Particulars**	**Dr. (Rs.)**	**Cr. (Rs.)**
1.	Business Purchase A/c Dr. To Liquidators of Y Ltd. A/c (Being the amount of purchase consideration)	7,15,000	7,15,000
2.	Fixed Assets A/c Dr. Current Assets A/c Dr. Goodwill A/c Dr. (Balancing figure) To Sundry Creditors A/c To Business Purchase A/c (Being assets and liabilities taken over and the balance amount transfer to Goodwill A/c)	4,00,000 1,80,000 2,55,000	 1,20,000 7,15,000
3.	Liquidators of Y Ltd. A/c Dr. To Equity Share Capital A/c To Securities Premium A/c To Shares in Y Ltd. (Being payment of Purchase Consideration)	7,15,000	5,00,000 50,000 1,65,000
4.	Shares in Y Ltd. A/c Dr. (Rs.1,65,000 – Rs.1,60,000) To Goodwill A/c (Being the profit on revaluation of shares in Y Ltd. credited to goodwill A/c)	5,000	5,000

Illustration -6: B Ltd. is absorbed by A Ltd. on 31st March 2013 on the basis of the following balance sheets:

Liabilities	**A Ltd. Rs.**	**B Ltd. Rs.**	**Assets**	**A Ltd. Rs.**	**B Ltd. Rs.**
Paid up Capital			***Fixed Assets***:		
(2,00,000 equity	10,00,000		Factory Shed	5,00,000	---
shares of Rs.5			Machinery	3,00,000	---
each)		5,00,000	Furniture	50,000	---
(5,000 shares of			***Investments***:		
Rs.100 each			500 shares of	50,000	---
fully paid)	2,50,000	---	B Ltd.	---	2,00,000
General Reserve	---	3,00,000	40,000 share		
6% Debentures			of A Ltd.	70,000	---
(Rs.100 each)	2,50,000	3,00,000	Others	50,000	---
Sundry			Debentures in		1,20,000
Creditors			B Ltd.		
			Profit & Loss	2,20,000	
			A/c	2,00,000	
			Current	60,000	5,00,000
			Assets:		2,50,000
			Stock		30,000
			Debtors		
			Bank Balance		
	15,00,000	**11,00,000**		**15,00,000**	**11,00,000**

The following is the scheme of absorption:

(i) Prior to absorption A Ltd. was o declared a dividend of 25%.

(ii) For every share in B Ltd. 14 fully paid up equity shares in A Ltd. were to be issued.

(iii) For each debenture in B Ltd., 71/2% preference shares of Rs.100 each of A Ltd. were to be issued as fully paid.

Directors of A Ltd. decided to revalue the shares in B Ltd. according to their intrinsic value just before absorption

Draw up the Balance Sheet of A Ltd. after absorption is completed. Merger is to be in the nature of purchase as per AS-14. Show necessary workings.

Solution:

(i) Calculation of Intrinsic Value:

A Ltd. holds 1/10 shares of B Ltd., and B Ltd. holds 1/5 shares of A Ltd. Suppose intrinsic value of A Ltd. is *'a'* and that of B Ltd. is *'b'*.

a = Rs.9,50,000 (i.e. 15,00,000 of total assets – Rs.50,000 investments in shares of B Ltd.

– Rs.2,50,000 Dividend – Rs.2,50,000 sundry creditors) + 1/10b

b = Rs.2,30,000 + 1/5a

= Rs.2,30,000 + 1/5 (Rs.9,50,000 + 1/10b)

b = Rs.2,30,000 + Rs.1,90,000 + 1/50 b

49/50b = Rs.4,20,000

b = Rs.4,20,000 X 50/49 = <u>Rs.4,28,571</u>

a = Rs.9,50,000 X 1/10 of Rs.4,28,571

= Rs.9,50,000 + 42,857 = <u>Rs.9,92,857</u>

Intrinsic value of 500 shares in B Ltd. 1/10 of Rs.4,28,571		Rs.42,857
Amount paid	<u>Rs.50,000</u>	
Loss to be written off	<u>Rs. 7,143</u>	

(ii) Calculation of Purchase Consideration:

Shares in B Ltd. held by outsiders (5,000-500)	4,500	
Total No. of shares to be issued by A Ltd. (4,500 X14)	63,000	
Shares already held		40,000
Additional Shares to be issued	23,000	
Value of shares 23,000 @Rs.5 per share	1,15,000	

(iii) Calculation of Capital Reserve:

Value of net assets taken over by A Ltd.		
Sundry Assets	8,30,000	
(Rs.5,00,000 + Rs.2,50,000 + Rs.30,000 + Rs.50,000 for Dividend received)		
<u>Less</u>: Debentures Rs.3,00,000 + Creditors Rs.3,00,000)	<u>6,00,000</u>	
Purchase Consideration (Rs.1,15,000 + Rs.42,857)		<u>1,57,857</u>
Capital Profit	72,143	
<u>Less</u>: Loss on revaluation of shares of B Ltd.(Rs.50,000 – Rs.42,857)		<u>7,123</u>
Capital Reserve	<u>65,000</u>	

Balance Sheet of A Ltd. as on 31-03-2013 (After Absorption)

Liabilities	**Rs.**	**Assets**	**Rs.**
Share Capital:		***Fixed Assets***:	
Issued, subscribed and Paid 2,23,000 shares of Rs. 5 each fully paid (of the above23,000 shares have been issued for consideration other than cash)	11,15,000	Factory Shed	5,00,000
		Machinery	3,00,000
		Furniture	50,000
		Investments	70,000
2,500 Preference Shares of Rs.100 each (Rs.3,00,000 – Rs.50,000)	2,50,000	***Current Assets, Loans & Advances***:	
		Stock in Trade	7,20,000
		Debtors	4,50,000
		Bank Balance	90,000
Reserves & Surplus:			
Capital Reserve (see Note No.iii)	65,000		
Current Liabilities & Provisions:			
Sundry Creditors	5,50,000		
Dividend Payable	2,00,000		
	21,80,000		**21,80,000**

6.5. MODEL EXAMINATION QUESTIONS

1. What do you meant by intercompany holdings?
2. Define Amalgamation. What are the entries to be passed by a company to close its books when it is amalgamated by another company?
3. What is the accounting treatment should be followed when the shares are held by the Transferee Company in the Transferor Company.

- How to eliminate the intercompany holdings in case of shares are held by the Transferor Company in the Transferee Company.
- What is the accounting treatment should be followed when the shares are held by the both the Companies in each other.
- The Balance Sheet of A Ltd. and B Ltd. as on 31st March 2022 are as under:

Liabilities	**A Ltd. Rs.**	**B Ltd. Rs.**	**Assets**	**A Ltd. Rs.**	**B Ltd. Rs.**
Share Capital (shares of Rs.10 each fully paid)	25,00,000	50,00,000	Tangible Fixed Assets	1,10,00,000	50,00,000
General Reserve	1,31,00,000	29,25,000	Investments	16,25,000	25,00,000
12% Debentures	11,00,000	5,50,000	Current Assets	40,25,000	3,25,000
Current Liabilities	8,00,000	2,75,000	Preliminary Expenses	8,50,000	9,25,000
	1,75,00,000	**87,50,000**		**1,75,00,000**	**87,50,000**

Investments of A Ltd. represent 1,25,000 shares of B Ltd. Investments of B Ltd. are considered worth of Rs.30,00,000.

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

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

- . X Ltd. absorbs Y Ltd. by issue of 6 share of Rs.10 each at a premium of 10% for every 5 shares of Y Ltd. This consideration is for the agreed value of net assets acquired. For purpose of absorption, it was agreed that trade investments held by Y Ltd. will release their book value and goodwill of Y Ltd. will be Rs.20,000. The Balance Sheets of the two companies were as under:
-

Liabilities	**X Ltd. Rs.**	**Y Ltd. Rs.**	**Assets**	**X Ltd. Rs.**	**Y Ltd. Rs.**
Share Capital (shares of Rs.10 each fully paid)	4,00,000	3,00,000	Tangible Fixed Assets	1,10,00,000	50,00,000
Reserves	2,40,000	1,50,000	Investments	16,25,000	25,00,000
Trade Creditors	40,000	30,000	Current Assets	40,25,000	3,25,000
			Preliminary Expenses	8,50,000	9,25,000
	6,80,000	**4,80,000**		**6,80,000**	**4,80,000**

Prepare the Balance Sheet of X Ltd. after absorption of Y Ltd.

- The following are the Balance Sheets of X Ltd. and Y Ltd. at 31st March 2022:

Liabilities	X Ltd. Rs.	Y Ltd. Rs.	Assets	X Ltd. Rs.	Y Ltd. Rs.
Share Capital (shares of Rs.100 each fully paid)	2,00,000	1,00,000	Tangible Fixed Assets	1,20,000	55,000
Profit & Loss A/c	60,000	30,000	***Investments***:		
Sundry Creditors	40,000	70,000	200 shares in Y Ltd.	25,000	---
			100 shares in X Ltd.	---	12,000
			Stock	75,000	45,000
			Debtors	60,000	68,000
			Cash at Bank	20,000	20,000
	3,00,000	**2,00,000**		**3,00,000**	**2,00,000**

The two companies agree on amalgamation on the following basis:

(a) A new company is to be formed called Z Ltd.
(b) The Goodwill is valued for X Ltd. Rs.50,000 and for Y Ltd. Rs.25,000.
(c) The shares of Z Ltd. are of nominal value of Rs.10 each.

Prepare Balance Sheet of Z Ltd. resulting from the merger and schedule showing fully the shareholdings therein attributable to shareholders of X Ltd. and Y Ltd.

6.6. SUMMARY

After studying this unit, you should be able: To understand accounting treatment when the shares are held by the Transferee Company in the Transferor Company. To know accounting treatment when the shares are held by the Transferor Company in the Transferee Company. To study accounting treatment when the shares are held by the both the Companies in each other.

6.7. TECHNICAL TERMS

Transferee: Any party who is receiving title or custody of the delivery would be considered a transferee, any party who relinquishes title or custody would be considered a transferor and any party who both receives and relinquishes title or custody would be both a transferee and a transferor.

Transferor: In the sale deed, there are two parties, who are called seller and buyer. The seller, also called transferor, transfers the ownership of the property and the buyer, also called transferee, gets the ownership of the property.

6. 8. SELF-ASSESSMENT QUESTIONS

1. Who is transferor or seller?
2. Who is transferor and transferee in amalgamation?
3. What is the difference between assignee and transferee?
4. What are the two types of amalgamation?
5. What is difference between merger and amalgamation?

6.9. SUGGESTED READINGS

1. CA (Dr.) P.C. Tulsian & CA Bharat Tulsian, '***Financial Reporting'***, S. Chand & Company Pvt. Ltd., New Delhi, 2013.

2. S. N. Maheshwari & S K. Maheshwari, '***Advanced Accountancy'***, Vikas Publishing House Pvt. Ltd., New Delhi, 2009.

3. M. C. Shukla, T. S. Grewal & S. C. Gupta, '***Solutions to Problems in Advanced Accounts'***, S S. Chand & Company Pvt. Ltd., New Delhi, 2014.

4. S.P. Jain & K.L. Narang, '***Corporate Accounting'***, Kalyani Publishers, Ludhiana, 2006.

Dr. NAGARAJU

LESSON-7
PRINCIPLES OF CONSOLIDATED FINANCIAL STATEMENTS

AIMS AND OBJECTIVES

After studying this lesson students should be able to

- To know the concept of group, holding company and subsidiary company.
- To Understand group as a single economic entity
- To acquired knowledge on prepare the consolidated financial statements.

STRUCTURE

7.1. Introduction
7.2. Economic substance over form
7.3. Definitions
7.4. Control
7.5. Wholly owned and partly owned subsidiaries
7.6. Summary
7.7. Technical Terms
7.8. Self Assessment Questions
7.9. Suggested Readings

7.1. INTRODUCTION

To grow the business, many organizations are growing into large organizations by acquiring another company by which one company controls the other company.

Consolidated financial statements are the financial statements of a group presented as those of a single enterprise.

For a wide variety of reasons such as taxation, investment laws, foreign exchange fluctuations and other business purposes, entities may choose to conduct their operations through several entities instead of a single legal entity. However, all these entities remain under the control of the ultimate parent. Hence the financial statements of the parent alone do not represent the entire economic picture of the financial position or performance of the parent. Users of the financial statements would like to know the picture of the group as a whole. Hence, there is a strong case for mandatory presentation of the consolidated financial statements so as to reflect the economic reality.

If one company owns (purchases) more than 50% of the equity (ordinary) shares of another company:

a. This will usually give the first company 'control' of the second company.
b. The first company is called the parent company (Holding company), P. It has enough voting power to appoint all/majority of the directors of the second company (called as the subsidiary company, S).
c. P is able to control S in terms of governing financial and operating policies, as if it were merely a department of P, rather than a separate entity.
d. As per legal terms, P and S remain distinct (separate), but in economic substance they can be regarded as a single unit (a 'group').i.e "p" is an individual legal entity which prepares its own financial statements and "S" is another individual legal entity which prepares its own financial statements. Since 'P' controls 'S' they form a single economic entity – the Group

Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control. Control also exists when the parent owns half or less of the voting power of an entity when there is:

(a) power over more than half of the voting rights by virtue of an agreement with other investors;
(b) power to govern the financial and operating policies of the entity under a statute or an agreement;
(c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or
(d) power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body

Erstwhile only clause 32 of the listing agreement mandated listed companies to publish Consolidated Financial Statements. Neither the Companies Act, 1956 mandated the preparation of consolidated financial statements nor do the Accounting Standards require companies to prepare Consolidated Financial Statements. With insertion of Section 129(3) in the Companies Act 2013 ("Act"), all companies including unlisted and private companies with one or more subsidiaries will in addition to separate financial statements now have to prepare Consolidated Financial Statements ("CFS").

An entity may own share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the entity voting power or reduce another party's voting power over the financial and operating policies of another entity (potential voting rights).

The existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by another entity, are considered when assessing whether an entity has the power to govern the financial and operating policies of another entity.

Potential voting rights are not currently exercisable or convertible when, for example, they cannot be exercised or converted until a future date or until the occurrence of a future event.

In assessing whether potential voting rights contribute to control, the entity examines all facts and circumstances (including the terms of exercise of the potential voting rights and any other contractual arrangements whether considered individually or in combination) that affect potential voting rights, except the intention of management and the financial ability to exercise or convert such rights

7.2. ECONOMIC SUBSTANCE OVER FORM

From the legal point of view, every company is a separate legal entity. But from the economic point of view companies may not be separate.

In particular, when one company (Investor) owns enough shares in another company (Investee) to have a majority of votes at that company's annual general meeting (AGM), the first company may appoint all the directors of the second company. Also first company can decide what dividends should be paid by the second company.

This degree of control enables the first company to manage the financial policies, trading activities, future plans and strategies of the second company as if it were merely a department of the first company.

Accounting standards recognise this situation, and require a parent company to produce consolidated financial statements showing the position (Balance sheet) and performance (Profit and loss account) of the whole group.

Consolidated financial statements normally include consolidated balance sheet, consolidated statement of profit and loss, consolidated cash flow statement, a consolidated statement of change in equity (if applicable) and any explanatory notes annexed to, or forming part thereof.

Consolidated financial statements are presented, to the extent possible, in the same format as adopted by the parent for its separate financial statements. The formats for preparation of balance sheet, statement of profit and loss and a statement of change in equity (if applicable) are prescribed under the Schedule III of the Companies Act, 2013.

An entity which prepares the consolidated financial statements, either under any law or regulation governing the entity or suomotu, might be required to or otherwise engage the auditor for conducting the audit of consolidated financial statements. However, a law or regulation governing the entity may require the consolidated financial statements to be audited by the statutory auditor of the entity.

7.3. DEFINITIONS

Consolidated financial statements: The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

Holding Company/ Parent Company: Is an entity that controls one or more entities (Known as subsidiaries)

Subsidiary: Is an entity that is controlled by other entity (Known as the parent/holding company).

As per Companies Act, 2013,Section 2 (87):

"subsidiary company" or "subsidiary", in relation to any other company (that is to say the holding company), means a company in which the holding company—

(i) controls the composition of the Board of Directors; or

(ii) exercises or controls more than one-half of the total share capital either at its own or together with one or more of its subsidiary companies:

Provided that such class or classes of holding companies as may be prescribed shall not have layers of subsidiaries beyond such numbers as may be prescribed.
Explanation.—For the purposes of this clause,—

(a) a company shall be deemed to be a subsidiary company of the holding company even if the control referred to in sub-clause (i) or sub-clause (ii) is of another subsidiary company of the holding company;
(b) the composition of a company's Board of Directors shall be deemed to be controlled by another company if that other company by exercise of some power exercisable by it at its discretion can appoint or remove all or a majority of the directors;
(c) The expression "company" includes anybody corporate;

(d) "layer" in relation to a holding company means its subsidiary or subsidiaries;

Control: Is achieved through:

a) The ownership, directly or indirectly through subsidiary (ies), of more than 50% of the voting power of the entity: (or)
b) Control of the composition of the board of directors in case of a company. (i.e power to appoint or remove majority of the board of directors)

Group: A group exists where one entity, the parent (referred to as 'the investor'), has control over another entity, the subsidiary (referred to as 'the investee'). Parent and subsidiaries together are called Group.
Non controlling interest: Is the part of the net results of the operations and of the net assets of the subsidiary attributable to interests which are not owned by the parent.
Note: When a parent entity controls a subsidiary it is possible that it does not own (Purchase) all the shares, which means there are other, minority, shareholders. These are known as Non controlling interest holders.
Total Share Capital:
The term ‘total share capital’ is defined under the Rule 2(r) of Companies (Specification of Definition Details) Rules, 2014:

“Total Share Capital” means aggregate of the:-

(a) paid- up equity share capital- and

(b) Convertible preference share capital.

Hence, for calculating control/ownership percentage, Share capital includes, paid up equity share capital and Convertible preference share capital

Note: To determine whether a parent-subsidiary relationship exists from an ownership perspective, accounting requires the parent to own more than 50% of the voting power of the other enterprise whereas the Companies Act requires exercise or control of more than 50% of the total share capital.

The Companies Rules clarify that total share capital shall mean aggregate of paid-up share capital and convertible preference share capital. Thus there may be a situation where a company may be a subsidiary under the Companies Act 2013 merely because of a particular company is holding the entire preference share capital and is not exercising any voting power. Further the word ‘convertible’ may include optionally convertible, partly convertible or fully convertible.

Relevant activities: relevant activities are activities of the investee that significantly affect the investee’s returns.

7.4. CONTROL

An investor, regardless of the nature of its involvement with an entity (the investee),shall determine whether it is a parent by assessing whether it controls the investee.

An investor controls an investee when it is exposed, or has rights, to variable returnsfrom its involvement with the investee and has the ability to affect those returns throughits power over the investee

Thus, an investor controls an investee if and only if the investor has all the following:

(a) Power over the investee
(b) Exposure, or rights, to variable returns from its involvement with the investee and
(c) The ability to use its power over the investee to affect the amount of the investor’s returns

Consideration of the following factors may assist to determine the control

(a) The purpose and design of the investee

(b) What the relevant activities are and how decisions about those activities are made

(c) Whether the rights of the investor give it the current ability to direct the relevant activities

(d) Whether the investor is exposed, or has rights, to variable returns from its involvement with the investee; and

(e) Whether the investor has the ability to use its power over the investee to affect the amount of the investor’s return

When assessing control of an investee, an investor shall consider the nature of its relationship with other parties

When assessing control of an investee, an investor shall consider the purpose and design of the investee in order to identify the relevant activities, how decisions about the relevant activities are made, who has the current ability to direct those activities and who receives returns from those activities

When an investee’s purpose and design are considered, it may be clear that an investee is controlled by means of equity instruments that give the holder proportionate voting rights, such as ordinary shares in the investee. In this case, in the absence of any additional arrangements that alter decision-making, the assessment of control focuses on which party, if any, is able to exercise voting rights sufficient to determine the investee’s operating and financing policies. In the most straight forward case, the investor that holds a majority of those voting rights, in the absence of any other factors, controls the investee.

An investee may be designed so that voting rights are not the dominant factor in deciding who controls the investee, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. In such cases, an investor's consideration of the purpose and design of the investee shall also include consideration of the risks to which the investee was designed to be exposed, the risks it was designed to pass on to the parties involved with the investee and whether the investor is exposed to some or all of those risks. Consideration of the risks includes not only the downside risk, but also the potential for upside.

Power

An investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities, ie the activities that significantly affect the investee's returns.

For the purpose of assessing power, only substantive rights and rights that are not protective shall be considered.

Power arises from rights. Sometimes assessing power is straightforward, such as when power over an investee is obtained directly and solely from the voting rights granted by equity instruments such as shares, and can be assessed by considering the voting rights from those shareholdings. In other cases, the assessment will be more complex and require more than one factor to be considered, for example when power results from one or more contractual arrangements.

An investor with the current ability to direct the relevant activities has power even if its rights to direct have yet to be exercised. Evidence that the investor has been directing relevant activities can help determine whether the investor has power, but such evidence is not, in itself, conclusive in determining whether the investor has power over an investee.

Relevant activities and direction of relevant activities

For many investees, a range of operating and financing activities significantly affect their returns. Examples of activities that, depending on the circumstances, can be relevant activities include, but are not limited to:

(a) Selling and purchasing of goods or services;
(b) Managing financial assets during their life (including upon default);
(c) Selecting, acquiring or disposing of assets;
(d) Researching and developing new products or processes; and
(e) Determining a funding structure or obtaining funding.

Examples of decisions about relevant activities include but are not limited to:

(a) Establishing operating and capital decisions of the investee, including budgets; and

(b) Appointing and remunerating an investee's key management personnel or service providers and terminating their services or employment.

If two or more investors each have existing rights that give them the unilateral ability to direct different relevant activities, the investor that has the current ability to direct the activities that most significantly affect the returns of the investee has power over the investee.

An investor can have power over an investee even if other entities have existing rights that give them the current ability to participate in the direction of the relevant activities, for example when another entity has significant influence. However, an investor that holds only protective rights does not have power over an investee, and consequently does not control the investee.

Returns

An investor is exposed, or has rights, to variable returns from its involvement with the investee when the investor's returns from its involvement have the potential to vary as a result of the investee's performance. The investor's returns can be only positive, only negative or both positive and negative.

Although only one investor can control an investee, more than one party can share in the returns of an investee. For example, Non controlling interests can share in the profits or distributions of an investee

Link between power and returns

An investor controls an investee if the investor not only has power over the investee and exposure or rights to variable returns from its involvement with the investee, but also has the ability to use its power to affect the investor's returns from its involvement with the investee.

Thus, an investor with decision-making rights shall determine whether it is a principal or an agent. An investor that is an agent does not control an investee when it exercises decision-making rights delegated to it.

Rights that give an investor power over an investee

Power arises from rights. To have power over an investee, an investor must have existing rights that give the investor the current ability to direct the relevant activities. The rights that may give an investor power can differ between investees.

Examples of rights that, either individually or in combination, can give an investor power include but are not limited to:

(a) Rights in the form of voting rights (or potential voting rights) of an investee

(b) Rights to appoint, reassign or remove members of an investee's key management personnel who have the ability to direct the relevant activities;

(c) Rights to appoint or remove another entity that directs the relevant activities;

(d) Rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor; and

(e) Other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities.

Generally, when an investee has a range of operating and financing activities that significantly affect the investee's returns and when substantive decision-making with respect to these activities is required continuously, it will be voting or similar rights that give an investor power, either individually or in combination with other arrangements.

When voting rights cannot have a significant effect on an investee's returns, such as when voting rights relate to administrative tasks only and contractual arrangements determine the direction of the relevant activities, the investor needs to assess those contractual arrangements in order to determine whether it has rights sufficient to give it power over the investee. To determine whether an investor has rights sufficient to give it power, the investor shall consider the purpose and design of the investee

Substantive rights

An investor, in assessing whether it has power, considers only substantive rights relating to an investee (held by the investor and others). For a right to be substantive, the holder must have the practical ability to exercise that right.

Determining whether rights are substantive requires judgment, taking into account all facts and circumstances. Factors to consider in making that determination include but are not limited to:

(a) Whether there are any barriers (economic or otherwise) that prevents the holder (or holders) from exercising the rights. Examples of such barriers include but are not limited to:

(i) Financial penalties and incentives that would prevent (or deter) the holder from exercising its rights.

(ii) An exercise or conversion price that creates a financial barrier that would prevent (or deter) the holder from exercising its rights.

(iii) Terms and conditions that make it unlikely that the rights would be exercised, for example, conditions that narrowly limit the timing of their exercise.

(iv)
The absence of an explicit, reasonable mechanism in the founding documents of an investee or in applicable laws or regulations that would allow the holder to exercise its rights.

(v) The inability of the holder of the rights to obtain the information necessary to exercise its rights.

(vi) Operational barriers or incentives that would prevent (or deter) the holder from exercising its rights (eg the absence of other managers willing or able to provide specialized services or provide the services and take on other interest sheld by the incumbent manager).

(vii) legal or regulatory requirements that prevent the holder from exercising it srights (eg where a foreign investor is prohibited from exercising its rights).

Protective rights

In evaluating whether rights give an investor power over an investee, the investor shall assess whether its rights, and rights held by others, are protective rights. Protective right sr elate to fundamental changes to the activities of an investee or apply in exceptional circumstances. However, not all rights that apply in exceptional circumstances or are contingent on events are protective

Because protective rights are designed to protect the interests of their holder without giving that party power over the investee to which those rights relate, an investor that holds only protective rights cannot have power or prevent another party from having power over an investee.

Examples of protective rights include but are not limited to:

(a) a lender's right to restrict a borrower from undertaking activities that could significantly change the credit risk of the borrower to the detriment of the lender.

(b) the right of a party holding a non-controlling interest in an investee to approvecapital expenditure greater than that required in the ordinary course of business, orto approve the issue of equity or debt instruments.

(c) the right of a lender to seize the assets of a borrower if the borrower fails to meetspecified loan repayment conditions.

7.5.WHOLLY OWNED AND PARTLY OWNED SUBSIDIARIES

Wholly owned subsidiary company:

Wholly owned subsidiary company is one in which all of the shares are owned by the holding company (Parent company)

100% voting rights are vested by the holding company (Parent company)

There is not Non controlling interest because all the shares with voting rights are by the holding company (Parent company)

Partly owned subsidiary company:

In Partly owned subsidiary company, all the shares of subsidiary company are not acquired by the holding company. Only majority of the shares (i.e. more than 50%) are owned by the holding company (Parent company)

Voting rights of more than 50% but less than 100% are vested by the holding company (Parent company)

There is a Non controlling interest because less than 50% shares with voting rights are held by outsiders other than the holding company (Parent company)

7.6. SUMMARY

This lesson focus on understanding the basic principles of consolidation, concepts of holding company, subsidiary company and group. This lesson also focuses on the concepts of economic substance over form and detailed meaning of control.

7.7. TECHNICAL TERMS

protective rights: Rights designed to protect the interest of the party holding those rights without giving that party power over the entity to which those rights relate.

Substantive rights: right to be substantive, the holder must have the practical ability to exercise that right.

7.8. SELF ASSESSMENT QUESTIONS

Multiple Choice questions:

1. Which one (or more) of the following would be accounted for as a subsidiary of A?

(a) A holds no shares in B; however through an agreement with B's shareholders, A chooses 6 of the 10 Board members.

(b) A owns 25% of C's shares. No other individual shareholder owns more than 5%.

(c) A owns 55% of D's shares. Under an contract in place, A must make all decisions in agreement with E, who owns 45% of the shares.

(d) A controls F, a partnership, under an agreement.

2. In consolidated balance sheet, share of the outsiders in the net assets of subsidiary must be shown as

(a) Current liability
(b) Non controlling interest
(c) Capital reserve

7.9. SUGGESTED READINGS

1. Indian Accounting Standard 110 published by Ministry Of Corporate Affairs (“MCA”)
2. Educational Material on Ind AS 110, Consolidated Financial Statements, published by The Institute of Chartered Accountants of India, Delhi.
3. RSN Pillai, Bagarathi & S. Uma, Fundamentals of Advanced Accounting, Vol.1, S. Chand, New Delhi.
4. Nehru J. Financial Reporting by diversified companies vision Books, New Delhi.
5. Hawkins David, Financial Statements Corporations Dow Jones – Irwin Homewood 1973.

C.A. MAHESWARARAO, NETHI

LESSON-8
CONSOLIDATED BALANCE SHEET - INTRODUCTION

AIMS AND OBJECTIVES

After studying this lesson students should be able to

- To prepare and review the consolidated balance sheet in accordance with legal and regulatory requirements.

- To understand Working through this chapter will help to understand how to demonstrate the above objective.

STRUCTURE

8.1 Introduction
8.2 Requirement to prepare consolidated financial statements
8.3 Process of preparing a consolidated statement of financial position
8.4 Exemption from preparation of group financial statements
8.5 Exclusion of subsidiary in preparing the consolidated financial statements
8.6 Standards workings for consolidated balance sheet
8.7 Disclosures of subsidiary in financial statements
8.8 Associates
8.9 Disclosure of Associate in financial statements
8.10 Summary
8.11 Technical Terms
8.12 Self Assessment Questions
8.13 Suggested Readings

8.1. INTRODUCTION

This chapter introduces consolidated accounts and the standard workings required to produce a consolidated Balance sheet.

The chapter also introduces some of the standard accounting adjustments that may be required when preparing consolidated financial statements.

It also covers the basic concepts of associates and joint ventures and accounting them in the consolidated financial statements.

8.2. REQUIREMENT TO PREPARE CONSOLIDATED FINANCIAL STATEMENTS

If one entity controls another, then single set of consolidated financial statements be prepared to reflect the:

a) Financial performance (Profit and loss account and other comprehensive income) of the group as a whole.
b) Financial position (Balance sheet) of the group as a whole.
c) Cash flows (Cash flow statement) of the group as a whole.

Consolidation of an investee shall begin from the date the investor obtains control of the investee and cease when the investor loses control of the investee.
This shows the fact that the investment of the parents' shareholders is now tied up in more than one entity.

In order to make informed decisions about their investment, shareholders would need to read and interpret the financial statements of both entities (Parent and subsidiary). If there were more than one subsidiary entity this could become quite complex for shareholders.

To this end one set of financial statements is prepared where the revenues, expenses, assets and liabilities of the parent and subsidiary are combined for ease of understanding and analysis.

8.3. PROCESS OF PREPARING A CONSOLIDATED STATEMENT OF FINANCIAL POSITION

Section 129(3) requires that “where a company has one or more subsidiaries, it shall, in addition to standalone financial statements, prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own which shall also be laid before the annual general meeting of the company along with the laying of its standalone financial statement.”

Explanation to Section 129(3) provides that the word "subsidiary" shall include associate company and joint venture.

The first proviso provides that the Company shall also attach along with its financial statement, a separate statement containing the salient features of the financial statement of its subsidiary or subsidiaries in Form AOC-1 as prescribed under Rule 5, Companies (Accounts) Rules, 2014.

The second proviso delegates power to the Central Government to prescribe the manner in which such consolidation shall be made. Accordingly, the Central Government has issued Rule 6 of Companies (Accounts) Rules 2014 for the purpose.

The Companies Act 2013 thus requires mandatory preparation of consolidated financial statements. Further, the provisions of the Act applicable to the preparation, adoption and audit of the financial statements of a holding company shall, mutatis mutandis, apply to the consolidated financial statements

Process:

a) The assets and liabilities of the Holding Company (parent) and the subsidiary are added together on a line by line basis.

b) The investment in the subsidiary included in the parent's balance sheet is cancelled and replaced by goodwill (asset) in the consolidated balance sheet.

c) The equity (ordinary) share capital and share premium balances of the parent and subsidiary are not added together; only the parent balances for equity share capital and share premium are included in the consolidated balance sheet.
This shows the fact that the consolidated balance sheet includes all of the assets and liabilities under the control of the parent entity.

d) The amount attributable to Non controlling interests is calculated and shown separately as a liability on the face of the consolidated Balance sheet.
That means Consolidate as if you owned everything then show the extent to which you do not own as Non controlling interests.

e) The group share of the subsidiary's post acquisition retained earnings is calculated and included as part of group retained earnings (reserves).
That means consolidated reserves comprise the parent's reserves plus the group share of the subsidiary's post acquisition reserves.

f) Intra-group transactions will need to be removed, meaning that no income, expenses, assets or liabilities are included that have arisen from transactions between entities within the group. For example, sale of goods by parent to subsidiary should be eliminated in consolidated financial statements.

Note: It is not necessary for a parent to own all of the equity or voting shares in another entity to have control. Voting control is normally achieved by owning a majority (in excess of 50%) of the equity or voting shares. To the extent that there are 'outside' or 'external shareholders in the subsidiary, they are referred to as a 'Non controlling interest' i.e. they have a financial and voting interest in the subsidiary, but are not in a position to exercise control. Control is exercised by the parent.

For example: if the parent owns 90% of the equity (ordinary) share capital it is likely to have control due to the majority of voting rights it controls (unless proven otherwise). The remaining 10% of shareholders are the Non controlling interests.

8.4. EXEMPTION FROM PREPARATION OF GROUP FINANCIAL STATEMENTS

A parent need not present consolidated financial statements if and only if:

a. the parent itself is a wholly owned subsidiary or a partially-owned subsidiary and its owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not preparing consolidated financial statements

b. its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets)

c. the parent did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and

d. the ultimate parent company produces consolidated financial statements that comply with accounting Standards and are available for public use

Note: All the above conditions should be satisfied to avail exemption from preparation of group financial statements

8.5. EXCLUSION OF SUBSIDIARY IN PREPARING THE CONSOLIDATED FINANCIAL STATEMENTS

A subsidiary should be excluded from consolidation when:

Control is intended to be temporary because subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future.

It operates under severe long term restrictions which significantly impair its ability to transfer resources (Funds) to the parent.

The directors of a parent company may not wish to consolidate (may try to escape) some subsidiaries due to:

a. poor performance (Subsidiary is in losses) of the subsidiary
b. poor financial position of the subsidiary
c. Differing activities of the subsidiary from the rest of the group.

These reasons are not permitted under accounting Standards.

8.6. STANDARDS WORKINGS FOR CONSOLIDATED BALANCE SHEET

Consolidated financial statements combine the information contained in separate financials of parent and subsidiaries as if they were the accounts of a single entity.

The assets and liabilities of the Holding Company (parent) and the subsidiary are added together on a line by line basis.

The investment in the subsidiary included in the parent's balance sheet is cancelled and replaced by goodwill (asset) in the consolidated balance sheet.

Only the parent balances for equity share capital and share premium are included in the consolidated balance sheet.

In order to prepare the consolidated balance sheet, following standard workings should be prepared.

Step 1: Date of acquisition (Date of control)

Identity the date when shares are acquired by the parent in subsidiary company.

This date is relevant for the purpose of analyzing the subsidiary profits in to pre-acquisition and post-acquisition profits (losses).

Step 2: Share holding pattern (Control percentage):

Determine the shareholding pattern of the subsidiary company as on the date on which consolidated balance sheet is to be prepared.

This is required to apportion the subsidiary profits.

Particulars	No. of shares	%
a) Parent	XXX	XX
b) Non controlling interest	XXX	XX
c) Total (A+B)	XXX	XX

This indicates how much parent owns in subsidiary company and how much belongs to Minority shareholders.

Step 3: working for Net assets (Share capital and reserves) of the Subsidiary

	At the date of acquisition (Pre Acquisition)	**At the balance sheet (reporting) date (Post acquisition)**
Equity Share capital	X	X
Share premium	X	X
General reserves	X	X
Other reserves	X	X
Total	X	X

The total of issued share capital and share premium from the subsidiary balance sheet should be unchanged at both the date of acquisition and the balance sheet (reporting) date.

The difference between at acquisition reserves and at balance sheet date reserves are called post acquisition reserves.

Reserves of the subsidiary company on the date of acquisition are called pre acquisition reserves and reserves earned by subsidiary after the acquisition are called post acquisition reserves.

Step 4: Goodwill

	Particulars	**Rs.**
A)	Cost of investment i.e. Amount invested (Asset side of Parent balance sheet) *(How much holding company ready to pay to purchase the subsidiary shares)*	XXX
B)	Parent share of net assets of the subsidiary as on the date of investment. (From Step no. 3) i) Share Capital ii) Pre acquisition reserves *(What is the worth of the subsidiary, i.e. how much subsidiary deserves. Multiply this with parent share)*	XXX
C)	Goodwill (+ve)/ Capital reserve (-ve) (A-B)	XXX

Note: Net assets (assets – liabilities) = Capital + Reserves

The cost to the parent of its investment in each subsidiary (i.e. asset in parent books) and the parent’s portion of equity of each subsidiary, at the date on which investment in each subsidiary is made, should be eliminated and this will be replaced by Goodwill/capital reserve.

Any excess of the cost to the parent of its investment in a subsidiary (i.e. asset in parent books) over the parent’s portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, should be described as good will to be recognized as an asset in the consolidated financial statements.

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 on which investment in the subsidiary is made, the difference should be treated as a capital reserve in the consolidated financial statements.

Full cancellation: The asset 'investment in subsidiary companies' which appears in the parent company's accounts will be matched with the liability 'share capital and Reserves' in the subsidiaries' accounts.

These two will be cancelled if both the values are equal and no goodwill/capital reserve will arise.

Goodwill/Capital reserve will arise only in case of part cancellation as discussed above.

Parent's portion of equity means:

- Share Capital of Subsidiary
- Parent share on Reserve and Surplus of Subsidiary (before acquisition) – Pre acquisition reserves

Step 5: Non controlling interest: in the net assets of consolidated subsidiaries should be identified and presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders.

Non controlling interests in the net assets consist of:

(i) The amount of equity attributable to minorities at the date on which investment in a subsidiary is made; and

(ii) The minorities' share of movements in equity since the date the parent-subsidiary relationship came inexistence

Minority share in net assets of the subsidiary at the balance sheet date. (From Step no 3)		
Share Capital of Subsidiary Company (unchaged at acquisition and post acquisition)	XXX	
Share on Pre-acquisition profits/ reserves of Subsidiary	XXX	
Share on Post-acquisition profits/ reserves of Subsidiary	XXX	XXX

Non controlling interests should be presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders.

Non controlling interests in the income of the group should also be separately presented.

Step 6: Reserves for consolidated balance sheet

Particulars	Rs.
Reserves as appearing in parent balance sheet	XXX
Add: Parent share of post acquisition reserves of the subsidiary (Step 3)	XXX

Add: Capital reserve (Step 4)	XXX
Total	**XXX**

8.7. DISCLOSURE OF SUBSIDIARY IN FINANCIAL STATEMENTS

CONSOLIDATE STATEMENT OF PROFIT AND LOSS FOR THE YEAR ENDED 31st MARCH, 2023 (Extracts)

Amount in Rs.

	Note No	31.03.2023	31.03.2022
Profit /(Loss) after Tax before Non controlling interest and Share of Profit/ (Loss) of Associates		XXX	XXX
Non controlling interest		XXX	XXX
Share of Profit/ (Loss) of Associate		XXX	XXX
Profit /(Loss) after Tax before Non controlling interest and Share of Profit/ (Loss) of Associates		XXX	XXX

CONSOLIDATE BALANCE SHEET AS AT 31st MARCH, 2023

	Note No	31.03.2023	31.03.2022
EQUITY AND LIABILITIES			
1) SHAREHOLDERS' FUNDS			
(a) Share Capital		XXX	XXX
(b) Reserves And Surplus		XXX	XXX
2) NON CONTROLLING INTEREST		XXX	XXX
3) NON-CURRENT LIABILITIES		XXX	XXX
Assets			
NON-CURRENT ASSETS			
(a) Fixed Assets			
(i) Tangible Assets		XXX	XXX
(ii) Intangible Assets		XXX	XXX
(b) Goodwill on Consolidation		XXX	XXX
(c) Non Current Investments		XXX	XXX

8.8. ASSOCIATES

An associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.

Consolidation of Associates

The equity method is a method of accounting whereby the investment is initially recorded at cost, identifying any goodwill/capital reserve arising at the time of acquisition.

The carrying amount of the investment is adjusted thereafter for the post acquisition change in the investor's share of net assets of the investee.

The consolidated statement of profit and loss reflects the investor's share of the results of operations of the investee.

Steps:

Find out the date of acquisition

An investment in an associate is accounted for under the equity method from the date on which it falls within the definition of an associate.

On acquisition of the investment any difference between the cost of acquisition and the investor's share of the equity of the associate is described as goodwill or capital reserve, as the case may be.

Calculate the Capital Reserve/ Goodwill:

If the cost to the investor's investment in the associate is more than the investor's portion of equity in the associate then the difference is recognized as Goodwill

If the cost to the investor's investment in the associate is less than the investor's portion of equity in the associate then the difference is recognized as Capital Reserve.

Goodwill/capital reserve arising on the acquisition of an associate by an investor should be included in the carrying amount of investment in the associate but should be disclosed separately

Investor's portion of Equity means:

- Share Capital of Associate
- Reserve and Surplus of Associate (before acquisition)

Goodwill/ Capital reserve

	Particulars	**Rs.**
A)	Cost of investment i.e. Amount invested (Parent balance sheet)	XXX
B)	Parent share of net assets of the associate as on the date of investment. i) Share Capital of associate ii) Pre acquisition reserves of associate	XXX
C)	Goodwill (+ve)/ Capital reserve (-ve) (A-B)	XXX

Intra group balances/ transactions

In using equity method for accounting for investment in an associate, unrealized profits and losses resulting from transactions between the investor (or its consolidated subsidiaries) and the associate should be eliminated to the extent of the investor's interest in the associate.

Unrealized losses should not be eliminated if and to the extent the cost of the transferred asset cannot be recovered.

Investments in associates accounted for using the equity method should be classified as long-term investments and disclosed separately in the consolidated balance sheet.

The investor's share of the profits or losses of such investments should be disclosed separately in the consolidated statement of profit and loss.

The investor's share of any extraordinary or prior period items should also be separately disclosed

In considering the share ownership, the potential equity shares (example: Convertible debentures) of the investee held by the investor are not taken into account for determining the voting power of the investor.

Adjustments to the carrying amount of investment in an investee arising from changes in the investee's equity that have not been included in the statement of profit and loss of the investee are directly made in the carrying amount of investment without routing it through the consolidated statement of profit and loss. The corresponding debit/credit is made in the relevant head of the equity interest in the consolidated balance sheet.

For example, in case the adjustment arises because of revaluation of fixed assets by the investee, apart from adjusting the carrying amount of investment to the extent of proportionate share of the investor in the revalued amount, the corresponding amount of revaluation reserve is shown in the consolidated balance sheet.

8.9. DISCLOSURE OF ASSOCIATE IN FINANCIAL STATEMENTS

CONSOLIDATE STATEMENT OF PROFIT AND LOSS FOR THE YEAR ENDED 31st MARCH, 2023 (Extracts)

Amount in Rs.

	Note No	31.03.2023	31.03.2022
Profit /(Loss) after Tax before Non controlling interest and Share of Profit/ (Loss) of Associates		XXX	XXX
Non controlling interest		XXX	XXX
Share of Profit/ (Loss) of Associate		XXX	XXX
Profit /(Loss) after Tax before Non controlling interest and Share of Profit/ (Loss) of Associates		XXX	XXX

NOTES TO FORMING PART OF THE CONSOLIDATED FINANCIAL STATEMENTS FORTHE YEAR ENDED 31st MARCH, 2023

	31.03.2023	31.03.2022
NON CURRENT INVESTMENTS		
(At Cost unless otherwise stated)		
Long Term, Trade Investments		
Investment in Equity Instruments		
In Associates		
ABC Ltd		
(i) Cost of Investment (xxx equity shares of Rs. XX each, fully paid up) (including Rs. XX (previous yearRs. XX) of goodwill arising on consolidation	XXX	XXX
(ii) Share of post acquisition profit (net of losses)	XXX	XXX
PQR Ltd		
(i) Cost of Investment xxx equity shares of Rs. XX each, fully paid up) (includingRs. XX (Previous year. Rs. XX) net ofcapital reserve) arising on consolidation	XXX	XXX
(ii) Share of post acquisition profit (net of losses)	XXX	XXX

8.10. SUMMARY

This lesson focuses on standard workings required to prepare consolidated balance sheet as per the legal and regulatory requirements. A consolidated balance sheet is a document that shows the entire financial situation of a parent company, along with all its subsidiaries within a single sheet, without separating the companies. A Balance Sheet is a document of the financial situation of a company, while a Consolidated Balance Sheet is a statement showing the financial status of more than one company in the same group taken together. A consolidated balance sheet presents the financial position of an affiliated group of companies. The result is a balance sheet that shows the assets, liabilities, and equity of the group as though they were a single firm. Consolidated financial statements are the overall financial statements of any entity with multiple divisions, including the parent company and all subsidiaries that are controlled by the parent company. They include three key financial statements; income, cash flow, and financial position. In general, the consolidation of financial statements requires a company to integrate and combine all of its financial accounting functions together in order to create consolidated financial statements that shows results in standard balance sheet, income statement, and cash flow statement reporting.

8.11. TECHNICAL TERMS

Trade Investments: Trade Investments means Investments of the Borrower or any of its Subsidiaries in Securities of trade debtors or other Persons in consideration of or as evidence of past-due or restructured accounts receivable**.**

Equity Instruments: An equity instrument represents an ownership interest in an entity and is determined either by the absence of a settlement requirement or the type of return the instrument conveys to the counterparty.

Mutual indebtedness: It appears under liabilities on the balance sheet as part of all the money the company owes its creditors. Companies use bank debt to pay for long-term assets such as land, buildings and equipment or to add more cash to their working capital to cover ongoing, short-term expenses (current liabilities).

Subsidiary company: A subsidiary is an independent company that is more than 50% owned by another firm—called the parent company or holding company. Subsidiaries are separate and distinct legal entities from their parent companies.

8.12. SELF ASSESSMENT QUESTIONS

1. What is the meaning of holding and Subsidiary company?
2. What is Mutual indebtedness? Discuss.
3. How can be creating Reserves and surplus for both holding and subsidiary companies?
4. What is Non controlling interest? How it should be presented in the consolidated balance sheet
5. Explain about the liabilities and the equity of the parents shareholders

8.13. SUGGESTED READINGS:

1. Indian Accounting Standard 110 published by Ministry Of Corporate Affairs (“MCA”)

2. Educational Material onInd AS 110, Consolidated Financial Statements, published by The Institute of Chartered Accountants of India, Delhi.

3. RSN Pillai, Bagarathi & S. Uma, Fundamentals of Advanced Accounting, Vol.1, S. Chand, New Delhi.

4. Nehru J. Financial Reporting by diversified companies vision Books, New Delhi.

5. Hawkins David, Financial Statements Corporations Dow Jones – Irwin Homewood 1973.

C.A. MAHESWARARAO, NETHI

LESSON-9
CONSOLIDATED BALANCE SHEET AND CONSOLIDATED PROFIT AND LOSS ACCOUNT

AIMS AND OBJECTIVES

After studying this lesson students should be able to

- To know familiarize with various adjustments/workings needed to prepare the consolidated financial statements in accordance with legal and regulatory requirements.

- To understand Working through this chapter will help to understand how to demonstrate the above objective.

STRUCTURE

9.1. Introduction
9.2 Goodwill or capital reserve
9.3 Revaluation of assets of the subsidiary
9.4 Non controlling interest
9.5 Profit or loss of the subsidiary
9.6 Elimination of intra group transactions
9.7 Adjustments in preparing consolidated Profit and loss account
9.8 Disposal of subsidiary
9.9 Associate
9.10 Summary
9.11 Technical Terms
9.12 Self Assessment Questions
9.13 Suggested Readings

9.1. INTRODUCTION

This lesson introduces various adjustments required to prepare the consolidated balance sheet and consolidated statement of profit or loss.
This lesson also covers the accounting treatment in case of loss of control due to disposal of a subsidiary
Key accounting of associates and various disclosures required in notes to the consolidated financial statements are also covered in this lesson.

9.2. GOODWILL OR CAPITAL RESERVE

On the date of investment, the cost of investment is compared with the Equity in the subsidiary.
Equity is nothing but net assets of the subsidiary on the date of investment.
Goodwill = Cost of investment – parent's share in the equity of the subsidiary on the date of investment.
Capital Reserve: parent's share in the equity of the subsidiary on the date of investment – Cost of investment.
To know the "Cost of Investment" we will look into the Asset side of the balance sheet of the parent.
To know the equity of the subsidiary on the date of investment, we need financials of the subsidiary on the date of investment.
In the financial statements of the subsidiary, Equity section is relevant.

9.3. REVALUATION OF ASSETS OF THE SUBSIDIARY

Profit or loss on the revaluation of the subsidiary on the date of investment should also be considered while calculating the goodwill or capital reserve, because revaluation happened on the date of investment.

Adjustment for depreciation would be made in the profit and loss account of the subsidiary as a post acquisition adjustment.

9.4. NON CONTROLLING INTEREST

Non controlling interest represents claims of outside shareholders of a subsidiary.

Non controlling interest in the net income of the subsidiary for the reporting period is identified and adjusted against the income of the group in order to arrive at the net income attributable to the shareholders of the holding company.
Non controlling interests should be presented in the consolidated balance sheet separately from liabilities and equity of the parent shareholders.
Non controlling interest in the income of the group should be separately presented in the consolidated profit and loss account.
Profit or loss and other comprehensive income are attributed to the owners of the parent and to the non-controlling interests.
Total comprehensive income is also attributed to the owners of the parent and to the non-controlling interests.

9.5.PROFIT OR LOSS OF THE SUBSIDIARY

For the purpose of consolidated balance sheet preparation, all reserves and profits (losses) of the subsidiary should be classified into pre and post acquisition reserves and profits (losses).

Profits or losses earned by the subsidiary up to the date of acquisition will be used for calculating the Goodwill or capital reserve. They are called capital profits.

Profits or losses earned by the subsidiary after the date of acquisition will be used for calculating the consolidated reserves. They are called revenue profits.

If holding interest in the subsidiary is acquired during any day of the current year, pre acquisition profits (losses) should be calculated accordingly.

i.e. In case of midyear acquisitions, when calculating the reserves at the date of acquisition assume that the subsidiary's profits accrue evenly throughout the period, if information is not given in the question.

9.6.ELIMINATION OF INTRA GROUP TRANSACTIONS

In order to prepare consolidated financial statements for the group, the effect of transactions between group companies (i.e transactions between holding company with subsidiary company and vice versa) should be eliminated.

Accounting standards states that intra group balances, intra group transactions and its resulting unrealized profits should be eliminated in full.

Unrealized losses resulting from intra group transactions should also be eliminated unless cost cannot be recovered.

Liabilities due to one group company (creditors/trade payables/borrowings) by another will be set off against the corresponding receivables (Debtors/trade receivables/ advances to) in the other group company financial statements.

The trade receivable in one company's books should equal the trade payable in the other.

These two balances should be cancelled on consolidation as intra-group receivables and payables.

Where the two balances do not agree at the year end this will be due to items such as inventories in transit and cash in transit.

Prior to consolidation, adjustments will need to be made in the separate company financial statements for the inventories or cash in transit.

This is usually done by following through the transaction to its ultimate destination.

The accounting entries to do this are:

For cash in transit: (Realization from debtors)

DEBIT Cash

CREDIT Trade Receivables

For inventories in transit: (Purchase of goods which are in stock)

DEBIT Inventories

CREDIT Trade Payables

Then to eliminate the now reconciled current account balances:

DEBIT Intra-group Payables

CREDIT Intra-group Receivables

This adjustment is only done as a consolidation adjustment.

Sales made by one group company to another should be excluded both from turnover and cost of sales in the consolidated statement of profit or loss. When buying company further sold these goods to third party, then no further adjustments are required except eliminations to the turnover and cost of sales as discussed above.

However, when buying company has these goods still in inventory at year end (Unsold goods), they may be carried at an amount that is in excess of cost to the group and the amount of the intra group profit must be eliminated, and assets are reduced to cost to the group.

For transactions between group companies, unrealized profits resulting from intra group transactions that are included in the carrying amount of assets, such as inventories and tangible fixed assets are eliminated in full.

The requirement to eliminate such profits in full applies to transactions of all subsidiaries that are consolidated – even those in which the group interest is less than 100%.

Unrealized profits in inventories: Whereas Group Company sells goods to another group company, the selling company records the profit made on these sales in its individual financial statements as a separate legal entity.

If these goods are still held in inventory by the buying company at the year end, the profit recorded by the selling company, when viewed from the standpoint view of group as a whole, has not yet been earned, and will not be earned until the goods are eventually sold outside the group.

On consolidation, the unrealized profit on closing inventories will be eliminated from the group's profit, and the closing inventories of the group will be recorded at cost to the group.

Intra group transactions can be either **upstream transactions** or **downstream transactions.**

Upstream transaction: Is a transaction in which the subsidiary company sells goods to holding company.

Downstream transaction: Is a transaction in which the holding company sells goods to subsidiary company.

In case of upstream transaction, since the goods are sold by the subsidiary company to holding company, profit is made by the subsidiary company, which is ultimately shared by the holding company and minority shareholders.

In this case, if some or all of the goods are remain unsold by the holding company at the balance sheet date; the unrealized profit on such goods should be eliminated from consolidated profits as well as Non controlling interest on the basis of their shareholding. On other side, same unrealized profit should be deducted from unsold inventory.

Journal entry:

DEBIT Consolidated SPL (P's share)

DEBIT Non-controlling interest (NCI's share)

CREDIT Group inventory

In case of downstream transaction, since the goods are sold by the holding company to subsidiary company, whole profit is made by the holding company.

In this case, if some or all of the goods are remain unsold by the subsidiary company at the balance sheet date, the unrealized profit on such goods should be eliminated from consolidated profits and should be deducted from unsold inventory.

Journal entry:

DEBIT Consolidated SPL

CREDIT Group inventory

Unrealized profit on transfer of noncurrent asset:

The treatment of elimination of unrealized profits on sale of noncurrent assets by holding company to subsidiary company or vice versa is similar to that of inventories.

The transfer of noncurrent asset at a profit within the group is similar as the transfer of inventories, and the profit on the sale is unrealized and to be eliminated.

An additional issue is that the items of noncurrent assets will subsequently be depreciated based on the new carrying amount.

This is in effect a realization of the unrealized profit through use and therefore reduces the consolidation adjustment.

Firstly, calculate the unrealized profit:

Unrealized profits on transfer	X
Less proportion depreciated by year-end	(X)
	X

Then make the adjustment in the books of the company making the sale:

DEBIT Retained earnings

CREDIT Property, plant and equipment

9.7. ADJUSTMENTS IN PREPARING CONSOLIDATED PROFIT AND LOSS ACCOUNT

Consolidated statement of profit or loss account shows total incomes and total expenses and the resultant total net profit of the holding company and its subsidiaries subject to the following adjustments.

a. Add all the items, i.e incomes, expenses, gains and losses of all the group companies on line by line basis.
b. Eliminate intra group transactions from the consolidated numbers

Examples are: holding company may sell goods or services to subsidiary company, receives consultancy fees, commission, revenue, royalty etc. These items will be included in sales and other income heads in the books of holding company and in cost of sales or other expenses in the books of subsidiary company.

Alternatively, subsidiary company may sell goods or services to holding company. These intra group transactions are to be eliminated in full.

c. Eliminate unrealized profits in the inventory by increasing cost of sales in consolidated profit or loss account

9.8. DISPOSAL OF SUBSIDIARY

The consolidated statement of profit or loss will include the results of subsidiaries disposed of up to the date of disposal

The results of operations of a subsidiary with which parent-subsidiary relationship ceases to exist are included in the consolidated statement of profit and loss until the date of cessation of their relationship.

If a parent loses control of a subsidiary, it:

a) derecognizes the assets (including any goodwill) and liabilities of the subsidiary at their carrying amounts at the date when control is lost;

(b) Derecognizes the carrying amount of any non-controlling interests in the former subsidiary at the date when control is lost (including any components of other comprehensive income attributable to them);

Thedifferencebetweentheproceedsfromthedisposalofinvestmentinasubsidiaryandthecarryinga mountofitsassetslessliabilitiesasofthedateofdisposalis recognized in the consolidated statement of profitandloss as the profit or loss on the disposal of the investment in the subsidiary.

When a subsidiary is disposed of, this must be accounted for in both the parent's separate financial statements and the consolidated financial statements.

In the individual financial statements of the parent, the profit or loss on disposal is calculated as follows

Particulars	**In Rs.**
Sale proceeds received	XXX
Less: Carrying amount of cost of investment	XXX
Profit/ (loss) on disposal	XXX

In the consolidated financial statements profit or loss on disposal is calculated as follows:

Particulars	**In Rs.**
Sale proceeds received	XXX
Less: Carrying amount of :	

Net assets of subsidiary at disposal (assets- liabilities) XXX	
Goodwill XXX	
Non controlling interest(XXX)	XXX
Profit/ (loss) on disposal	XXX

9.9. ASSOCIATE

In case of associates, there is no such thing as consolidation.

Consolidation of assets/liabilities is not done in case of associates.

Merely, the valuation of investment in the associate is valued as per equity method of accounting. However, such a valuation is required only in "group accounts".

Since a company not having subsidiaries is never required to prepare group accounts, there is no question of consolidation in case of a company which merely had associates.

Hence, the proponents of this view argue that that a company is not required to prepare consolidated financial statements if it does not have a subsidiary but has an associate or a joint venture.

9.10. SUMMARY

In this lesson, various key adjustments like Goodwill/capital reserves, revaluation adjustments, unrealized profits, which are required to prepare consolidated balance sheet and consolidated statement of profit or loss, are covered. This lesson ends with accounting treatment in case of associates and in case of loss of control on account of disposal of a subsidiary. A consolidated balance sheet is a document that shows the entire financial situation of a parent company, along with all its subsidiaries within a single sheet, without separating the companies. Consolidated financial statements are presented by a parent (also known as holding enterprise) to provide financial information about the economic activities of its group. A Balance Sheet is a document of the financial situation of a company, while a Consolidated Balance Sheet is a statement showing the financial status of more than one company in the same group taken together. Consolidation of loans is a special form of consolidation. In this process, several loans are combined into one loan. For example, a company that has two current loans with different interest rates can take out a new loan and thereby pay off the other two loans. What Are the Rules of Consolidation Accounting? Declare minority interests. ... The financial reporting statements must be prepared in the same way for the parent company as they are for the subsidiary company. Completely eliminate intra group transactions and balances.

However, a Comparative Income Statement or Comparative Statement of Profit & Loss is a horizontal analysis of the Income Statement showing operating results for more than one accounting year. In simple terms, it shows the absolute change and percentage change in the figures from one period to another. Comparative Income Statement or comparative statement is a financial statement that defines the current financial position of a business and compares it with prior period statements. Here's the main one: The balance sheet reports the assets, liabilities and shareholder equity at a specific point in time, while a P&L statement summarizes a company's revenues, costs, and expenses during a specific period of time.

9.11. TECHNICAL TERMS

Parent company: A parent company is a single company that has a controlling interest in another company or companies. Parent companies are formed when they spin-off or carve out subsidiaries, or through an acquisition or merger.

Consolidation of loans: Debt consolidation means that your various debts–whether credit card bills or other loan payments–are rolled into one loan or monthly payment. If you have multiple credit card accounts or loans, consolidation may be a way to simplify or lower payments.

Consolidation Accounting: To consolidate (consolidation) is to combine assets, liabilities, and other financial items of two or more entities into one. In financial accounting, the term consolidate often refers to the consolidation of financial statements wherein all subsidiaries report under the umbrella of a parent company.

Income Statement: An income statement is a financial statement that shows you the company's income and expenditures. It also shows whether a company is making profit or loss for a given period. The income statement, along with balance sheet and cash flow statement, helps you understand the financial health of your business.

Balance Sheet: A balance sheet is a financial statement that contains details of a company's assets or liabilities at a specific point in time. It is one of the three core financial statements (income statement and cash flow statement being the other two) used for evaluating the performance of a business.

9.12. SELF ASSESSMENT QUESTIONS

Question 1

H Ltd. acquires 80% of the equity shares of S Ltd. on 1.01.2023.

On that date, paid up share capital of S Ltd. wasRs. 1,00,000 represented by 10,000 equity shares of Rs.10 each.

Accumulated reserves balance was Rs. 1,00,000.

H Ltd. paid Rs. 1,60,000 to acquire 80% interest in the S Ltd.

Assets of S Ltd. were revalued on 1.1.2023 and a revaluation loss of Rs. 20,000 was ascertained.

Calculate Goodwill or capital reserve that should be reported in consolidated balance sheet of HLtd.

Question 2

A Ltd. acquires 70% of the equity shares of B Ltd. on 1.01.2023.

On that date, paid up share capital of B Ltd. was 10,000 equity shares of Rs.10 each.

Accumulated reserves balance was Rs. 1,00,000.

A Ltd. paid Rs. 1,30,000 to acquire 70% interest in the B Ltd.

Assets of B Ltd. were revalued on 1.1.2023 and a revaluation profit of Rs. 20,000 was ascertained.

Calculate Goodwill or capital reserve that should be reported in consolidated balance sheet of A Ltd.

Question 3

H Ltd. holds 70% of the equity capital and voting power in S Ltd.

H Ltd. sells inventories costing Rs. 3,60,000 to S Ltd. at a price of Rs. 4,00,000.

The entire inventories remain unsold with S Ltd. at the balance sheet date.

Suggest the accounting treatment of above transaction in the consolidated financial statements of H Ltd.

Question 4

A Ltd. holds 80% of the equity capital and voting power in B Ltd.

A Ltd. purchases inventories costing Rs. 1,50,000 from B Ltd. at a price of Rs. 2,00,000.

The entire inventories remain unsold with A Ltd. at the balance sheet date.

Suggest the accounting treatment of above transaction in the consolidated financial statements of H Ltd.

Question 5

A Ltd. holds 80% of the equity capital and voting power in B Ltd.

A Ltd. purchases inventories costing Rs. 1,50,000 from B Ltd. at a price of Rs. 2,00,000.

The 60% of inventories remain unsold with A Ltd. at the balance sheet date.

Suggest the accounting treatment of above transaction in the consolidated financial statements of H Ltd.

Question 6

Red Co acquired 80% of Blue Co’s 40,000,Rs.10equity share capital on 1 January 2012 for a consideration of Rs. 35 cash per share.

Fair value of the net assets acquired was 14,50,000.

What should be recorded as goodwill on acquisition of Blue Co in the consolidated financial statements?

Question 7

Philip acquired 85% of the share capital of Stanley on 31 December 2022.

The profit for the year ended 31 March 2023 for Stanley was Rs. 36,000.

Profits are deemed to accrue evenly over the year.

At 31 March 2023 Stanley's statement of financial position showed:

Equity share capital	Rs.200,000
Retained earnings	Rs. 180,000

What are the net assets on acquisition?

Question 8

Pink Co acquired 80% of Scarlett's Co ordinary shares on 1 January 2012.

As at 31 December 2012, extracts from their individual statements of financial position showed:

	Pink Co (Rs.)	Scarlett Co (Rs.)
Current assets:		
Receivables	50,000	30,000
Current liabilities:		
Payables	70,000	42,000

As a result of trading during the year, Pink Co's receivables balance included an amount due from Scarlett of Rs. 4,600.

What should be shown as the consolidated figure for receivables and payables?

Question 9

MNO has a 75% owned subsidiary PQR.

During the year MNO sold inventory to PQR for an invoiced price of Rs. 800,000.

PQR have since sold 75% of that inventory on to third parties.

The sale was at a mark-up of 25% on cost to MNO.

PQR is the only subsidiary of MNO.

What is the adjustment to inventory that would be included in the consolidated statement of financial position of MNO at the year-end resulting from this sale?

Question 10

Oxford owns 100% of the issued share capital of Cambridge, and sells goods to its subsidiary at a profit margin of 20% on selling price.

At the year end, their statements of financial position showed inventories of:

Oxford	Rs. 290,000
Cambridge	Rs. 160,000

The inventories of Cambridge included Rs. 40,000 of goods supplied by Oxford and there were inventories in transit amounting to a further Rs. 20,000.

At what value should inventories appear in the consolidated statement of financial position?

Question 11

Rugby has a 75% subsidiary, Stafford and is preparing its consolidated statement of financial position on 31 March 2023. The carrying amount of property, plant and equipment in the two companies at that date is:

Rugby	Rs. 260,000
Stafford	Rs. 80,000

On 1 April 2022 Stafford had transferred an item of equipment to Rugby for Rs. 40,000.

At the date of transfer :

Cost of Equipment is Rs. 70,000

Carrying amount of equipment is Rs. 30,000

Remaining useful life is five years.

The group accounting policy is to depreciate equipment on a straight line basis down to a nil residual value.

It is also the group policy not to revalue property, plant and equipment.

What is the figure that will be disclosed as the carrying amount of property, plant and equipment in the consolidated statement of financial position of Rugby as on 31 March 2023?

9.17. SUGGESTED READINGS

1. Indian Accounting Standard 110 published by Ministry Of Corporate Affairs (“MCA”)

2. Educational Material onInd AS 110, Consolidated Financial Statements, published by The Institute of Chartered Accountants of India, Delhi.

3. RSN Pillai, Bagarathi & S. Uma, Fundamentals of Advanced Accounting, Vol.1, S. Chand, New Delhi.

4. Nehru J. Financial Reporting by diversified companies vision Books, New Delhi.

5. Hawkins David, Financial Statements Corporations Dow Jones – Irwin Homewood 1973.

6. Indian Accounting Standard (Ind AS) 27, Consolidated and Separate Financial Statements issued by Ministry of corporate affairs

C.A. MAHESWARARAO, NETHI

LESSON-10
CONSOLIDATED FINANCIAL STATEMENTS – MISCELLANEOUS AREAS

AIMS AND OBJECTIVES

After studying this lesson students should be able to

- To understand various areas which are required to prepare and review the consolidated financial statements in accordance with legal and regulatory requirements.

- To acquire knowledge on Working through this chapter will help to understand how to demonstrate the above objective.

STRUCTURE

10.1. Introduction
10.2.Consolidated cash flow statement
10.3. Different accounting periods
10.4. Uniform accounting policies
10.5. Accounting for Investments in Subsidiaries, Jointly Controlled Entities and Associates in Separate Financial Statements
10.6. Disclosures
10.7. Form of consolidated financial statements
10.8. Format of Consolidated balance sheet
10.9. Format of Consolidated statement of profit or loss and other comprehensive income
10.10. Summary
10.11. Technical Terms
10.12. Self Assessment Questions
10.13. Suggested Readings

10.1. INTRODUCTION

This lesson introduces various miscellaneous areas which should be needed to prepare the consolidated financial statements.

This lesson also covers the formats of consolidated balance sheet and Format of Consolidated statement of profit or loss and other comprehensive income specified in the Appendix to the accounting standards.

10.2. CONSOLIDATED CASHFLOW STATEMENT

As per accounting standard 21, consolidated cash flow statement is presented in case a parent presents its own cash flow statement.

Cash flow statement shows the liquidity position of the company and it takes in to account all the cash movements during the accounting year.

In individual cash flow statements of holding company and subsidiary company, Cash flows (Inflows and outflows) are divided in to below three activities:

i. Cash flows from operating activities
ii. Cash flows from investing activities
iii. Cash flows from financing activities

For the purpose of preparation of consolidated cash flow statement, all the items of Cash flows from operating activities, investing activities and financing activities of holding company and subsidiary company are added on line by line basis.
Intra group transactions will be eliminated.

10.3. DIFFERENT ACCOUNTING PERIODS

Some companies in the group may have differing accounting dates. In practice such companies will often prepare financial statements up to the group accounting date for consolidation purposes.

i.e. the financial statements used in the consolidation should be drawn up to the same reporting date.

For the purpose of consolidation, accounting standards states that where the reporting date (Balance sheet date) for a parent is different from that of a subsidiary, the subsidiary should prepare additional financial information as of the same date as the financial statements of the parent unless it is impracticable to do so.

If it is impracticable to do so, that is when the financial statements of a subsidiary used in the preparation of consolidated financial statements are prepared as of a date different from that of the parent’s financial statements, adjustments shall be made for the effects of significant transactions or events that occur between that date and the date of the parent’s financial statements

In any case, the difference between the end of the reporting period of the subsidiary and that of the parent shall be no more than three months.

The consistency principle requires that the length of the reporting periods and any difference in the reporting dates should be the same from period to period.

10.4. UNIFORM ACCOUNTING POLICIES

Accounting standard 21 says that consolidated financial statements shall be prepared using uniform accounting policies for like transactions and other events in similar circumstances.

If a member of a group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to that group member's financial statements in preparing the consolidated financial statements to ensure conformity with the group's accounting policies

For example, if Parent company is following FIFO method for valuing the closing stock and Subsidiary company is following weighted average cost method for valuing the closing stock, then for the purpose of consolidation Subsidiary closing stock should be adjusted by applying FIFO method for valuation of closing stock.

If it is not practicable to use uniform accounting policies while preparing consolidated financial statements, the fact should be disclosed together with the proportion of items to which different accounting policies have been applied.

10.5. ACCOUNTING FOR INVESTMENTS IN SUBSIDIARIES, JOINTLY CONTROLLED ENTITIES AND ASSOCIATES IN SEPARATE FINANCIAL STATEMENTS

For preparing separate financial statements the entity shall account for investments in subsidiaries, jointly controlled entities and associates either:

(a) At cost, or
(b) In accordance with other accounting standards.
The entity shall apply the same accounting for each category of investments.

10.6.DISCLOSURES

The following disclosures shall be made in consolidated financial statements:

(a) The nature of the relationship between the parent and a subsidiary when the parent does not own, directly or indirectly through subsidiaries, more than half of the voting power;

(b) The reasons why the ownership, directly or indirectly through subsidiaries, of more than half of the voting or potential voting power of an investee does not constitute control;

(c) The end of the reporting period of the financial statements of a subsidiary when such financial statements are used to prepare consolidated financial statements and are as of a date or for a period that is different from that of the parent’s financial statements, and the reason for using a different date or period;

(d) The nature and extent of any significant restrictions (e.g. resulting from borrowing arrangements or regulatory requirements) on the ability of subsidiaries to transfer funds to the parent in the form of cash dividends or to repay loans or advances;

(e) A schedule that shows the effects of any changes in a parent’s ownership interest in a subsidiary that do not result in a loss of control on the equity at tributable to owners of the parent; and

(f) If control of a subsidiary is lost, the parent shall disclose the gain or loss, if any, recognized.

(g) The line item(s) in the statement of profit and loss in which the gain or loss is recognized (if not presented separately in the statement of profit and loss).

Separate financial statements of a parent, venture with an interest in a jointly controlled entity or an investor in an associate shall disclose:

(a) The fact that the statements are separate financial statements;

(b) a list of significant investments in subsidiaries, jointly controlled entities and associates, including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held; and

(c) A description of the method used to account for the investments listed under (b);

10.7. FORM OF CONSOLIDATED FINANCIAL STATEMENTS

It sets out the minimum requirements for disclosure on the face of

(a) The Consolidated Balance Sheet at the end of the period and a Consolidated Statement of Changes in Equity for the period as a part of the Consolidated Balance Sheet,

(b) The Consolidated Statement of Profit and Loss for the period. (The term Consolidated 'Statement of Profit and Loss' has the same meaning as 'Consolidated Profit and Loss Account').

The Consolidated Statement of Profit and Loss shall include:

(1) Profit or loss for the period;
(2) Other Comprehensive Income for the period.

The sum of (1) and (2) above is 'Total Comprehensive Income'.

(c) Notes (hereinafter referred to as "Consolidated Financial Statements" for the purpose of this Appendix).

Line items, sub-line items and sub-totals shall be presented as an addition or substitution on the face of the Consolidated Financial Statements when such presentation is relevant to an understanding of the Group's (i.e. the parent and its subsidiaries) financial position or performance or to cater to industry/sector specific disclosure requirements or when required for compliance with any law or under the Indian Accounting Standards.

Except in the case of the first Consolidated Financial Statements laid before the Company (after its incorporation) the corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Consolidated Financial Statements including notes shall also be given

An asset shall be classified as current when it satisfies any of the following criteria:

(a) It is expected to be realized in, or is intended for sale or consumption in, the entity's normal operating cycle;
(b) It is held primarily for the purpose of being traded;
(c) It is expected to be realized within twelve months after the reporting date; or
(d) It is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

All other assets shall be classified as non-current.

An **operating cycle** is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have duration of 12months.

A liability shall be classified as current when it satisfies any of the following criteria:

(a) It is expected to be settled in the entity's normal operating cycle;
(b) It is held primarily for the purpose of being traded;
(c) It is due to be settled within twelve months after the reporting date;
or
(d) The entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.

A receivable (Debtor) shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.

A payable (Creditor) shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.

When an accounting policy is applied retrospectively or items in the consolidated financial statements are restated or when items are reclassified in consolidated financial statements, a Consolidated Balance Sheet as at the beginning of the earliest comparative period from which the above adjustments are made shall be attached to the Consolidated Balance Sheet.

10.8. FORMAT OF CONSOLIDATED BALANCE SHEET

Consolidated Balance Sheet as at ……………………………….. (In Rupees)

	Particulars	Note no	As at current reporting period	As at the end of previous reporting period
I	**EQUITY AND LIABILITIES**			
(1)	**Equity**			
	Equity attributable to owners of the Parent			
	(a) Equity Share capital			
	(b) Other Equity			
	Retained Earnings			
	Reserves			

	Other Reserves **Equity attributable to non-controlling Interests** (a) Equity Share Capital (b) Other equity			
(2)	**Share application money pending Allotment**			
(3)	**Non-current liabilities** (a) Financial Liabilities (b) Long-term provisions (c) Deferred tax liabilities (Net) (d) Other non-current liabilities			
(4)	**Current liabilities** (a) Financial Liabilities (b) Other current liabilities (c) Short-term provisions (d)) Liabilities for Current Tax (Net)			
	Total			
II	**ASSETS**			
(1)	**Non-current assets** (a) Property, Plant and Equipment (b) Capital work-in-progress (c) Investment Property (d) Intangible Assets (i) Goodwill (ii) Other intangible assets (iii) Intangible assets under development (e) Biological Assets (f) Financial Assets (i) Non-current investments (ii) Long-term loans and advances (iii) Others (g) Deferred tax assets (net) (h) Other non-current assets			

(2)	**Current assets** (a) Inventories (b) Financial Assets (i) Current investments (ii) Trade and other receivables (iii) Cash and cash equivalents (iv) Short-term loans and advances (c) Non-current assets classified as held forsale (d) Assets for Current Tax (Net) (e) Other current assets			
	Total			

10.9. CONSOLIDATED STATEMENT OF PROFIT AND LOSS FOR THE PERIOD ENDED ………………………

(Rupees in…………)

	Particulars	**Note No.**		**Current reporting period (Rs.)**		**Previous year reporting period (Rs.)**
I	Revenue From Operations			XXX		XXX
	Other Income			XXX		XXX
	Total Revenue (I)			**XXX**		**XXX**
II	**EXPENSES**					
	Cost of materials consumed			XXX		XXX
	Purchases of Stock-in-Trade			XXX		XXX
	Changes in inventories of finished goods, Stock-in -Trade and work-in-progress			XXX		XXX
	Employee benefits expense			XXX		XXX
	Finance costs			XXX		XXX
	Depreciation and amortization expense			XXX		XXX
	Other expenses			XXX		XXX
	Total expenses (II)			**XXX**		**XXX**

III	**Profit before exceptional items and tax (I-II)**			**XXX**		**XXX**
IV	Exceptional Items			XXX		XXX
V	**Profit/(loss) before tax (III-IV)**			**XXX**		**XXX**
VI	Tax expense: (1) Current tax (2) Deferred tax		 XXX XXX	 XXX	 XXX XXX	 XXX
VII.	**Profit (Loss) for the period from continuing operations (V-VI)**			**XXX**		**XXX**
VIII	**Profit/(loss) from discontinued operations**			**XXX**		**XXX**
IX.	**Tax expense of discontinued operations**			**XXX**		**XXX**
X.	**Profit/(loss) from Discontinued operations (after tax) (VIII-IX)**			**XXX**		**XXX**
XI.	**Profit/(loss) for the period attributable to (VII+ X)** **(a)Owners of the parent** **(b)Non-controlling Interests**		 **XXX** **XXX**	 **XXX**	 **XXX** **XXX**	 **XXX**
XII.	**Other Comprehensive Income attributable to** **(a)Owners of the parent** **(b)Non-controlling Interests**		 **XXX** **XXX**	 **XXX**	 **XXX** **XXX**	 **XXX**
XIII.	**Total Comprehensive Income for the period (XI + XII)** **(Comprising Profit (Loss) and Other Comprehensive Income for the period) attributable to** **(a)Owners of the parent**		**XXX**		**XXX**	

	(b)Non-controlling Interests		**XXX**	**XXX**	**XXX**	**XXX**

10.10. SUMMARY

This lesson includes broad understanding of various areas that should be familiarized with to prepare the consolidated financial statements. Formats of Consolidated balance sheet and Format of Consolidated statement of profit or loss and other comprehensive income helps to know the presentation of items of assets, liabilities, incomes and expenses. To acquire knowledge on Working through this chapter will help to understand how to demonstrate the above objective. Further, it is emphasized on consolidated cash flow statement, Different accounting periods, Uniform accounting policies, Accounting for Investments in Subsidiaries, Jointly Controlled Entities and Associates in Separate Financial Statements, Disclosures, Form of consolidated financial statements, Format of Consolidated balance sheet, Format of Consolidated statement of profit or loss and other comprehensive income.

A consolidated cash flow statement aggregates cash flows from financing, investing and operating activities across all majority-owned companies that are legally separate businesses. This means that you exclude general partnerships and sole proprietorships, which are not legally distinct, from consolidation. Consolidated financial statements are the overall financial statements of any entity with multiple divisions, including the parent company and all subsidiaries that are controlled by the parent company. They include three key financial statements; income, cash flow, and financial position. Full consolidation, proportionate consolidation, and equity consolidation are the three consolidation methods. A consolidated financial statement is a combination of a financial statement of a parent company and its branches. This statement is important to review the financial situation of the group of companies owned by one business. Consolidation of loans is a special form of consolidation. In this process, several loans are combined into one loan. For example, a company that has two current loans with different interest rates can take out a new loan and thereby pay off the other two loans.

10.11. TECHNICAL TERMS

Full consolidation: Full Consolidation consists in transferring all the Subsidiary's Assets, Liabilities and Equity to the Parent company's Balance sheet and all the Revenues and Expenses to the Parent company's Income statement. The accounts of a Subsidiary are fully consolidated if it is controlled by its parent.

Proportionate consolidation: The term “proportionate consolidation” means presenting an investor's pro-rata share of a venture's assets and liabilities in each applicable line item of the investor's balance sheet, and pro-rata results of a venture's operations in each applicable line item in its income statement.

Equity consolidation: The consolidation method records “investment in subsidiary” as an asset on the parent company's balance sheet, while recording an equal transaction on the equity side of the subsidiary's balance sheet.

Investments in Subsidiaries: Investment Subsidiary means (1) any Subsidiary engaged principally in the business of directly or indirectly buying, holding, transferring or selling real estate related assets, including securities of companies engaged principally in such business (including, without limitation, Real Estate Companies and Qualified ...

Uniform accounting policies: Uniform accounting policies means the specific principles, bases, conventions, rules, and practices adopted by the group, based on the applicable financial reporting framework, that the components use to report similar transactions consistently.

10.12. SELF ASSESSMENT QUESTIONS

1. Define consolidated cash flow statement? Explain it.
2. What are the Different accounting periods?
3. What are Uniform accounting policies?
4. What is the Accounting for Investments in Subsidiaries,
5. Discuss about Jointly Controlled Entities and Associates in Separate Financial Statements
5. What are Disclosures?
6. What are the Forms of consolidated financial statements
7. Draw the Format of Consolidated balance sheet
8. Draw the Format of Consolidated statement of profit or loss and other comprehensive income

Question 1

The statements of financial position of P and S as at 31 March 2023 were as follows.

	P	S
Liabilities		
Capital (Shares of Rs.1 each fully paid)	65,000	20,000
Reserves	1,05,000	35,000
Trade payables	1,35,000	47,000
Total	**3,05,000**	**1,02,000**
Assets		
Non current assets		
Machinary	85,000	18,000
Non current investments		
Shares in S Ltd	60,000	
Trade receivables	1,60,000	84,000
Total	**3,05,000**	**1,02,000**

P acquired a 100% holding in S on 1 April 2022. At that date S's retained earnings were Rs. 15,000. Prepare the consolidated statement of financial position for the H group as at 31 March 2023.

Question 2

The statements of profit or loss for Paddle and Skip for the year ended31 March 2023 are shown below. Paddle acquired 75% of the ordinaryshare capital of Skip several years ago.

	Paddle (Rs'000)	**Skip (Rs'000)**
Revenue	2,400	800
Other income Investment income: Dividend received from skip	 3	 -
Total revenue	**2,403**	**800**
EXPENSES		
Cost of materials consumed	2,000	700
Other expenses	160	20
Total Expenses	**2,160**	**720**
Profit before exceptional items and tax	**243**	**80**
Income tax expense	115	40
Profit for the year	128	40

Prepare Paddle's consolidated statement of profit or loss for theyear ended 31 March 2023.

Question 3

On 1 April 2022 Zebedee acquired 60% of the ordinary shares ofXavier.

The following statements of profit or loss have been produced byZebedee and Xavier for the year ended 31 March 2023.

	Zebedee (Rs'000)	**Xavier (Rs'000)**
Revenue	1,260	520
Other income Investment income:		

Dividend received from Xavier	36	-
Total revenue	**1,296**	**520**
EXPENSES		
Cost of materials consumed	420	210
Other expenses	300	150
Total Expenses	**720**	**360**
Profit before exceptional items and tax	**576**	**160**
Income tax expense	130	26
Profit for the year	446	134

During the year ended 31 March 2023 Zebedee sold Rs.84,000worth of goods to Xavier.

These goods had cost Zebedee Rs. 56,000.

On31 March 2023 Xavier still had Rs. 36,000 worth of these goods ininventories (held at cost to Xavier).

Prepare the consolidated statement of profit or loss to incorporateZebedee and Xavier for the year ended 31 March 2023.

10.13. SUGGESTED READINGS

1. Indian Accounting Standard 110 published by Ministry Of Corporate Affairs ("MCA")

2. Educational Material onInd AS 110, Consolidated Financial Statements, published by The Institute of Chartered Accountants of India, Delhi.

3. RSN Pillai, Bagarathi & S. Uma, Fundamentals of Advanced Accounting, Vol.1, S. Chand, New Delhi.

4. Nehru J. Financial Reporting by diversified companies vision Books, New Delhi.

5. Hawkins David, Financial Statements Corporations Dow Jones – Irwin Homewood 1973.

6. Indian Accounting Standard (Ind AS) 27, Consolidated and Separate Financial Statements issued by Ministry of corporate affairs

C.A. MAHESWARARAO, NETHI

LESSON-11
CONSOLIDATION OF FINANCIAL STATEMENTS WITH FOREIGN SUBSIDIARIES

AIMS AND OBJECTIVES

After studying this lesson students should be able to

- To understand various areas which are required to prepare and review the consolidated financial statements in accordance with legal and regulatory requirements.
- To acquire knowledge on Working through this chapter will help to understand how to demonstrate the above objective.
- Consolidating with a Foreign Subsidiary
- Understanding IAS 21
- Using the correct rates for translation

STRUCTURE

11.1 Introduction
11.2 IAS 21 - In Consolidation of Foreign Subsidiaries
11.3 Initial recognition
11.4 Translation at reporting dates
11.5 Monetary and non-monetary items
11.6 Recognition of exchange differences
11.7 Several available exchange rates
11.8 Advance Consideration (IFRIC 22)
11.9 Exchange differences on borrowings
11.10 Exchange differences on deferred tax
11.11 Translation of a foreign operation
11.12 General requirements for translation of a foreign operation
11.13 Cumulative translation adjustment (CTA)
11.14 Intra group balances
11.15 Exchange differences in intra group balances
11.16 Goodwill
11.17 Net Investment in Foreign Operation
11.18 Disposal or partial disposal of a foreign operation
11.19 Translation from the currency of a hyperinflationary economy
11.20 Functional and foreign currencies
11.21 Definition of functional and foreign currencies
11.22 Summary
11.23 Technical Terms
11.24 Self-Assessment Questions
11.25 Suggested Readings

11.1. INTRODUCTION

The consolidation of the financial statements of a foreign subsidiary pretty much follows the same path as the consolidation of financial statements of a domestic subsidiary except all we learned so far follows after the conversion of the assets and liability of the foreign subsidiary into the domestic currency.

Care should be taken that such transactions follow the Indian Accounting Standard 21, which deals with foreign currency transactions.

11.2. IAS 21 - IN CONSOLIDATION OF FOREIGN SUBSIDIARIES

Effects of changes in foreign exchange rates are dealt with in IAS 21. Specifically, IAS 21 is applied in (IAS 21.3):

- accounting for transactions and balances in foreign currencies,
- translating the results and financial position of foreign operations that are included in the financial statements of the entity by consolidation
- translating an entity's results and financial position into a presentation currency

11.3. INITIAL RECOGNITION

On initial recognition, foreign currency transaction is recorded at the spot exchange rate (i.e. rate for immediate delivery) between the functional currency and the foreign currency at the date of the transaction (IAS 21.21). A foreign currency transaction is a transaction that is denominated or requires settlement in a foreign currency, including transactions arising when an entity (IAS 21.20):

1. Buys or sells goods or services whose price is denominated in a foreign currency;

2. Borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency; or

3. Otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency

The date of the transaction is the date on which the transaction first qualifies for recognition in accordance with IFRS (IAS 21.22). IAS 21 allows the application of simplifications in determining the foreign exchange rate, e.g. by using an average rate, provided that exchange rates do not fluctuate significantly (IAS 21.22).

In practice, entities most often use the **average of monthly rates**, as central banks usually publish these for most currencies.

Example

Foreignness Subsidiary S made the following sales at the following dates

Month	Sales in $	Dollar to Rupee	In Rupees
January	1000	70	70000
February	1000	71	71000
March	1000	72	72000

April	1000	73	73000
May	1000	74	74000
June	1000	75	75000
July	1000	76	76000
August	1000	77	77000
September	1000	78	78000
October	1000	79	79000
November	1000	80	80000
December	1000	81	81000
Total	12000		906000
Average		75.5	
Practice	12000	75.5	906000

In this example there is a linear progression of rates and sales are equal every month that is why there is no difference between what is practiced and what is in actual. But what if both these are no longer true?

Let us find out.

Month	**Sales in $**	**Dollar to Rupee**	**In Rupees**
January	1000	70	70000
February	3000	70.5	211500
March	10000	72	720000
April	500	73.5	36750
May	1500	72	108000
June	5000	73	365000
July	2000	72.5	145000
August	4000	74	296000
September	8000	75	600000
October	3000	77	231000
November	6000	77.7	466200
December	12000	76	912000
Total	56000		4161450
Average		73.6	
Practice	56000	73.6	4121600

As you can see there is a difference between actual sales and translation. This is acceptable.

11.4. TRANSLATION AT REPORTING DATES

At the end of each reporting period (IAS 21.23):

1. Foreign currency monetary items are translated using the closing rate (i.e. the spot exchange rate at the end of the reporting period);

2. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction, i.e. are not retranslated using the closing rate;

3. Non-monetary items that are measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was measured.

To clarify the above let us understand with an example

Example

H took a loan of $10,000 when $ is ₹77 on 1/1/ 2021 to invest in subsidiary S. S bought $10,000 worth of land.

On the date of the balance sheet of 31/12/2022 following are true.

The Land was valued at $12,000 and a dollar rate of ₹81 per $ in November 2022

Loan pending is $8,000 with a dollar rate of ₹82 per $ on 31/12/2022

In the balance sheet the following rates are used.

1. Cost of investment in S = ₹7,70,000 (10,000 X 77)
2. Land = ₹9,72,000 (12,000 X 81)
3. Loan = ₹6,56,000 (8,000 X 82)

11.5. MONETARY AND NON-MONETARY ITEMS

Monetary items are defined as units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency (IAS 21.8). Most common examples of monetary items include trade receivables and payables or loans.

According to IAS 21.16, Intra group balances and intra group transactions and resulting unrealized profits should be eliminated in full. Unrealized losses resulting from intra group transactions should also be eliminated unless cost cannot be recovered. These are also monetary items.

Investments in equity instruments are also non-monetary items, however, they are measured at fair value and therefore their carrying amount is effectively impacted by foreign exchange movements.

11.6. RECOGNITION OF EXCHANGE DIFFERENCES

As a rule, exchange differences arising on settlement or translation of a monetary asset are recognized in P/L (IAS 21.28). When non-monetary assets are measured at fair value (or revalued amount) in a foreign currency, exchange differences are recognized the same way as gains/losses on re measurement, i.e. they can be recognized in other comprehensive income in instances specified by other IFRS (IAS 21.30-31).

IAS 21.30-31 states, in the case of companies, the information such as the following given in the notes to the separate financial statements of the parent and/or the subsidiary need not be included in the consolidated financial statements:

1. Source from which bonus shares are issued, e.g., capitalization of profits or Reserves or from Share Premium Account.
2. Disclosure of all unutilized monies out of the issue indicating the form in which such unutilized funds have been invested.

3. The name(s) of small-scale industrial undertaking(s) to whom the company owe any sum together with interest outstanding for more than thirty days.
4. A statement of investments (whether shown under "Investment" or under "Current Assets" as stock-in-trade) separately classifying trade investments and other investments, showing the names of the bodies corporate (indicating separately the names of the bodies corporate under the same management) in whose shares or debentures, investments have been made (including all investments, whether existing or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investment so made in each such body corporate.
5. Quantitative information in respect of sales, raw materials consumed, opening and closing stocks of goods produced/ traded and purchases made, wherever applicable.
6. A statement showing the computation of net profits in accordance with section 349 of the Companies Act, 1956, with relevant details of the calculation of the commissions payable by way of a percentage of such profits to the directors (including managing directors) or manager (if any).
7. In the case of manufacturing companies, quantitative information in regard to the licensed capacity (where the license is in force); the installed capacity; and the actual production

Example

Entity A purchases an item of PP&E on 1 January 20X1. Entity A's functional and presentation currency is EUR, and the invoice for the PP&E is USD 1,000. EUR/USD rate on 1 January 20X1 is 1.1 (i.e. 1 EUR = 1.1 USD). The invoice is paid on 1 May 20X1 when the EUR/USD rate is 1.2.

1 January 20X1	***DR***	***CR***
PP&E	909	
Payables		909

In May it translates to

1 May 20X1	**DR**	**CR**
PP&E	–	–
Cash		833
Payables	909	
Exchange differences (P/L)		76

As we can see, an item of PP&E is carried at historical cost and is not subsequently retranslated to reflect movements in exchange rates between initial recognition and invoice payment.

11.7. SEVERAL AVAILABLE EXCHANGE RATES

When several exchange rates are available, the rate used is that at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date (IAS 21.26).

11.8. ADVANCE CONSIDERATION (IFRIC 22)

IFRIC Interpretation 22 'Foreign Currency Transactions and Advance Consideration' clarifies that the date of the transaction for the purpose of determining the exchange rate to be used for initial recognition of the related asset, expense or income is the date when an entity initially recognizes the non-monetary asset or non-monetary liability arising from the payment or receipt of advance consideration (IFRIC 22.8-9).

11.9. EXCHANGE DIFFERENCES ON BORROWINGS

Paragraph IAS 23.6(e) state that borrowing costs may include exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

11.10. EXCHANGE DIFFERENCES ON DEFERRED TAX

Exchange differences on deferred foreign tax liabilities or assets can be classified as a deferred tax expense (income) in P/L (or OCI in certain instances specified in IFRS) (IAS 12.78). Change in functional currency. Functional currency can be changed only if there is a change to underlying transactions, events and conditions that the functional currency reflects. Change in functional currency is accounted for prospectively (IAS 21.35-37).

11.11. TRANSLATION OF A FOREIGN OPERATION AND 11.12. GENERAL REQUIREMENTS FOR TRANSLATION OF A FOREIGN OPERATION

A group entity with a presentation currency different from the presentation currency of the consolidated financial statements is translated using the following procedures (IAS 21.39):

1. assets (including goodwill and fair value adjustments – IAS 21.47) and liabilities are translated at the closing rate at the reporting date (including comparatives translated using historical rates);
2. income and expenses are translated at exchange rates at the dates of the transactions (including comparatives translated using historical rates), and
3. All resulting exchange differences are recognised in other comprehensive income.

IAS 21 allows the application of simplifications in determining the foreign exchange rate, e.g. by using an average rate, provided that exchange rates do not fluctuate significantly (IAS 21.40). In practice, an average rate for each month is used most often.

11.13. CUMULATIVE TRANSLATION ADJUSTMENT (CTA)

The exchange differences referred to in IAS 21.39(c) are often labeled as cumulative translation adjustment, or CTA. Their two major sources are (IAS 21.41):

1. Translating income and expenses at the exchange rates at the dates of the transactions, but assets and liabilities at the closing rate.
2. Translating the opening assets and liabilities at a closing rate that differs from the opening rate.

Example

Group A has EUR as its presentation currency. Entity X is one of the subsidiaries of Group A with USD as its presentation currency. The following exchange rates apply: EUR/USD closing rate on 1 January 20X1: 1.1

EUR/USD average rate in 20X1: 1.2
EUR/USD closing rate on 31 December 20X1: 1.3
Entity X is consolidated to Group A financial statements as follows:

Statement of financial position (USD)

		1 Jan 20X1	31 Dec 20X1
Assets		5,000	5,300
	Share capital	2,000	2,000
	Retained earnings	-	300
Total equity		2,000	2,300
Liabilities		3,000	3,000

P/L for year 20X1 (USD)

Revenue	1,000
Expenses	-700
Net income	300

Statement of financial position (EUR) - 1 January 20X1

		Stand-alone	Consolidation	Consolidated	
		Parent (A)	Subsid (X)	Adjustments	Group (A+X)
	Investment in X	1,818	-	-1,818	-
	Other assets	7,000	4,545	-	11,545
Total assets		8,818	4,545	-1,818	11,545
	Share capital	3,000	1,818	-1,818	3,000
	Retained earnings	-	-	-	-
Total equity		3,000	1,818	-1,818	3,000
Liabil ities		5,818	2,727	-	8,545

Statement of financial position (EUR) - 31 December 20X1

		Stand-alone	**Consolidation**	**Consolidated**	
		Parent (A)	**Subsid (X)**	**Adjustments**	**Group (A+X)**
	Investment in X	1,818	-	-1,818	-
	Other assets	8,000	4,077		12,077
Total assets		9,818	4,077	-1,818	12,077
	Share capital	3,000	1,538	-1,538	3,000
	Retained earnings	1,000	231	19	1,250
	CTA	**-**	**-**	**-299**	**-299**
Total equity		4,000	1,769	-1,818	3,951
Liabilities		5,818	2,308	-	8,126

P/L for year 20X1 (EUR)

	Stand-alone	**Consolidation**	**Consolidated**	
	Parent (A)	**Subsid (X)**	**Adjustments**	**Group (A+X)**
Revenue	2,500	833	-	3,333
Expenses	-1,500	-583	-	-2,083
Net income	1,000	250	-	1,250
CTA (OCI)		**-**	**-299**	**-299**

11.14. INTRA GROUP BALANCES AND 11.15. EXCHANGE DIFFERENCES IN INTRAGROUP BALANCES

Intra group balances are obviously eliminated on consolidation; however exchange differences arising on those balances are not eliminated, as the group is effectively exposed to foreign exchange gains/losses even on intra group transactions (IAS 21.45). This includes also dividend receivables and payables.

11.16. GOODWILL

As stated before, goodwill is treated as an asset of a foreign operation and is re-translated at each reporting date. For acquisitions of multinational groups, goodwill should be allocated to the level of each functional currency of the acquired foreign operation (IAS 21.BC32).

11.17. NET INVESTMENT IN FOREIGN OPERATION

Net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation (IAS 21.8). Monetary items receivable from, or payable to, a foreign operation for which settlement is neither planned nor likely to occur in the foreseeable future are treated as a part of the entity's net investment in that foreign operation (IAS 21.15-15A). Exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation are recognized in P/L in separate financial statements but are recognized in OCI (as a part of CTA) in consolidated financial statements (IAS 21.32-33).

11.18. DISPOSAL OR PARTIAL DISPOSAL OF A FOREIGN OPERATION

On the disposal of a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation, recognized in other comprehensive income and accumulated in the separate component of equity (i.e. CTA), are reclassified from equity to P/L (as a reclassification adjustment) when the gain or loss on disposal is recognized (IAS 21.48). Additionally, paragraph IAS 21.48A specifies accounting for partial disposals.

11.19. TRANSLATION FROM THE CURRENCY OF A HYPERINFLATIONARY ECONOMY

Separate provisions on translating from the currency of a hyperinflationary economy are given in paragraphs IAS 21.42-43.

Hyperinflation is a term to describe rapid, excessive, and out-of-control general price increases in an economy. While inflation measures the pace of rising prices for goods and services, hyperinflation is rapidly raising inflation, typically measuring more than 50%.

In 2023 top 5 inflationary economies are:

Inflation rate, average consumer prices (Annual percent change)	**2023**
Venezuela	400
Zimbabwe	172.2
Argentina	98.6
Sudan	71.6
Türkiye, Republic of	50.6

Source: IMF

11.20. FUNCTIONAL AND FOREIGN CURRENCIES AND 11.21. DEFINITIONS OF FUNCTIONAL AND FOREIGN CURRENCIES

Functional currency is the currency of the primary economic environment in which the entity operates, i.e. primarily generates and spends cash. Paragraphs IAS 21.9-10 lists factors to consider in determining the functional currency of an entity.

Foreign currency is a currency other than the functional currency of the entity (IAS 21.8).

Determining functional currency may be particularly challenging when a reporting entity is a foreign operation of another entity and is in substance an extension of its operations. For example, a 'financial' subsidiary (i.e. a subsidiary that holds only financial assets or issues debt) with core financial assets/liabilities denominated in the parent's functional currency may have the same functional currency as the parent, irrespective of the country that it operates in. Paragraph IAS 21.11 lists additional factors to consider when determining the functional currency of a foreign operation. When these indicators are mixed, priority is given to the primary indicators listed in paragraph IAS 21.9.

The above rules are applicable to translating a foreign operation and are also applicable to the use of a presentation currency other than the functional currency.

IAS 21 is silent on which part of P/L should foreign exchange differences be presented in. Entities need therefore to develop an accounting policy. The most usual approach is that exchange differences are presented in the same area of P/L that the original income or expense was recognized (or will be recognized) on the item that subsequently gave rise to exchange differences. For example, exchange differences in trade receivables are presented within the operating profit and exchange differences in debt are presented within finance costs. This is also the approach proposed by the IASB in their primary financial statements project.

Statement of cash flows is excluded from the scope of IAS 21, as IAS 7 covers also a presentation of cash flows arising from transactions in a foreign currency and the translation of cash flows of a foreign operation (IAS 21.7).

Disclosure requirements are set out in paragraphs IAS 21.51-57.

11.22. SUMMARY

After studying this lesson students should be able: To understand various areas which are required to prepare and review the consolidated financial statements in accordance with legal and regulatory requirements. To acquire knowledge on Working through this chapter will help to understand how to demonstrate the above objective. Consolidating with a Foreign Subsidiary- Understanding IAS 21-Using the correct rates for translation. Further it is explained various aspects such as: IAS 21 - In Consolidation of Foreign Subsidiaries, Initial recognition, Translation at reporting dates, Monetary and non-monetary items, Recognition of exchange differences, Several available exchange rates, Advance Consideration (IFRIC 22), Exchange differences on borrowings, Exchange differences on deferred tax, Translation of a foreign operation, General requirements for translation of a foreign operation, Cumulative translation adjustment (CTA), Intragroup balances, Exchange differences in intragroup balances, Goodwill, Net Investment in Foreign Operation, Disposal or partial disposal of a foreign operation, Translation from the currency of a hyperinflationary economy, Functional and foreign currencies, Definition of functional and foreign currencies.

11.23. TECHNICAL TERMS

Foreign Subsidiary: A foreign subsidiary is a company that operates in one country but is partially or wholly owned by a parent company based in another country. Also known as a daughter company, a foreign subsidiary is a separate legal entity that must comply with the local jurisdiction's tax and employment laws.

Consolidation of Foreign Subsidiaries: When preparing consolidated financial statements that include a foreign subsidiary, the financial statements of the foreign subsidiary need to be translated to the reporting currency of the parent. There are two methods for currency translation, the current-rate method and the temporal method.

Cumulative translation adjustment (CTA): Cumulative translation adjustment (CTA) is an accounting entry that reflects the impact of fluctuations in currency exchange rates on a company's financial statements. While the CTA can be positive or negative, it is generally considered a non-cash item that does not impact a company's cash flow.

Intra group balances: Intra-Group Balances means all sums owed by or to Marsxxx xx or from any other members of the Seller's Guarantor's Group at Completion save for those in respect of trade creditors arising through normal business transactions.

Hyperinflationary economy: Hyperinflation is generally defined as price increases of 50% or more per month, but in the worst-known cases prices have doubled in days or hours. Hyperinflation happens only when people lose all confidence in a government and its institutions, usually in the aftermath of political or economic upheaval.

11.24. SELF –ASSESSED QUESTIONS

1. How is Consolidating with a Foreign Subsidiary?
2. How is Understanding IAS 21-Using the correct rates for translation.?
3. Explain about IAS 21 - In Consolidation of Foreign Subsidiaries,
4. What is Initial recognition?
5. Explain the Monetary and non-monetary items & Recognition of exchange differences.
6. Explain about Advance Consideration (IFRIC 22), Exchange differences on borrowings.
7. Discuss about Exchange differences on deferred tax, Translation of a foreign operation.
8. Explain regarding General requirements for translation of a foreign operation.
9. What is Cumulative translation adjustment (CTA)?
10. What are the Exchange differences in intragroup balances?
11. What is Net Investment in Foreign Operation?
12. What is the Disposal or partial disposal of a foreign operation?

11. 25. SUGGESTED READINGS

1. Indian Accounting Standard 110 published by Ministry Of Corporate Affairs (“MCA”)

2. Educational Material on Ind AS 110, Consolidated Financial Statements, published by The Institute of Chartered Accountants of India, Delhi.

3. RSN Pillai, Bagarathi & S. Uma, Fundamentals of Advanced Accounting, Vol.1, S. Chand, New Delhi.

4. Nehru J. Financial Reporting by diversified companies vision Books, New Delhi.

5. Hawkins David, Financial Statements Corporations Dow Jones – Irwin Homewood 1973.

6. Indian Accounting Standard (Ind AS) 27, Consolidated and Separate Financial Statements issued by Ministry of corporate affairs

Dr. B. RAJA

LESSON-12
PREPARING CONSOLIDATED FINANCIAL STATEMENTS

AIMS AND OBJECTIVES

After studying this lesson students should be able to

- To understand various areas which are required to prepare and review the consolidated financial statements in accordance with legal and regulatory requirements.
- To acquire knowledge on Working through this chapter will help to understand how to demonstrate the above objective.
- Preparing a Consolidate BS
- Preparing a Consolidated P&L
- Preparing a Consolidated CF12

STRUCTURE

12.1 Introduction
12.2 Consolidated Statements with a Subsidiary
12.3 100% Subsidiary VS Non 100% Subsidiary
12.4 Procedure for consolidation
12.5 Steps involved in the consolidation process is as follows:
12.6 Goodwill and Reserve
12.7 Minority interest
12.8 Preparing Consolidated Balance Sheet
12.9 Consolidated P&L statement
12.10 Eliminating Intra group Transactions
12.11 Unrealized Profit in Inventories
12.12 P&L
12.13 Consolidated Cash Flows
12.14 Summary
12.15 Technical Terms
12.16 Self-Assessment Questions
12.17 Suggested Readings

12.1. INTRODUCTION

By now you are familiar with consolidated financial statements. So we are going to dive into calculations and the process of making the financial statements

12.2. CONSOLIDATED STATEMENTS WITH A SUBSIDIARY AND 12.3. 100% SUBSIDIARY VS NON 100% SUBSIDIARY

We have earlier mentioned that we are going to explore the consolidation of financial statements of 100% subsidiary. So the question automatically arises is there a difference between 100% Subsidiary and then non 100% Subsidiary

Serial No.	100% Subsidiary	Non-100% Subsidiary
1.	This is called a wholly-owned subsidiary	This is not a wholly-owned subsidiary. It is also called a partly-owned subsidiary
2.	There is no minority interest in the subsidiary	There is a minority in interest because some shares are held by outside shareholders.

First, we are going to explore only the 100% wholly owned subsidiary and consolidation of its statements with the holding company

12.4. PROCEDURE FOR CONSOLIDATION

When preparing the consolidated financial statements, the individual balances of the parent and its subsidiaries are combined and are consolidated line by line basis and then certain consolidation adjustments are made.

The objective is that the consolidated financial statement should represent the information contained in the consolidated financial statements of a parent and its subsidiary as if they were the financial statements of a single unit

12.5. STEPS INVOLVED IN THE CONSOLIDATION PROCESS ARE AS FOLLOWS:

1) The cost of the parent of its investment in each subsidiary and the parent's portion of equity of each is made and should be eliminated in case cost of acquisition exceeds or is less than the cost of acquisition at the date of which investment in the subsidy is made goodwill or capital reserve should be recognized respectively in the consolidated financial statements.
2) Intra group transactions including sales expenses and dividends are eliminated in full.
3) Adjustments in respect of unrealised profit and losses should be made.
4) Minority interest in the net income of the consolidated subsidiaries for the reporting period are identified and adjusted against the income of the group in order to arrive at the net income of the attribute to the owners of the parent company.

5) Minority interest in the net assets of the consolidated subsidiary should be identified represented in the consolidated balance sheet separately from liabilities and equity of the parent shareholders and minority interest in the net assets consist of:

The amount of equity attributable to minorities at the date at which investment is subsidiary is made and the minority share of movements in equities since the date of parent-subsidiary relationship came into existence.

12.6. GOODWILL AND RESERVE

Equity

By now you should be familiar with equity. But for the purpose of calculations here we use:

Equity is the difference between total assets – total liabilities.

That is:

Equity = Total Assets – Total Liabilities

Goodwill

Goodwill arises when the amount of payment made far exceeds the amount value of the subsidiary according to the book value.

Reserve

Reserve arises when the book value of the subsidiary is greater than the amount paid to acquire the subsidiary.

Mathematical representation:

Goodwill = Cost of Acquisition (of shares in subsidiary) – Equity of Subsidiary (When positive or > zero)

Reserve = Cost of Acquisition – Equity of Subsidiary (When Negative or < zero) or

= Equity of Subsidiary– Cost of Acquisition (When Positive or > zero)

Example Goodwill

Company X buys Company Y for 1,00,00,000 (1 crore). Company Y has a total asset of 150,00,000 and loans of 1,00,00,000.

Equity of Y is
Total Assets – Total liabilities = 1,50,00,000 – 1,00,00,000 = 50,00,000
Goodwill of Y shown in the book of consolidated X is
Goodwill = Cost of Acquisition – Equity of Y
= 100,00,000 – 50,00,000
= 50,00,000

Example of Reserves

In the above example X has bought Y 30,00,000 (30 lakhs)

Reserves = Equity of Y – Cost of Acquisition

= 50,00,000 – 30.00,000

= 20,00,000

12.7. MINORITY INTEREST

Minority interest arises when the holding company does not hold 100% of the subsidiary.

Example

Company X buys 60% of Company Y for 1,00,00,000 (1 crore). Company Y has a total asset of 150,00,000 and loans of 1,00,00,000.
Equity of Y is (as calculated above) 50,00,000
Equity of Y owned by Company X is 60% of 50,00,000 = 30,00,000
Minority Interest in Y is 40% (100% -60% owned by X) of 50,00,000 = 20,00,000
Now Goodwill = Cost of Acquisition – Equity in Y
= 1,00,00,000 = 30,00,000
= 70,00,000
If, however, X paid only 20,00,000 for 60% of Y then the reserves are
Reserves = Equity in Y – Cost of Acquisition
= 30,00,000 – 20,00,000
= 10,00,000 (10 Lakhs)
This shall be dealt in depth in the next section.

12.8. PREPARING CONSOLIDATED BALANCE SHEET

While preparing the consolidated balance sheet, the assets and liabilities of the subsidiary company are merged with those of the holding company. Share capital and reserves and surplus of the subsidiary company are appropriated between the holding company and minority shareholders these items along with investments of the holding company in the shares of the software company are not separately shown in the consolidated balance sheet. The net amounts resulting from the various compositions of the item are shown as

- minority interest
- cost of control and
- holding company shares in post-acquisition profits of the subsidiary company (added to the appropriated concerned amount of the holding company)

are entered in the consolidated balance sheet.

Example

From the **Balance Sheets** and information given below, prepare the Consolidated Balance Sheet of H and S as of 31st Dec of year xxx1. H holds 80% of Equity shares in S, since its incorporation.

The balance sheets of H and V as of 31st December, xxx1

Particulars	**Note No.**	**H Rs.**	**S Rs.**
1. Equity & Liabilities			
(1)Shareholder's Funds			
(a) Share Capital	1	6,00,000	4,00,000
(b) Reserves and surplus	2	1,00,000	1,00,000
(2) Non-Current Liabilities			
Long term borrowings		2,00,000	1,00,000
(3) Current Liabilities			
Trade payables		1,00,000	1,00,000
Total		10,00,000	7,00,000
2. Assets			
(1) Non-Current Assets			
(a) Plant and Machinery		4,00,000	3,00,000
(b) Investments	3	3,20,000	-
(2) Current Assets			
(a) Inventories		1,60,000	2,00,000
(b) Trade Receivables		80,000	1,40,000
(c) Cash and Cash equivalents		40,000	60,000
		10,00,000	7,00,000

Notes to Accounts

Note No.	**Particulars**	**H Rs.**	**S Rs.**
1	Share Capital		
	Shares of H	6,00,000	
	Shares of S		4,00,000
	Total	6,00,000	4,00,000
2	Reserves and surplus		
	General Reserve	1,00,000	1,00,000
	Total	1,00,000	1,00,000

3	Investments		
	Shares is S	3,20,000	

Working for the above

Working Notes:

1. **Basic Information**
    a. H is Holding Company
    b. S is Subsidiary Company
    c. H acquired 80% shares in S at incorporation
    d. Date of Consolidation 31st December xxx1
2. **Analysis of Reserves of S**
   Since H holds shares in S since incorporation entire reserves are post acquisiiton reserves.

3. **Consolidations of Reserve Balances of S with H**

	Total	Minority Interest	Holding Company	
Equity Capital	4,00,000	80,000	3,20,000	
General Reserves	1,00,000	20,000		80,000
Total		1,00,000	3,20,000	80,000
Cost of Investment			-3,20,000	
Goodwill (Reserves)			-	-
Total				-
H Reserves				1,00,000
Total				1,80,000

Notes to accounts

	Particulars	**Rs.**	**Rs.**
1	Share Capital		
	Shares of H		6,00,0000
2	Reserves and Surplus		
	General Reserve	1,00,000	
	Add General Reserve of S	80,000	
	(80% of !,00,000)		
	Total		1,80,000
3	Minority Share		
	20% in S (WN 3)		1,00,000
4	Long Term Borrowings		
	H long term borrowings	2,00,000	
	S long term borrowings	1,00,000	

	Total		3,00,000
5	Trade Payables		
	H Trade payables	1,00,000	
	S Trade payables	1,00,000	
	Total		2,00,000
6	Plant and Machinery		
	H	4,00,000	
	S	3,00,000	
	Total		7,00,000
7	Inventories		
	H	1,60,000	
	S	2,00,000	
			3,60,000
8	Trade Receivables		
	H	80,000	
	S	1,40,000	
			2,20,000
9	Cash and Cash Equivalents		
	H	40,000	
	S	60,000	
			1,00,000

Consolidated Balance Sheet of H and its subsidiaries as fo 31st December, xxx1

Sno.	Particulars	Note	Amount in Rs.
1	Equity and Liabilities		
(1)	Shareholders funds:		
	(a) Share Capital	1	6,00,000
	(b) Reserve and Surplus	2	1,80,000
(2)	Minority Interest	3	1,00,000
(3)	Non- Current Liabilities		
	Long term Borrowings	4	3,00,000
(4)	Current Liabilities		
	Trades Payables	5	2,00,000
	Total		13,80,000
2	Assets		
(1)	Non-Current Assets		
	Plant and Machinery	6	7,00,000
(2)	Current Assets		
	(a) Inventories	7	3,60,000
	(b) Trade receivables	8	2,20,000
	(c) Cash and Cash Equivalents	9	1,00,000
			13,80,000

Note: This is the best order to do the working. However, in general presentations, notes though worked out before are shown below the consolidated balance sheet. Because there the priority is the reader and not how to accurately prepare the balance sheet.

12.9 CONSOLIDATED P&L STATEMENT AND 12.10. ELIMINATING INTRAGROUP TRANSACTIONS

In order to present financial statements for the group in a consolidated format, the effect of transactions between group Enterprises should be eliminated. And realized losses resulting from intra group transactions should also be eliminated unless cost cannot be recovered.

Liabilities due to one group enterprise by another will be set off against the corresponding asset in the group enterprises financial statements sales made by one group enterprise to another should be excluded from the turnover from turnover and cost of sales or the appropriate expense heading in the consolidated statements of profit and loss account.

For transactions between groups enterprises, that are included in the caring amount of the assets, such as inventories and tangible fixed assets, are eliminated in full. The requirement elements at profits in full apply to transactions of all subsidiaries that are consolidated - even those in which the group’s Interest is less than 100%.

12.11. UNREALIZED PROFIT IN INVENTORIES

When a group company self goods to another group company and such goods are not finally sold to an unrelated company, The profit on the first sale to another group company is not actually earned profit in the case of a consolidated financial statement.

Hence, not only the profit on the sale of the first group company is reduced, but also the corresponding value of the inventory in the second group company that purchased these goods, thus the closing inventories of the group will be recorded at the cost to the group.

Here the point to be noted is that one has to see whether the intra group transaction is an upstream or a downstream transaction. An upstream transaction is it transaction in which the subsidiary cells goods to the holding company while the downstream transaction is where the holding company self goods to the Subsidiary company.

Upstream Transaction	**Downstream Transaction**
Seller - Subsidiary	Seller - Holding company
Buyer - Holding Company	Buyer - Subsidiary
Unrealized profit in the Subsidiary	Unrealized profit in the Holding Company
Reduce the excess value in the inventory of Holding Company	Reduce the excess value in the inventory of subsidiary

Examples

1. A holds 80% of equity Capital and voting power in B. A sells inventories costing ₹180 lakhs to be at the price of ₹200 lakhs. The entire inventories remain unsold with B. at the financial year end. **Downstream sales.**

   In this case, the consolidated profit and loss of the year, the entire sale and purchase transaction of ₹200 lakhs would be eliminated by reducing both sales and purchases.

   Further, the unrealized profits of ₹20 lakhs would be eliminated from the consolidated financial statements for the financial year, by reducing the consolidated profits or increasing the consolidated losses, and reducing the value of closing inventories.

2. A holds 75% of the equity capital and voting power in B. A purchases inventories costing ₹150 lakhs from B at a price of ₹200 lakhs. The entire inventories remain unsold with A at the end of the financial year. **Upstream sales.**

   Here too, in the consolidated profit and loss account for the year, the entire transaction of sale and purchase of ₹200 lakhs each, would be eliminated by reducing sales and purchases.

   Further, the unrealized profits of ₹50 lakhs would be eliminated in the consolidated financial statements for the financial year, by reducing the value of closing inventories by ₹50 lakhs. In the consolidated balance sheet, A's share of profit from B will be reduced by 37.50 and the minority's share of profits of B would be reduced by ₹12.50 lakhs (25% of ₹50 lakhs)

12.12. P&L

All the items of the profit and loss accounts are to be added on line by line basis and intercompany transactions should be eliminated from consolidated figures.

For example, a holding company may sell goods or services to its subsidiary, and receive consultancy fees, Commission, royalty etc. These items are included in sales and other income of the holding company and in expense items of the subsidiary. Alternatively, the subsidiary may also sell goods or services to the holding company. These intercompany transactions are to be fully eliminated.

If there remains any realized profit in the Inventory of any group company such unrealized profit is to be eliminated from the value of the inventory to arrive at the consolidated profit.

Example

H is the holding company and S is the subsidiary, the following is the information for the year-end XXX3

	H (₹ in lakhs)	S (₹ in lakhs)
Sales and other income	5,000	1,000
Increase in inventory	1,000	200
Raw material consumed	800	200
Wages and salaries	800	150
Production expenses	200	100
Administrative expenses	200	100

Selling and Distribution Expenses	200	50
Interest	100	50
Depreciation	100	50

Other information:

H sold goods to S at ₹120 lakhs at cost plus 20%. Inventory fo S includes such goods valuing ₹24 lakhs. Administrative expenses of S include ₹5 lakhs paid to H as a consultancy fee. Selling and distribution expenses of H include ₹10 lakhs paid to S as commission.

H holds 80% of the equity share capital of ₹1000 lakhs in S in the year XXX1-XXX2. H took credit to its P&L Account, the proportionate amount of dividend declared and paid by S for the year XXX1-XXX2.

Now preparing a consolidated statement of profit and loss for H and S.

Notes to Accounts

Consolidated Profit and Loss statement of H and S for the year ended XXX3

12.13. CONSOLIDATED CASH FLOWS

All the companies' cash flow statements are divided into three parts.

- Cashflow from operations
- Cashflow from investments
- Cashflow from finance activities

Similar to the consolidated balance sheet and consolidated profit and loss account even the consolidated cash flow statements need some elements to be eliminated. as we keep on adding the light by line items to arrive and the consolidated cash flows we have to be taken to conservation the investment made by the holding company into the subsidiary or sales items by the subsidiary to the holding company or by the holding company to the subsidiary and similarly any other transactions specifically affect the consolidated cash flow statement.

Example

Consolidate Cash Flow Statement (₹ in millions)

	A Ltd.	**B Ltd**	**Total**
Cash Flow from Operating Activities			
Change in Reserve	8	2	10
Change in P&L	-	1	1
Dividend Paid	22	-	22
Tax Provision	20	1	21
Depreciation	10	5	15
Interest	-10	10	-
Total	50	19	69
Less: Tax payment	-20	-1	-21
	30	18	48

Working capital adjustment	-13	12	-1
(A)	17	30	47
Cash Flows from Investment Activities			
Sale of fixed assets	30	-	30
Purchase of fixed assets	-30	-20	-50
(B)	-	-20	-20
Cash Flows from Financing Activities			
(C)	-5	-10	-15
Net Cash Flows (A+B+C)	12	-	12

12.14. SUMMARY

After studying this lesson the student should be able to : Consolidated Statements with a Subsidiary, 100% Subsidiary VS Non 100% Subsidiary, Procedure for consolidation, Steps involved in the consolidation process , Goodwill and Reserve, Minority interest, Preparing Consolidated Balance Sheet, Consolidated P&L statement, Eliminating Intra group Transactions, Unrealized Profit in Inventories, P&L, and Consolidated Cash Flows.

12.15. TECHNICAL TERMS

Consolidated Statements: Consolidated financial statements are presented by a parent (also known as holding enterprise) to provide financial information about the economic activities of its group.

Subsidiary: A subsidiary is an independent company that is more than 50% owned by another firm—called the parent company or holding company. Subsidiaries are separate and distinct legal entities from their parent companies.

Goodwill: A subsidiary is an independent company that is more than 50% owned by another firm—called the parent company or holding company. Subsidiaries are separate and distinct legal entities from their parent companies.

Minority interest: A minority interest is less than 50 per cent ownership or interest in a company. The word can apply to either stock ownership or a shareholding interest in a company. An investor or other entity other than the parent company holds a minority interest in a company.

Consolidated Balance Sheet: A consolidated balance sheet is a document that shows the entire financial situation of a parent company, along with all its subsidiaries within a single sheet, without separating the companies.

Consolidated Cash Flows: A consolidated cash flow statement aggregates cash flows from financing, investing and operating activities across all majority-owned companies that are legally separate businesses. This means that you exclude general partnerships and sole proprietorships, which are not legally distinct, from consolidation.

12.16. SELF-ASSESSMENT QUESTIONS

1. What is Consolidated Statements? Briefly Explain it.

2. Difference between 100% Subsidiary VS Non 100% Subsidiary.
3. Write the Procedure for consolidation?
4. What are the Steps involved in the consolidation process?
5. What is Goodwill? What is Reserve?
6. Explain briefly about Minority interest.
7. What is Consolidated Balance Sheet .Explain it
8. Explain about Consolidated P&L statement.
9. What is Eliminating Intra group Transactions? How it works.
10. Can you explain about Unrealized Profit in Inventories?
11. Explain briefly about P&L.
12. What is Consolidated Cash Flows? Explain it briefly.

12.17. SUGGESTED READINGS

1. Indian Accounting Standard 110 published by Ministry Of Corporate Affairs ("MCA")

2. Educational Material onInd AS 110, Consolidated Financial Statements, published by The Institute of Chartered Accountants of India, Delhi.

3. RSN Pillai, Bagarathi & S. Uma, Fundamentals of Advanced Accounting, Vol.1, S. Chand, New Delhi.

4. Nehru J. Financial Reporting by diversified companies vision Books, New Delhi.

5. Hawkins David, Financial Statements Corporations Dow Jones – Irwin Homewood 1973.

6. Indian Accounting Standard (Ind AS) 27, Consolidated and Separate Financial Statements issued by Ministry of corporate affairs

Dr. B. RAJA

LESSON-13
CONSOLIDATED FINANCIAL STATEMENTS WITH MULTIPLE SUBSIDIARIES

AIMS AND OBJECTIVES

After studying this lesson, you will be able to…

- Know the Preparing a Consolidated BS with multiple subsidiaries
- Know the Preparing a Consolidated P&L with multiple subsidiaries

Know the Preparing a Consolidated CF with multiple subsidiaries

STRUCTURE

13.1. Introduction
13.2. Calculating Minority interest with multiple subsidiaries
13.3. Preparing the Balance sheet with multiple subsidiaries
13.4. Preparing the P&L with multiple subsidiaries
13.5. Preparing the CF with multiple subsidiaries
13.6. Summary
13.7. Technical Terms
13.8. Self-Assessment Questions
13.9. Suggested Readings

13.1. INTRODUCTION

What does it mean to consolidate a subsidiary? Consolidation of subsidiaries is a type of accounting used for incorporating and reporting the financial results of majority-owned subsidiaries. This method is used when the parent company possesses effective control of the subsidiary. To consolidate (consolidation) is to combine assets, liabilities, and other financial items of two or more entities into one. In financial accounting, the term consolidate often refers to the consolidation of financial statements wherein all subsidiaries report under the umbrella of a parent company. The consolidation method works by reporting the subsidiary's balances in a combined statement along with the parent company's balances, hence "consolidated". Under the consolidation method, a parent company combines its own revenue with 100% of the revenue of the subsidiary. The directors of a parent company may not wish to consolidate some subsidiaries due to: Poor performance of the subsidiary. Poor financial position of the subsidiary. Differing activities (nature) of the subsidiary from the rest of the group. Two or more subsidiaries that either belong to the same parent company or having a

same management being substantially controlled by same entity/group are called sister companies.
There are different types of business consolidation, including statutory consolidation, statutory mergers, stock acquisitions, and variable interest entities. Consolidation can lead to a concentration of market share and a bigger customer base. There are three consolidation methods, which are used depending on the strength of the Parent company's control or influence (see also significant influence): Full consolidation, Proportionate consolidation, and the Equity method. The consolidation of soil is divided into three stages including initial consolidation, primary consolidation, and secondary consolidation. There are three types of subsidiaries: Wholly Owned Subsidiaries, Partly Owned Subsidiaries, and Joint Venture Subsidiaries.

13.2. CALCULATING MINORITY INTEREST WITH MULTIPLE SUBSIDIARIES

A minority interest is less than 50 per cent ownership or interest in a company. The word can apply to either stock ownership or a shareholding interest in a company. An investor or other entity other than the parent company holds a minority interest in a company. For example, suppose that Company A acquires a controlling interest of 75% in Company B. The latter retains the remaining 25% of the company. That portion is the minority interest. You can multiply the value of a subsidiary by the percentage that other parties own. For example, if the value of a subsidiary is ₹5,000,000 and if other parties own 10% of it, the minority interest value will be then ₹500,000.

The first Companies Act of 1913 also gave protection to minority shareholders against acts of oppression and mismanagement by the majority, mandating that if found just and equitable to do so, the company concerned could be wound up. A minority interest is the ownership of less than half of a corporation's outstanding shares. The party owning these shares is someone other than the parent company that has majority control over the business. While the majority interest refers to the right of the major dominant ethnic groups in a given society or country, the minority interest refers the right of several small ethnic groups scattered all over the state of the federation. Minority interests are also referred to as non-controlling interests. Under U.S. GAAP, non-controlling interests are listed on the equity section of the parent company's consolidated balance sheet, but separate from the parent company's equity. Under International Financial Reporting Standards (IFRS), minority interest is shown at the bottom of the equity section within the consolidated balance sheet of the parent company, and in the statement of changes in equity. Minority interest is an asset. How you record it and value it depends on how much you own: 20 percent or less, 21 to 50 percent or a majority stake.

You have learnt how to do the consolidated financial statements of holding companies and subsidiary companies, let us explore the differences between a holding company with multiple subsidiaries. There is little difference between the consolidations of a holding company with a single subsidiary versus a holding company with multiple subsidiaries. However, care should be taken between the company transactions of one subsidiary with another subsidiary. This transaction might look at arm's length considering they belong to the same group similar elimination of profits and transactions should be made for sale between the subsidiaries or any sale of assets or investments or loans between the subsidiaries.

You are already familiar with calculating the minority interest of a single subsidiary. The calculation of minority interest does not change with multiple subsidiaries however the working changes.

Let us see how with an example

Example

Determine in each case:

(1) Minority interest at the date of acquisition and the date of consolidation
(2) Goodwill or Capital reserve as the case may be
(3) Amount of the holding company's profit in the consolidated balance sheet assuming the holding company's own Profit & Loss account to be ₹2,00,000 in each case

Case	**Subsidiary name**	**% of Shares owned**	**Cost ₹**	**Date of Acquisition**	**Consolidation Date**		
				1/1/XXX1	**31/12/XXX1**		
				Share Capital ₹	**P&L Account ₹**	**Share Capital ₹**	**P&L Account ₹**
1	S1	90	1,40,000	1,00,000	50,000	1,00,000	70,000
2	S2	85	1,04,000	1,00,000	30,000	1,00,000	20,000
3	S3	80	56,000	50,000	20,000	50,000	20,000
4	S4	100	1,00,000	50,000	40,000	50,000	55,000

Solution

(1) Minority interest = Equity attributable to minorities

Equity is the residual interest in the assets of an enterprise after deducting all its liabilities i.e. in this case it should be equal to Share Capital + Profit & Loss A/C

Case	**Subsidiary name**	**% of Shares owned**	**Cost ₹**	**Date of Acquisition**		**Consolidation Date**	
				1/1/XXX1		**31/12/XXX1**	
				Share Capital ₹ A	**P&L Account ₹ B**	**Share Capital ₹ C**	**P&L Account ₹ D**
1	S1	90	1,40,000	1,00,000	50,000	1,00,000	70,000
2	S2	85	1,04,000	1,00,000	30,000	1,00,000	20,000
3	S3	80	56,000	50,000	20,000	50,000	20,000
4	S4	100	1,00,000	50,000	40,000	50,000	55,000

Note: A, B, C, and D Columns have been named

Case	**Minority % in Shares (100 - % held by Holding company) E**	**Minority interest at the date of acquisition E X (A+B) ₹**	**Minority Interest as the date of consolidation E X (C+D) ₹**
1	10%	15,000	17,000

2	15%	19,500	18,000
3	20%	14,000	14,000
4	0%	-	-

(2) Calculator of Goodwill or Capital Reserve

Case	**Shareholding % F**	**Cost G**	**Total Equity A+B = H**	**Parent's portion of Equity F X H**	**Goodwill (Capital Reserve) G-H**
1	90	1,40,000	1,50,000	1,35,000	5,000
2	85	1,04,000	1,30,000	1,10,000	-6,500
3	80	56,000	70,000	56,000	-
4	100	1,00,000	90,000	90,000	10,000

Note: Negative goodwill is a capital reserve

(3) The balance in the profit and loss Account on the date of acquisition (1/1/XXX1) is Capital profit, as such the balance of the Consolidated Profit & Loss account shall be equal to holding co.'s profit.

On 31/12/XXX1 in each case, the following amount shall be added or deducted from the balance of the holding co.'s profit and loss account.

Case	**Shareholding % F**	**P&L Account ₹ B**	**P&L Account ₹ D**	**P&L Post Acquisition D - B**	**Amount to be Added (deducted) from Holding P&L F x X**
1	90	50,000	70,000	20,000	18,000
2	85	30,000	20,000	-10,000	-8,500
3	80	20,000	20,000	0	0
4	100	40,000	55,000	15,000	15,000

Calculating minority years across multiple financial periods

Now that you are comfortable with minority interests with multiple subsidiaries let us understand the workings involved in multiple-year calculations.

Example

H acquired 70% of equity shares of S on 1/4/XXX1 at a cost of ₹10,00,000 when S had an equity share capital of ₹10,00,000 and reserves and surplus of ₹80,000. In four consecutive years, S fared badly and suffered losses of ₹2,50,000, ₹4,00,000, ₹5,00,000 and ₹1,20,000 respectively. Thereafter in the fifth year, S experienced a turnaround and registered an annual profit of ₹50,000. In the next two years, S recorded annual profits of ₹1,00,000 and ₹1,50,000 respectively. Show the minority interests and cost of control at the end of each year for consolidation.

Solution

The losses applicable to the minority in a consolidated subsidiary may exceed the minority interest in the equity of the subsidiary. The excess, and any further losses applicable to the minority, are adjusted against the majority interest except to the extent that the minority has a binding obligation to, and can, make good the losses. If the subsidiary subsequently reports profits, all such profits are allocated to the majority interest until the minority's share of losses previously absorbed by the majority has been recovered, according to AS 21.26. Accordingly, the minority interests will be computed as follows.

Working Notes

Calculating the minority interest and cost of control on 1/4/XXX1

	Total	**Share of H**	**Share of s**
	100%	**70%**	**30%**
	₹	**₹**	**₹**
Share Capital	10,00,000	7,00,000	3,00,000
Reserve	80,000	56,000	24,000
		7,56,000	3,24,000
Less: Cost of Investment		10,00,000	
Good Will		2,44,000	

Calculating the yearly changes

Year	**P & Loss**	**Minority Interest (30%)**	**Additional Consolidated P&L**	**Minority's Share of Losses borne by H**	**Cost of Control**	
				₹	**Balance**	
Opening xxx1		324,000				
Year 1-2	-2,50,000	-75,000	-1,75,000			2,44,000
Balance		2,49,000				
2-3	-4,00,000	-1,20,000	-2,80,000			2,44,000
Bal		1,29,000				
3-4	-5,00,000	-1,50,000	-3,50,000			2,44,000
Bal		-21,000				
Loss of Minority borne by H		21,000	-21,000	21,000	21,000	-
Bal		0	-3,71,000			
4-5	-1,20,000	-36,000	-84000			2,44,0000
Bal		-36000				
Loss of Minority borne by H		36,000	-36,000	36,000	57,000	-

Bal		0	-120,000			
5-6	50,000	15,000	35,000			2,44,000
Profit of Minority adjusted against losses of minority absorbed by H		-15,000	15,000	-15000	42,000	-
Bal		0	50,000			
6-7	1,00,000	30,000	70,000			2,44,000
Profit of Minority adjusted against losses of minority absorbed by H		-30,000	30,000	-30,000	12,000	-
Bal		0	1,00,000			\
XXX7-XXX8	1,50,000	45,000	1,05,000	-12,000	-	2,44,000
Profit of Minority adjusted against losses of minority absorbed by H		-12,000	12,000			
Balance		33,000	1,17,000			

13.3. PREPARING THE BALANCE SHEET WITH MULTIPLE SUBSIDIARIES

While preparing the consolidated balance sheet, the assets and liabilities of the subsidiary companies are merged with those of the holding company. Share capital and reserves and surplus of the subsidiary companies are appropriated between the holding company and minority shareholders, these items along with investments of the holding company in the shares of the software company are not separately shown in the consolidated balance sheet. The net amounts resulting from the various compositions of the item are shown as

- minority interest
- cost of control and
- Holding company shares in post-acquisition profits of the subsidiary company (added to the appropriated concerned amount of the holding company) are entered in the consolidated balance sheet.

In the case of multiple subsidiaries, the following scenarios might also arise

Indirect holding

The case when a company becomes a subsidiary of another though the second company outright does not hold more than 50%.
Examples:

1. A subsidiary holding a majority stake in another company, a subsidiary of a subsidiary.
   H holds 80% of S1
   S1 Holds 70% of S2
   S2 is a subsidiary of H
2. H holding company 70% of subsidiary S1 and 30% of S2, while S1 holds 30% of S2, making S2 a subsidiary of H

Sales between subsidiaries
Similar to downstream sales and upstream sales, sales between subsidiaries is not complete until the product is finally sold to an unrelated party, unrelated to holding subsidiary relationships.
Hence adjustments need to be made for unsold inventory and also for unearned profit booked.
Sample adjustment entry

	Dr.	Cr.
P & L account	XXX	
To Inventory		XXX
Being adjustment for unearned profits from intragroup sales between S1 and S2		

Example

From the **Balance Sheets** and information given below, prepare the Consolidated Balance Sheet of H, S1 and S2 as of 31st Dec of year xxx1. H holds 80% of Equity shares in S1, since its incorporation, and 70% of S2 since its incorporation.
H invested 3,20,000 for 80% in S1, and 80,000 for 70% in S1.

Particulars	**Note No.**	**H Rs.**	**S1 Rs.**	**S2 Rs.**
1. Equity & Liabilities				
(1)Shareholder's Funds				
(a) Share Capital	1	6,00,000	4,00,000	1,00,000
(b) Reserves and surplus	2	1,00,000	1,00,000	20,000
(2) Non- Current Liabilities				
Long term borrowings		2,80,000	1,00,000	25,000

(3) Current Liabilities				
Trade payables		1,00,000	1,00,000	25,000
Total		10,80,000	7,00,000	1,70,000
2. Assets				
(1) Non-Current Assets				
(a) Plant and Machinery		4,00,000	3,00,000	75,000
(b) Investments	3	4,00,000	-	-
(2) Current Assets				
(a) Inventories		1,60,000	2,00,000	50,000
(b) Trade Receivables		80,000	1,40,000	40,000
(c) Cash and Cash equivalents		40,000	60,000	5,000
		10,80,000	7,00,000	1,70,000

Notes to Accounts

Note No.	**Particulars**	**H Rs.**	**S1 Rs.**	**S2 Rs.**
1	Share Capital			
	Shares of H	6,00,000		
	Shares of S		4,00,000	1,00,000
	Total	6,00,000	4,00,000	1,00,000
2	Reserves and surplus			
	General Reserve	1,00,000	1,00,000	20,000
	Total	1,00,000	1,00,000	20,000
3	Investments			
	Shares in S1	3,20,000		
	Shares in S2	80,000		
	Total	4,00,000		

Solution

Working Notes:

1. **Basic Information**
   a. H is Holding Company
   b. S1 is a Subsidiary Company
   c. S2 is another subsidiary
   d. H acquired 80% of shares in S1 at incorporation
   e. H acquired 70% of shares in S2 at incorporation
   f. Date of Consolidation 31st December xxx1
2. **Analysis of Reserves of S1 and S2**
   Since H holds shares in S1 and S2 since incorporation, entire reserves are post acquisition reserves.
3. **Consolidations of Reserve Balances of S1, S2 with H**

1. For S1 with 80%

			Holding Company	
Holding vs Minority	Total	Minority Interest	Pre Acquisition	Post Acquisition
Equity Capital	4,00,000	80,000	3,20,000	
General Reserves	1,00,000	20,000		80,000
Total		1,00,000	3,20,000	80,000
Cost of Investment			-3,20,000	
Goodwill (Reserves)			-	-

2. For S2 with 70%

Holding vs Minority	**Total**	**Minority Interest**	**Pre Acquisition**	**Post Acquisition**
Equity Capital	1,00,000	30,000	70,000	
General Reserves	20,000	6,000		14,000
Total		36,000	70,000	14,000
Cost of Investment			-80,000	
Goodwill (Reserves)			-10,000	-

Notes to the Balance sheet

Note No.	**Particulars**	**Rs.**	**Rs.**
1	Share Capital		
	Shares of H		6,00,000
2	Reserves and Surplus		
	General Reserve	1,00,000	
	Add General Reserve of S	80,000	
	(80% of 1,00,000)		
	Add General Reserve of S2	14,000	
	(20% of 1,00,000)		
	Total		1,94,000
3	Minority Share		
	20% in S1 (WN 3.1)	1,00,000	
	30% in S2 (WN 3.2)	36,000	
	Total		1,36,000
4	Long Term Borrowings		
	H long-term borrowings	2,80,000	
	S1 long-term borrowings	1,00,000	
	S2 long-term borrowings	25,000	
	Total		4,05,000
5	Trade Payables		

	H Trade payables	1,00,000	
	S1 Trade payables	1,00,000	
	S2 Trade payables	25,000	
	Total		2,25,000
6	Plant and Machinery		
	H	4,00,000	
	S1	3,00,000	
	S2	75,000	
	Total		7,75,000
7	Inventories		
	H	1,60,000	
	S1	2,00,000	
	S2	50,000	
	Total		4,10,000
8	Trade Receivables		
	H	80,000	
	S1	1,40,000	
	S2	40,000	
			2,60,000
9	Cash and Cash Equivalents		
	H	40,000	
	S1	60,000	
	S2	5000	
			1,05,000
10	Goodwill (reserves)		
	WN 3.2 Reserves in S2	-10,000	
	Total Reserve		10,000

The consolidated Balance sheet of H on 31st Dec, XXX1

Sno.	**Particulars**	**Note No.**	**Amount in Rs.**
1	Equity and Liabilities		
(1)	Shareholders funds:		
	(a) Share Capital	1	6,00,000
	(b) Reserve and Surplus	2	1,94,000
	(c) Reserve Calculated in S2	10	-10,000
(2)	Minority Interest	3	1,36,000
(3)	Non-Current Liabilities		
	Long term Borrowings	4	4,05,000
(4)	Current Liabilities		
	Trades Payables	5	2,25,000
	Total		15,50,000
2	Assets		
(1)	Non-Current Assets		
	Plant and Machinery	6	7,75,000

(2)	Current Assets		
	(a) Inventories	7	4,10,000
	(b) Trade receivables	8	2,60,000
	(c) Cash and Cash Equivalents	9	1,05,000
			15,50,000

Note: Alternatively the reserve from investment in S2 can be deducted from Reserves and surplus from note 2. What needs to be included as a separate line item is defined as materiality as interpreted by the presenter. If you feel this is a line item that needs to be presented separately you can present it separately as shown in the example above. On the other hand, if you feel it is unimportant you can deduct it as a combined

13.4. PREPARING THE P&L WITH MULTIPLE SUBSIDIARIES

All the items of the profit and loss accounts need to be added on a line by line basis and intra-group transactions should be eliminated from consolidated figures.

For example, a holding company may sell goods or services to its subsidiary, and receive consultancy fees, Commission, royalty etc. These items are included in sales and other income of the holding company and expense items of the subsidiary. Alternatively, the subsidiary may also sell goods or services to the holding company. These intercompany transactions are to be fully eliminated.

If there remains any realized profit in the Inventory of any group company such unrealized profit is to be eliminated from the value of the inventory to arrive at the consolidated profit.

Major items to look out for

1. Expenses billed by one company to the other
2. Goods sold by one company to the other (adjustment in sales)
3. Profit on unsold inventory (adjustment in profit)
4. Services billed by one company to the other
5. Dividend paid by one company to the other

Example

H is the holding company and S1 and S2 are the subsidiaries, the following is the information for the year-end XXX3.

	H (₹ in lakhs)	S1 (₹ in lakhs)	S2 (₹ in lakhs)
Sales and other income	5,000	1,000	200
Increase in inventory	1,000	200	100
Raw material consumed	800	200	100
Wages and salaries	800	150	50
Production expenses	200	100	20
Administrative expenses	200	100	20
Selling and Distribution Expenses	200	50	10
Interest	100	50	10
Depreciation	100	50	10

Other information:

H sold goods to S1 at ₹120 lakhs at cost plus 20%. Inventory of S includes such goods valuing ₹24 lakhs. Administrative expenses of S1 include ₹5 lakhs paid to H as a consultancy fee. Selling and distribution expenses of H include ₹10 lakhs paid to S as commission.
H holds 80% of the equity share capital of ₹1000 lakhs in S1 in the year XXX1-XXX2. H took credit to its P&L Account, the proportionate amount of dividend declared and paid by S1 for the year XXX1-XXX2.
Now preparing a consolidated statement of profit and loss for H and S2.
S2 Sold all goods at cost + 25% to H. 50% of such sales are still unsold with H. H acquired 70% of S2 at its incorporation for ₹400 lakhs in the year XXX1. No dividend has been declared by S2 so far.

Solution

Notes to P&L Account

		₹ in Lakhs	**₹ in Lakhs**
1	Revenue from operations		
	Sales and Other Income		
	H	5,000	
	S1	1,000	
	S2	200	
		6,200	
	Less: Inter Company Sales		
	Sales by S2 to H	-200	
	Sales by S1 to H	-120	
	Consultancy fee received by H from S	-5	
	The commission received by S from H	-10	5,865
2	Cost of Material Purchased		
	H	800	
	S1	200	
	S2	100	
		1,100	
	Less: Purchases by S1 from H	-120	
	Purchases by H from S2	-200	680
	Direct Expenses - Production Expenses		
	H	200	
	S1	100	
	S2	20	320
			1,000
3	Changes of Inventories		
	H	1,000	
	S1	200	
	S2	100	
	Less: Unrealized profits S1 sales(20/120 X 24 lakhs)	-4	
	Unrealized profits of S2 sales (25% of(50%	-25	1,271

	of 200))		
4	Employee benefits and expenses		
	Wages and Salaries		
	H	800	
	S1	150	
	S2	50	1,000
5	Finance Cost		
	Interest		
	H	100	
	S1	50	
	S2	10	160
6	Depreciation		
	H	100	
	S1	50	
	S2	10	160
7	Other Expenses		
	Administrative Expenses		
	H	200	
	S1	100	
	S2	20	
		320	
	Less: Consultancy fee received by H from S	-5	315
	Selling and Distribution Expenses		
	H	200	
	S1	50	
	S2	10	
		260	
	Less Commission received by S from H	-10	250
			565

Consolidated Profit and Loss statement of H, S1 and S2 for the year ended XXX3

Particulars	**Note No.**	**₹ in Lakhs**
I. Revenue from Operations	1	5,865
II. Total Revenue		**5,865**
III. Expenses		
Cost of Material purchased	2	1,000
Changes in inventories of finished goods	3	-1,271
Employee benefit expense	4	1,000
Finance cost	5	160
Depreciation and amortization expense	6	160

Other expenses	7	565
Total Expense		**1,614**
IV. Profit before tax (II-III)		**4,251**

13.5. PREPARING THE CF WITH MULTIPLE SUBSIDIARIES

Preparing consolidated cash flow statements for a holding company with multiple subsidiaries is similar to preparing the consolidated balance sheet and consolidated profit and loss account. Even the consolidated cash flow statements need some elements to be eliminated. As we keep on adding the line-by-line items to arrive and the consolidated cash flows we have to be taken into consideration the investments made by the holding company into the subsidiaries or sales items by the subsidiaries to the holding company or by the holding company to the subsidiaries and similarly any other transactions specifically affect the consolidated cash flow statement.

Illustration

	A Ltd.	**B Ltd**	**C Ltd**	**Total**
Cash Flow from Operating Activities				
Change in Reserve	8	2	3	13
Change in P&L	-	1	1	2
Dividend Paid	22	-		22
Tax Provision	20	1	2	23
Depreciation	10	5	8	23
Interest	-10	10	-	0
Total	50	19	14	83
Less: Tax payment	-20	-1	-3	-24
	30	18	11	59
Working capital adjustment	-13	12	-	-1
(A)	17	30	11	58
				0
Cash Flows from Investment Activities				0
Sale of fixed assets	30	-	10	40
Purchase of fixed assets	-30	-20		-50
(B)	-	-20	10	-10
				0
Cash Flows from Financing Activities				0
(C)	-5	-10	10	-5
				0
Net Cash Flows (A+B+C)	12	-	31	43

Conclusion:

We have entered an era where you probably don’t have to do these calculations manually. Most major companies of this size do have software. However, care should be taken to properly set up the software. Still setting the software to the Accounting Standards is a manual job and is usually done by someone well-versed in the accounting field. If you do pursue a career in accounting you are more than likely to use your skill sets to modify the software to your needs. Having a strong foundation allows one to enter the right parameters and right journal entries. Do not ignore what looks like an esoteric subject just because you may not use it in life. You still need it to pass the exam and while you are at it you might as well learn it so that you can apply it with confidence when you need to use it.

We avoided giving multiple problems and complicated numbers, as the objective is not to test your math skills but to build your understanding of the steps involved in making consolidated financial statements.

13.6. SUMMARY

After studying this lesson, you will be able to…Know the Preparing a Consolidated BS with multiple subsidiaries. Know the Preparing a Consolidated P&L with multiple subsidiaries. Know the Preparing a Consolidated CF with multiple subsidiaries. Consolidated financial statements are presented by a parent (also known as holding enterprise) to provide financial information about the economic activities of its group. A standalone statement represents a company's financial performance as a single entity, while a consolidated statement reports a company's financial performance on the whole. It includes information about its associate companies, subsidiary companies, and joint ventures. A consolidated financial statement is a report of a company's financial position using the aggregated financials of the parent company and its subsidiaries. Shareholders, creditors, executive management, board members and stakeholders use consolidated financial statements to gauge the health of the overall company.

13.7. TECHNICAL TERMS

Tax Provision: A tax provision is the estimated amount of income tax that a company is legally expected to pay to the IRS for the current year.

Depreciation: Depreciation represents the estimated reduction in value of a fixed assets within a fiscal year. Tangible assets, such as buildings, equipment, vehicles and so on, are purchased in large lump sums.

Interest: Interest is the fee a business pays a lender (creditor) to borrow money. Interest payments are usually based on the outstanding balance of a loan and paid monthly, though many different arrangements are possible. Interest is usually calculated as a percentage of the loan balance at an agreed-upon interest rate.

Working capital: working capital is the money available to meet your current, short-term obligations. To make sure your working capital works for you, you'll need to calculate your current levels, project your future needs and consider ways to make sure you always have enough cash.

Amortization expense: Amortization is an accounting method for spreading out the costs for the use of a long-term asset over the expected period the long-term asset will provide value. Amortization expenses account for the cost of long-term assets (like computers and vehicles) over the lifetime of their use.

Finance cost: Financing costs are defined as the interest and other costs incurred by the Company while borrowing funds. They are also known as "Finance Costs" or "borrowing .

13.8. SELF-ASSESSMENT QUESTIONS

1. What is a consolidated subsidiary?
2. What are the stages of consolidation?
3. What are the different types of consolidation?
4. What is multiple subsidiaries?
5. What is the consolidation process of subsidiary companies?
6. What is consolidation with two or more subsidiaries?
7. What does it mean to consolidate a subsidiary?

13.9. SUGGESTED READINGS

1. Indian Accounting Standard 110 published by Ministry Of Corporate Affairs ("MCA")
2. Educational Material onInd AS 110, Consolidated Financial Statements, published by The Institute of Chartered Accountants of India, Delhi.
3. RSN Pillai, Bagarathi & S. Uma, Fundamentals of Advanced Accounting, Vol.1, S. Chand, New Delhi.
4. Nehru J. Financial Reporting by diversified companies vision Books, New Delhi.
5. Hawkins David, Financial Statements Corporations Dow Jones – Irwin Homewood 1973.
6. Indian Accounting Standard (Ind AS) 27, Consolidated and Separate Financial Statements issued by Ministry of corporate affairs

Dr. B. RAJA

LESSON -14
FINANCIAL INSTRUMENTS

AIMS AND OBJECTIVES

After studying this lesson, you will be able to…

- Understand the meaning of Financial Asset.
- Understand the meaning of Financial Liability.
- Know different types of Financial Instruments.
- Understand the features of Cash Instruments.
- Understand the characteristics of Derivative Instruments.
- Know the features of Foreign Exchange Instruments.

STRUCTURE

14.1 Introduction
14.2 Financial Assets
14.3 Financial Liability
14.4 Types of Financial Instruments
14.5 Asset classes of Financial Instruments
14.6 Recognition & De recognition
14.7 Compound Financial Instruments
14.8 Compound FI vs Hybrid FI
14.9 Summary
14.10 Technical Terms
14.11 Self –Assessment Questions
14.12 Suggested Readings

14.1 INTRODUCTION

Financial instruments are contracts for monetary assets that can be purchased, traded, created, modified, or settled for. In terms of contracts, there is a contractual obligation between involved parties during a financial instrument transaction.

For example, if a company were to pay cash for a bond, another party is obligated to deliver a financial instrument for the transaction to be fully completed. One company is obligated to provide cash, while the other is obligated to provide the bond.

Basic examples of financial instruments are cheques, bonds, securities.

There are typically three types of financial instruments: cash instruments, derivative instruments, and foreign exchange instruments.

14.2 FINANCIAL ASSETS

A **financial asset** is a non-physical asset whose value is derived from a contractual claim, such as bank deposits, bonds, and participations in companies' share capital. Financial assets are usually more liquid than tangible assets, such as commodities or real estate.

The opposite of financial assets is non-financial assets, which include both tangible property (sometimes also called real assets) such as land, real estate or commodities, and intangible assets such as intellectual property, including copyrights, patents, trademarks and data.

Cash and cash equivalents are considered to be financial assets. Cash equivalents need to be highly liquid investments which are short term (3 months or shorter). Even if the maturity is short term, these items should be readily convertible to cash and subject to insignificant valuation risk.

Demand deposits would be considered a cash equivalent, as these are considered to have the same level of liquidity as cash and can usually be withdrawn at any time without penalty.

Accounts receivable are amounts receivable from the provision of goods and services.Loans receivable are amounts owed from lending of cash and cash equivalents.

Investment securities are securities issued by other entities such as shares, bonds and other investment products that are purchased with intention of obtaining an economic benefit either from capital appreciation of the security product or from interest or dividends paid from the security issuer.

A financial asset is any asset that is:

(a) Cash;
(b) An equity instrument of another entity;
(c) A contractual right:

  (i) to receive cash or another financial asset from another entity; or
  (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

(d) a contract that will or may be settled in the entity's own equity instruments and is:

  (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

  (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

14.3 FINANCIAL LIABILITIES

A financial liability is any liability that is:
(a) a contractual obligation :

  (i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Apart from the aforesaid, the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of the entity's own equity instruments is an equity instrument if the exercise price is fixed in any currency. Also for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.

An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. A puttable instrument is a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

Examples:

Accounts payable are amounts owed to third parties from purchases of supplies and materials required for operations and activities.

[

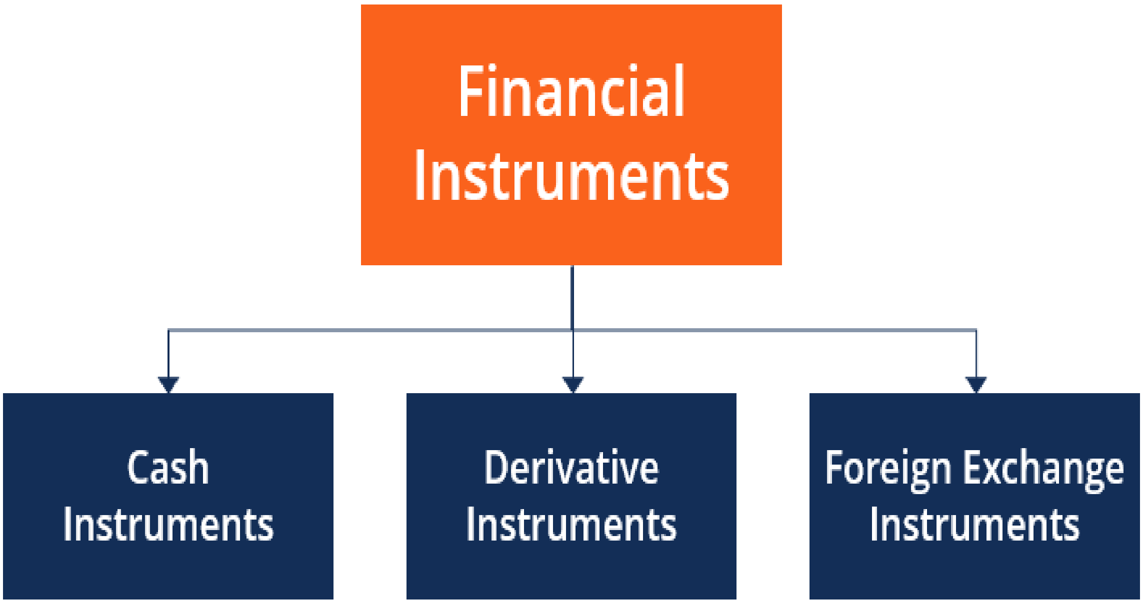
Loans and notes payable are amounts owed from borrowing arrangements.

Bonds are fixed income securities, which allow entities to borrow capital for a fixed period of time, with specified payment terms and interest payment terms.

An example is a government bond with either fixed or variable interest coupon payments, used to finance its operations and activities of the government.

14.4 TYPES OF FINANCIAL INSTRUMENTS:

Financial Instruments are classified into …….



14.4.1. Cash Instruments

Cash instruments are financial instruments with values directly influenced by the condition of the markets. Within cash instruments, there are two types; securities and deposits, and loans.

Securities: A security is a financial instrument that has monetary value and is traded on the stock market. When purchased or traded, a security represents ownership of a part of a publicly-traded company on the stock exchange.

Deposits and Loans: Both deposits and loans are considered cash instruments because they represent monetary assets that have some sort of contractual agreement between parties.

14.4.2. Derivative Instruments

Derivative instruments are financial instruments that have values determined from underlying assets, such as resources, currency, bonds, stocks, and stock indexes.

The five most common examples of derivatives instruments are synthetic agreements, forwards, futures, options, and swaps. This is discussed in more detail below.

Synthetic Agreement for Foreign Exchange (SAFE): A SAFE occurs in the over-the-counter (OTC) market and is an agreement that guarantees a specified exchange rate during an agreed period of time.

Forward: A forward is a contract between two parties that involves customizable derivatives in which the exchange occurs at the end of the contract at a specific price.

Future: A future is a derivative transaction that provides the exchange of derivatives on a determined future date at a predetermined exchange rate.

Options: An option is an agreement between two parties in which the seller grants the buyer the right to purchase or sell a certain number of derivatives at a predetermined price for a specific period of time.

Interest Rate Swap: An interest rate swap is a derivative agreement between two parties that involves the swapping of interest rates where each party agrees to pay other interest rates on their loans in different currencies.

14.4.3. Foreign Exchange Instruments

Foreign exchange instruments are financial instruments that are represented on the foreign market and primarily consist of currency agreements and derivatives.

In terms of currency agreements, they can be broken into three categories.

Spot: A currency agreement in which the actual exchange of currency is no later than the second working day after the original date of the agreement. It is termed "spot" because the currency exchange is done "on the spot" (limited timeframe).

Outright Forwards: A currency agreement in which the actual exchange of currency is done "forwardly" and before the actual date of the agreed requirement. It is beneficial in cases of fluctuating exchange rates that change often.

Currency Swap: A currency swap refers to the act of simultaneously buying and selling currencies with different specified value dates.

14.5 ASSET CLASSES OF FINANCIAL INSTRUMENTS

Beyond the types of financial instruments listed above, financial instruments can also be categorized into two asset classes. The two asset classes of financial instruments are debt-based financial instruments and equity-based financial instruments.

14.5.1. Debt-Based Financial Instruments

Debt-based financial instruments are categorized as mechanisms that an entity can use to increase the amount of capital in a business. Examples include bonds, debentures, mortgages, U.S. treasuries, credit cards, and line of credits (LOC).

They are a critical part of the business environment because they enable corporations to increase profitability through growth in capital.

14.5.2. Equity-Based Financial Instruments

Equity-based financial instruments are categorized as mechanisms that serve as legal ownership of an entity. Examples include common stock, convertible debentures, preferred stock, and transferable subscription rights.

They help businesses grow capital over a longer period of time compared to debt-based but benefit in the fact that the owner is not responsible for paying back any sort of debt.

A business that owns an equity-based financial instrument can choose to either invest further in the instrument or sell it whenever they deem necessary.

14.6 RECOGNITION & DERECOGNITION

14.6.1 Recognition: Recognized when entity becomes a party to the contractual arrangement which is a financial instrument

- Financial asset derecognized when contractual rights expire, are waived or transferred Cumulative gain or loss recognized in surplus or deficit
- Financial liability derecognized when contract is discharged, waived, cancelled or expires. Difference between the carrying amount and consideration paid recognized in surplus or deficit The following are examples of applying the principle:
  - a) Receivables and payables are recognized as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash. For example, when goods and services have been shipped, delivered or rendered.
  - b) A forward contract is recognized as an asset or a liability on the commitment date, rather than on the date on which settlement takes place.
  - c) Debt is recognized when issued or derecognized when exchanged or repaid.

Planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.

14.6.2 Derecognition is the removal of a previously recognized financial asset or financial liability from an entity's statement of financial position.

- An entity de-recognizes a financial asset when
  - The contractual rights to the cash flows from the financial asset expire or are waived; or
  - It transfers the contractual rights to receive the cash flows of the financial asset and the transfer qualifies under IPSAS 29 for derecognition.

A transfer qualifies for derecognition if, and only if, an entity:

- Transfers the contractual rights to receive the cash flows of the financial asset; or
- Retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients.

On derecognition of a financial asset in its entirety, the difference between:

a) The carrying amount; and

b) The sum of:

- the consideration received (including any new asset obtained less any new liability assumed) and
- any cumulative gain or loss that had been recognized directly in net assets/equity; shall be recognized in surplus or deficit.

A cumulative gain or loss that had been recognized in net assets/equity is allocated between the part that continues to be recognized and the part that is derecognized, based on the relative fair values of those parts.

Normally, derecognition of a financial asset should be relatively straight forward. However, if the derecognition involves the transfer of a financial asset, requirements to determine whether the transfer qualifies for de-recognition are complex and beyond the scope of the training material.

An entity removes a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished – i.e., when the obligation specified in the contract is discharged, waived, cancelled or expires.

A financial liability (or part of it) is extinguished when the debtor either:

- Discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or
- Is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met).

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

An exchange of debt instruments with substantially different terms or a substantial modification of the terms of an existing financial liability shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

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

14.7 COMPOUND FINANCIAL INSTRUMENTS

Standard IAS 32 defines ***compound financial instrument*** as a ***non-derivative*** financial instrument that, from the issuer's perspective, contains ***both liability and an equity component***.

It means that the issuer of such an instrument cannot simply show it purely as a liability or purely as an equity, because this instrument contains a little bit of both.

Example: A bond convertible into a fixed number of issuer's shares

When the bond is convertible into shares, it means that the bond holder can get paid either by cash at maturity or exchange this bond for some fixed number of issuer's shares. It is a compound financial instrument because it contains 2 elements:

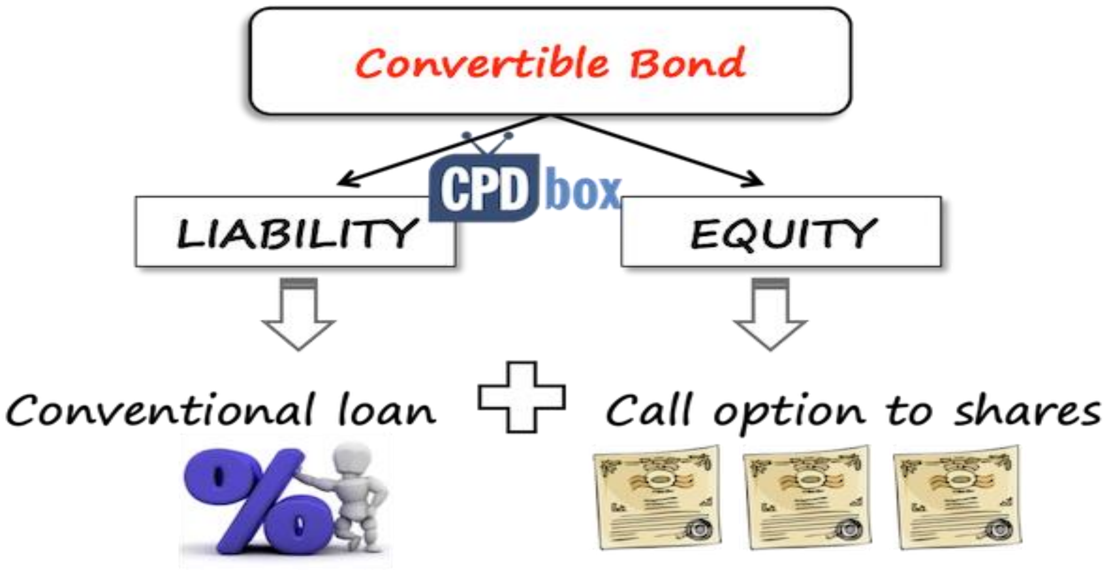
- ***a liability*** = issuer's obligation to pay interest or coupon and POTENTIALLY, to redeem the bond in cash at maturity (or a conventional loan); and
- ***an equity*** = the holder's call option for issuer's shares (or in other words, holder can chose to get fixed amount of shares instead of fixed amount of cash).

Example 2: A preference share redeemable at issuer's discretion with mandatorily paid dividends.

If an issuer issues a share, he must pay dividends each year (or in line with terms of the share), but the issuer can also choose whether and when he redeems the share. Again, this is a compound financial instrument with 2 elements:

- ***a liability*** = issuer's obligation to pay dividends; and

- ***an equity*** = the issuer's call option for own shares (or in other words, issuer can chose to pay fixed amount of cash for fixed amount of shares).

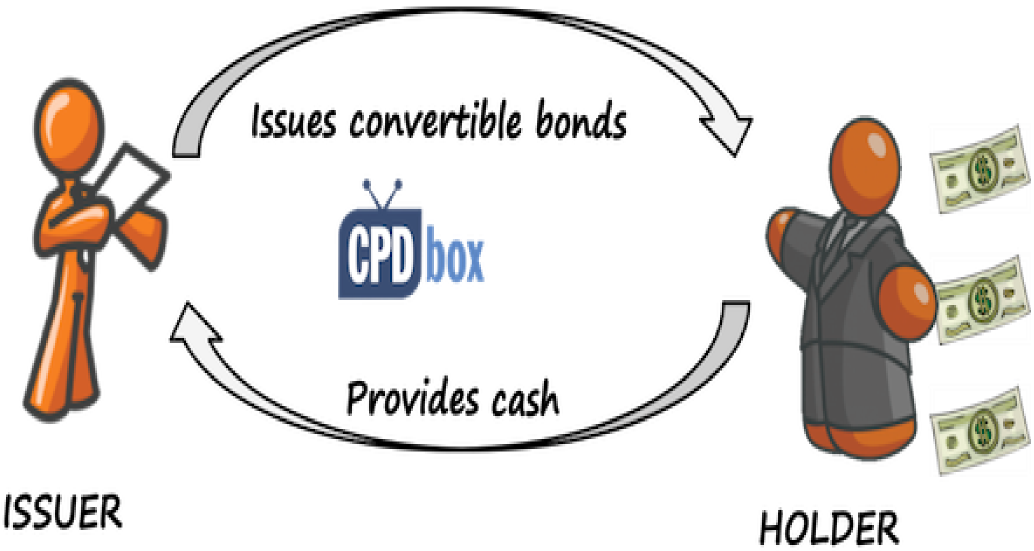


14.7.1 Accounting for compound financial instruments:

Before outlining the accounting treatment let me stress that the accounting treatment in issuer's financial statements significantly differs from accounting treatment in holder's financial statements.

Issuer is someone who creates the compound financial instrument—we can equally call him "borrower" because he raises money by issuing compound financial instrument.

As opposite, ***holder*** is someone who acquires compound financial instrument and we can call him "lender".



14.7.2 Accounting treatment in issuer's financial statements

IAS 32 requires so-called "***split accounting***" for compound financial instruments. It means that the issuer must perform the following steps on initial recognition:

- Step 1: Identify the various components of the compound financial instrument.
    - That's obvious. The issuer must clearly identify what the liability element is and what the equity element is—just refer to examples above.

- Step 2: Determine the fair value of the compound financial instrument as a whole.
    - Basically this shouldn't be any problem, because if the transaction happens under market conditions, then the fair value of the instrument as a whole equals to cash received in return for the instrument.

- Step 3: Determine the fair value of the liability component.
    - The fair value of the liability component can be determined at fair value of a similar liability that does NOT have any associated equity conversion feature. So for example, the fair value of the liability component of the convertible bond equals to fair value of the bond with the same parameters (maturity, coupon rate, etc.) but without the option to convert into issuer's shares.
- Step 4: Determine the fair value of the equity component.
  The equity component is determined simply as the fair value of the compound financial instrument as a whole (step 2) less the fair value of the liability component (step 3).

So as a result, the accounting entry on initial recognition is as follows:

DEBIT: Cash (or as applicable) / CREDIT: Liability (convertible bonds CREDIT: Equity (convertible bonds)

Now, if issuer incurs certain ***costs*** associated with the issue of compound financial instruments, these should be ***allocated*** to the liability and equity components ***proportionally***.
Subsequently, after initial recognition, ***the equity component remains untouched***—so it is NOT remeasured and stays where it is until the final settlement.
On the other hand, liability component is accounted for in line with IFRS 9—either by application of effective interest rate method or at fair value through profit or loss—that depends on the classification of the liability.

14.7.3 Accounting treatment in holder's financial statements

This is really a different cup of tea. When holder buys a compound financial instrument, for example—convertible bond, it also has 2 components:

- A derivative financial asset—which is the call option for issuer's share in this example, and
- A receivable towards issuer—which is the loan provided to issuer by acquiring his bond.

So the holder has 2 assets in fact. In this case, a derivative financial asset shall be measured at first (at fair value of the option) and the fair value of the receivable shall be calculated as a

residual.

14.8 COMPOUND FIVS. HYBRID FI

The difference between "compound" and "hybrid" financial instruments is ….

- ***Compound financial instrument***: that's the NON-DERIVATIVE financial instrument containing both equity and liability components.
- ***Hybrid financial instrument*** or hybrid contract is the one containing embedded derivative.

While accounting for compound financial instrument is arranged by IAS 32 Financial Instruments: Presentation, rules for identification and accounting for embedded derivatives are arranged by IFRS 9 Financial Instruments.

EXAMPLES OF COMPOUND FINANCIAL INSTRUMENTS:

1. 6% Optionally Convertible Debenture

X ltd (issuer) has issued 6% p.a. debentures to Y Ltd. (holder) for a consideration of Rs. 30 lakhs. The holder has an option to convert these debentures to a fixed number of equity instrument of the issuer anytime up to a period of 3 years. If the option is not exercised by the holder, the debentures are redeemed at the end of 3 years. The prevailing market rate for similar debentures without the conversion feature is 9% p.a.

The instrument has two components –
(1) Contractual obligation that is conditional on holder exercising his right to redeem, and
(2) conversion option with the holder.
The first component is a financial liability because the entity does not have an unconditional right to avoid delivering cash. The other component, conversion option with the holder, is an equity feature.

The values of liability and equity component are calculated as follows:
Present value of principal payable at the end of 3 years (Rs. 30 Lakhs discounted at 9% for 3 years)= Rs. 23,16,550.
Present value of interest payable in arrears for 3 years (Rs. 1,80,000 discounted at 9% for each of 3 years) = Rs. 4,55,632
Total financial liability= Rs. 27,72,182.
Therefore, equity component= fair value of CFI, say Rs. 30 Lakhs less financial liability component i.e. Rs. 27, 72,182=Rs. 2, 27,818.
In subsequent years the profit is charged with interest of 9% on the debt instrument.

2. 9% Preference shares with partial conversion and partial redemption
Company M has issued 10,000 9% Preference shares having face value Rs. 100 each with mandatory dividends and mandatory conversion of 50% preference shares into equity and balance 50% redemption at the end of 3 years from the date of issue. Market rate for Preference shares with similar credit status and other features except the conversion feature is 12%p.a.

The preference share has two components –
(1) Contractual obligation for payment of mandatory dividend and mandatory redemption of 50% Preference shares.
(2) Mandatory conversion of 50% Preference shares into equity.

The first component is a financial liability because the same consist of contractual obligation to pay cash and the entity does not have an unconditional right to avoid delivering cash.
The second component is equity since there is mandatory conversion into equity shares, which, in substance, signifies that the amount for the equity is already prepended even before receiving the shares in reality.

The values of equity and liability components are calculated as follows:
Present value of Principal payable at the end of the 3 years (Rs. 5,00,000 discounted at 12% for 3 years)= Rs.3,55,890.
Present value of contractual obligation to pay dividends in arrears for 3 years (Rs. 90,000 discounted at 12% for 3 years) = Rs. 2,16,165
Total financial liability= Rs.5, 72, 055.

Therefore, equity component= fair value of CFI, say Rs. 10,00,000 less financial liability component i.e. Rs. 5,72,055=Rs. 4,27,945.
Subsequent year‟s profit and loss account is charged with interest amortisation at 12% on the financial liability component and dividend expense of Rs. 90,000 each.

14.9. SUMMARY

After studying this lesson, you will be able to…Understand the meaning of Financial Asset. Understand the meaning of Financial Liability. Know different types of Financial Instruments. Understand the features of Cash Instruments. Understand the characteristics of Derivative Instruments. Know the features of Foreign Exchange Instruments Financial instruments are contracts for monetary assets that can be purchased, traded, created, modified, or settled for. In terms of contracts, there is a contractual obligation between involved parties during a financial instrument transaction. A **financial asset** is a non-physical asset whose value is derived from a contractual claim, such as bank deposits, bonds, and participations in companies' share capital. Financial assets are usually more liquid than tangible assets, such as commodities or real estate. A financial liability is any liability that is a contractual obligation or a contract that will or may be settled in the entity's own equity instruments. Financial instruments are classified into cash instruments, derivative instruments and foreign exchange instruments.

14.10. TECHNICAL TERMS

Financial Asset: A financial asset is a liquid asset that gets its value from a contractual right or ownership claim. Cash, stocks, bonds, mutual funds, and bank deposits are all are examples of financial assets.

Financial Liability: Financial liability: any liability that is: a contractual obligation: to deliver cash or another financial asset to another entity; or. to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity; or.

Financial Instruments: A financial instrument is defined as a contract between individuals/parties that holds a monetary value. They can be created, traded, settled, or modified as per the involved parties' requirement.

Cash Instruments: Cash instruments include things like deposits and loans, as well as easily transferable securities. This type of instrument is directly influenced by the market, so any market fluctuations will be directly reflected in the cash asset's value.

Derivative Instruments: A derivative is a financial instrument that derives its performance from the performance of an underlying asset. The underlying asset, called the underlying, trades in the cash or spot markets and its price is called the cash or spot price.

Foreign Exchange Instruments: Foreign exchange instruments are transactions that are concluded on the currency market. These include, for example: Spot transactions. Outright Forwards. Currency swaps.

14.11. SELF –ASSESSMENT QUESTIONS

1. What is the meaning of Financial Asset?
2. What is meaning of Financial Liability?
3. What are the different types of Financial Instruments?
4. What are the features of Cash Instruments?
5. What are the characteristics of Derivative Instruments?
6. What are the features of Foreign Exchange Instruments?

14.12. SUGGESTED READINGS

1. Indian Accounting Standard 110 published by Ministry Of Corporate Affairs (“MCA”)

2. Educational Material onInd AS 110, Consolidated Financial Statements, published by The Institute of Chartered Accountants of India, Delhi.

3. RSN Pillai, Bagarathi & S. Uma, Fundamentals of Advanced Accounting, Vol.1, S. Chand, New Delhi.

4. Nehru J. Financial Reporting by diversified companies vision Books, New Delhi.

5. Hawkins David, Financial Statements Corporations Dow Jones – Irwin Homewood 1973.

6. Indian Accounting Standard (Ind AS) 27, Consolidated and Separate Financial Statements issued by Ministry of corporate affairs

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LESSON - 15
INTRODUCTION TO FINANCIAL DERIVATIVES

AIMS AND OBJECTIVES

After studying this lesson, you will be able to…

1. Understand the meaning of Derivative Contract.
2. Understands different types of Derivatives.
3. Know different features of Futures.
4. Understand the features of Forwards.
5. Understand the characteristics of Forwards.
6. Apply different models of option valuation methods.

STRUCTURE

15.1 Introduction
15.2 Features of Derivatives
15.3 Benefits of Derivatives
15.4 Growth of Financial Derivatives in India
15.5 Participants
15.6 Function of Derivatives
15.7 Types of Derivatives
15.8 Regulatory Objectives
15.9 Binomial Model
15.10 Black & Scholes Option Pricing Model
15.11 Summary
15.12 Technical Terms
15.13 Self-Assessment Questions
15.14 Suggested Readings

15.1 INTRODUCTION

The past two decades has witnessed the multiple growths in the volume of international trade and business due to the wave of globalization and liberalization all over the world. As a result, the demand for the international money and financial instruments increased significantly at the global level. In this respect, changes in the interest rates, exchange rates and stock market prices at the different financial markets have increased the financial risks to the corporate world. Adverse changes have even threatened the very survival of the business world. It is, therefore, to manage such risks; the new financial instruments have been developed in the financial markets, which are also popularly known as financial derivatives.

The basic purpose of these instruments is to provide commitments to prices for future dates for giving protection against adverse movements in future prices, in order to reduce the extent of financial risks. Not only this, they also provide opportunities to earn profit for those persons who are ready to go for higher risks. In other words, these instruments, indeed, facilitate to transfer the risk from those who wish to avoid it to those who are willing to accept the same.

Financial derivatives like futures, forwards options and swaps are important tools to manage assets, portfolios and financial risks. Thus, it is essential to know the terminology and conceptual framework of all these financial derivatives in order to analyze and manage the financial risks. The prices of these financial derivatives contracts depend upon the spot prices of the underlying assets, costs of carrying assets into the future and relationship with spot prices. For example, forward and futures contracts are similar in nature, but their prices in future may differ. Therefore, before using any financial derivative instruments for hedging, speculating, or arbitraging purpose, the trader or investor must carefully examine all the important aspects relating to them.

15.1.1 Definition of Financial Derivatives

Before explaining the term financial derivative, let us see the dictionary meaning of ‘derivative’. Webster’s Ninth New Collegiate Dictionary (1987) states **Derivatives** as:

Something derived; it means that some things have to be derived or arisen out of the underlying variables. For example, financial derivative is an instrument indeed derived from the financial market.

The term “Derivative” indicates that it has no independent value, i.e., its value is entirely derived from the value of the underlying asset. The underlying asset can be securities, commodities, bullion, currency, livestock or anything else.

In other words, derivative means forward, futures, option or any other hybrid contract of predetermined fixed duration, linked for the purpose of contract fulfilment to the value of a specified real or financial asset or to an index of securities.

The Securities Contracts (Regulation) Act 1956 defines “derivative” as under:

“Derivative” includes

1. Security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security.
2. A contract which derives its value from the prices, or index of prices of underlying securities.

The above definition conveys that

1. The derivatives are financial products.
2. Derivative is derived from another financial instrument/contract called the underlying. In the case of Nifty futures, Nifty index is the underlying. A derivative derives its value from the underlying assets.

   Accounting Standard SFAS133 defines a derivative as, ‘a derivative instrument is a financial derivative or other contract with all three of the following characteristics:

(i) It has (1) one or more underlings, and (2) one or more notional amount or payments provisions or both. Those terms determine the amount of the settlement or settlements.

(ii) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contract that would be expected to have a similar response to changes in market factors.

(iii) Its terms require or permit net settlement. It can be readily settled net by a means outside the contract or it provides for delivery of an asset that puts the recipients in a position not substantially different from net settlement

In the 1980s, the financial derivatives were also known as off-balance sheet instruments because no asset or liability underlying the contract was put on the balance sheet as such. Since the value of such derivatives depend upon the movement of market prices of the underlying assets, hence, they were treated as contingent asset or liabilities and such transactions and positions in derivatives were not recorded on the balance sheet. However, it is a matter of considerable debate whether off-balance sheet instruments should be included in the definition of derivatives. Which item or product given in the balance sheet should be considered for derivative is a debatable issue.

15.2 FEATURES OF DERIVATIVES

1. A derivative instrument relates to the future contract between two parties. It means there must be a contract-binding on the underlying parties and the same to be fulfilled in future. The future period may be short or long depending upon the nature of contract, for example, short term interest rate futures and long term interest rate futures contract.
2. Normally, the derivative instruments have the value which derived from the values of other underlying assets, such as agricultural commodities, metals, financial assets, intangible assets, etc. Value of derivatives depends upon the value of underlying instrument and which changes as per the changes in the underlying assets, and sometimes, it may be nil or zero. Hence, they are closely related.
3. In general, the counter parties have specified obligation under the derivative contract. Obviously, the nature of the obligation would be different as per the type of the instrument of a derivative. For example, the obligation of the counter parties, under the different derivatives, such as forward contract, future contract, option contract and swap contract would be different.
4. The derivatives contracts can be undertaken directly between the two parties or through the particular exchange like financial futures contracts. The exchange-traded derivatives are quite liquid and have low transaction costs in comparison to tailor-made contracts. Example of exchange traded derivatives are Dow Jones, S&P 500, Nikki 225, NIFTY option, S&P Junior that are traded on New York Stock Exchange, Tokyo Stock Exchange, National Stock Exchange, Bombay Stock Exchange and so on.
5. In general, the financial derivatives are carried off-balance sheet. The size of the derivative contract depends upon its notional amount. The notional amount is the amount used to calculate the pay off. For instance, in the option contract, the potential loss and potential payoff, both may be different from the value of underlying shares, because the payoff of derivative products differs from the payoff that their notional amount might suggest.
6. Usually, in derivatives trading, the taking or making of delivery of underlying assets is not involved; rather underlying transactions are mostly settled by taking offsetting positions in the derivatives themselves. There is, therefore, no effective limit on the quantity of claims, which can be traded in respect of underlying assets.
7. Derivatives are also known as deferred delivery or deferred payment instrument. It means that it is easier to take short or long position in derivatives in comparison to other assets

or securities. Further, it is possible to combine them to match specific, i.e., they are more easily amenable to financial engineering.

8. Derivatives are mostly secondary market instruments and have little usefulness in mobilizing fresh capital by the corporate world; however, warrants and convertibles are exception in this respect.
9. Although in the market, the standardized, general and exchange-traded derivatives are being increasingly evolved, however, still there are so many privately negotiated customized, over-the-counter (OTC) traded derivatives are in existence. They expose the trading parties to operational risk, counter-party risk and legal risk. Further, there may also be uncertainty about the regulatory status of such derivatives.
10. Finally, the derivative instruments, sometimes, because of their off-balance sheet nature, can be used to clear up the balance sheet. For example, a fund manager who is restricted from taking particular currency can buy a structured note whose coupon is tied to the performance of a particular currency pair.

15.3 BENEFITS OF DERIVATIVES

The general benefits of using financial derivatives as follows:

1. A prudent use of financial derivatives can provide a new mechanism to manage or reduce various business risks at low transaction cost.
2. The innovative use of financial derivatives can greatly help end-users cut their financing cost.
3. Financial derivatives can provide more access to financial markets, especially to unfamiliar ones at lower costs. Put another way, they can create more complete markets to investors.
4. Financial derivative instruments play an important role in asset management due to their lower transaction costs relative to the spot market instruments.
5. The users of financial derivatives can expect to be offered opportunities on taking advantage of asymmetries in tax and regulatory requirements across different countries, markets or securities.
6. Financial derivatives can be used to speculate and make profits by assuming certain risks, probably with suitable degree.

15.4 GROWTH OF FINANCIAL DERIVATIVES IN INDIA

Equity derivatives market in India has registered an "explosive growth" and is expected to continue the same in the years to come. Introduced in 2000, financial derivatives market in India has shown a remarkable growth both in terms of volumes and numbers of traded contracts. NSE alone accounts for 99 percent of the derivatives trading in Indian markets. The introduction of derivatives has been well received by stock market players. Trading in derivatives gained popularity soon after its introduction. In due course, the turnover of the NSE derivatives market exceeded the turnover of the NSE cash market. For example, in 2008, the value of the NSE derivatives markets was Rs. 130, 90,477.75 Cr. whereas the value of the NSE cash markets was only Rs. 3,551,038 Cr. Among all the products traded on NSE in F& O segment, single stock futures also known as equity futures, are most popular in terms of volumes and number of contract traded, followed by index futures with turnover shares of 52 percent and 31 percent, respectively.

Derivatives Market: Derivatives trading commenced in Indian market in 2000 with the introduction of Index futures at BSE, and subsequently, on National Stock Exchange (NSE).

Since then, derivatives market in India has witnessed tremendous growth in terms of trading value and number of traded contracts.

15.4.1 Derivatives Products Traded in Derivatives Segment of BSE: The BSE created history on June 9, 2000 when it launched trading in Sensex based futures contract for the first time. It was followed by trading in index options on June 1, 2001; in stock options and single stock futures (31 stocks) on July 9, 2001 and November 9, 2002, respectively. BSE achieved another milestone on September 13, 2004 when it launched Weekly Options, a unique product unparalleled worldwide in the derivatives markets. Chota (mini) SENSEX7 was launched on January 1, 2008. With a small or 'mini' market lot of 5, it allows for comparatively lower capital outlay, lower trading costs, more precise hedging and flexible trading. Currency futures were introduced on October 1, 2008 to enable participants to hedge their currency risks through trading in the U.S. dollar-rupee future platforms.

15.4.2 Derivatives Products Traded in Derivatives Segment of NSE: NSE started trading in index futures, based on popular S&P CNX Index, on ***June 12, 2000*** as its first derivatives product. Trading on index options was introduced on June 4, 2001. Futures on individual securities started on November 9, 2001. Trading in options on individual securities commenced from July 2, 2001. The NSE achieved another landmark in product introduction by launching Mini Index Futures & Options with a minimum contract size of Rs 1 lac. NSE crated history by launching currency futures contract on US Dollar-Rupee on August 29, 2008 in Indian Derivatives market.

15.5 PARTICIPANTS

Each type of individual will have an objective to participate in the derivative market. You can divide them into following categories based on their trading motives:

- **Hedgers:** These are risk-averse traders in stock markets. They aim at derivative markets to secure their investment portfolio against the market risk and price movements. They do this by assuming an opposite position in the derivatives market. In this manner, they transfer the risk of loss to those others who are ready to take it. In return for the hedging available, they need to pay a premium to the risk taker. Imagine that you hold 100 shares of XYZ company which are currently priced at Rs. 120. Your aim is to sell these shares after three months. However, you don’t want to make losses due to a fall in market price. At the same time, you don’t want to lose opportunity to earn profits by selling them at a higher price in future. In this situation, you can buy a put option by paying a nominal premium that will take care of both the above requirements.

- **Speculators:** These are risk-takers of the derivative market. They want to embrace risk in order to earn profits. They have a completely opposite point of view as compared to the hedgers. This difference of opinion helps them to make huge profits if the bets turn correct. In the above example, you bought a put option to secure yourself from a fall in the stock prices. Your counterparty i.e. the speculator will bet that the stock price won’t fall. If the stock prices don’t fall, then you won’t exercise your put option. Hence, the speculator keeps the premium and makes a profit.

- **Margin traders:** A margin refers to the minimum amount that you need to deposit with the broker to participate in the derivative market. It is used to reflect your losses and gains on a daily basis as per market movements. It enables to get a leverage in derivative trades and maintain a large outstanding position. Imagine that with a sum of Rs. 2 lakh you buy 200 shares of ABC Ltd. of Rs 1000 each in the stock market. However, in the derivative market you can own a three times bigger position i.e. Rs 6 lakh with the same amount. A slight price change will lead to bigger gains/losses in the derivative market as compared to stock market.

- **Arbitrageurs:** These utilize the low-risk market imperfections to make profits. They simultaneously buy low-priced securities in one market and sell them at higher price in another market. This can happen only when the same security is quoted at different prices in different markets. Suppose an equity share is quoted at Rs 1000 in stock market and at Rs 105 in the futures market. An arbitrageur would buy the stock at Rs 1000 in the stock market and sell it at Rs 1050 in the futures market. In this process he/she earns a low-risk profit of Rs 50.

15.6 FUNCTIONS OF DERIVATIVES

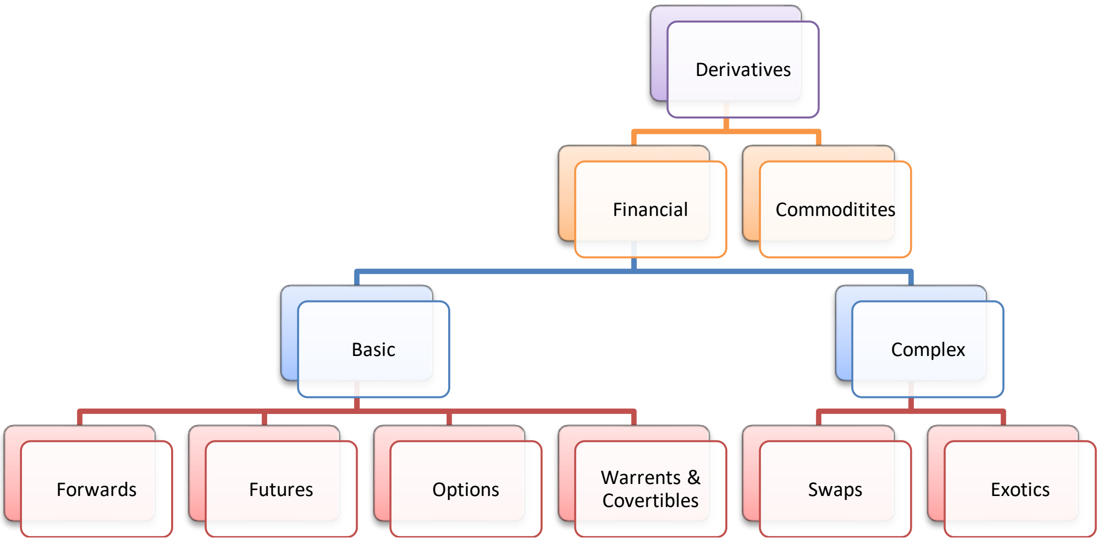
1. Derivatives shift the risk from the buyer of the derivative product to the seller and as such are very effective risk management tools.
2. Derivatives improve the liquidity of the underlying asset.

15.7 TYPES OF DERIVATIVES

One form of classification of derivative instruments is between commodity derivatives and financial derivatives. The basic difference between these is the nature of the underlying instrument or asset. In a commodity derivatives, the underlying instrument is a commodity which may be wheat, cotton, pepper, sugar, jute, turmeric, corn, soya beans, crude oil, natural gas, gold, silver, copper and so on.

In a financial derivative, the underlying instrument may be treasury bills, stocks, bonds, foreign exchange, stock index, gilt-edged securities, cost of living index, etc. It is to be noted that financial derivative is fairly standard and there are no quality issues whereas in commodity derivative, the quality may be the underlying matters. However, the distinction between these two from structure and functioning point of view, both are almost similar in nature.

Due to complexity in nature, it is very difficult to classify the financial derivatives, so in the present context, the basic financial derivatives which are popular in the market have been classified into the following.



Another way of classifying the financial derivatives is into basic and complex derivatives. In this, forward contracts, futures contracts and option contracts have been included in the basic derivatives whereas swaps and other complex derivatives are taken into complex category because they are built up from either forwards/futures or options contracts, or both. In fact, such derivatives are effectively derivatives of derivatives.

15.7.1 Forward Contracts

These transactions are for buying or selling underlying assets - shares. Herein, transactions are carried in the present with the settlement taking place on some future date mutually decided by the parties. All the critical parameters of the transaction are decided by the parties mutually; therefore these are non-standardised (customized). Both the parties decide about the underlying asset, exercise price, value date, and quantity without the intervention of the exchange. Transactions are reported to the exchange to give these a validity mark and to provide coverage for counter party risk. Netting of these transactions is difficult due to customisation and each transaction is settled individually. These transactions are done on 'Over the Counter Exchange' (OTC). Both parties are required to deposit margin according to the rules of the exchange and both have rights as well as obligation.

Features of Forward Transaction

1. Underlying Asset
2. Exercise Price
3. Duration and Value Date
4. Margin
5. Settlement
6. Square up
7. position
8. Customized
9. No expiration

I **Underlying asset**: The assets – commodity, currency, shares and debentures – for which transaction is done, are called underlying asset. The seller of forward transaction is required to deliver the asset on the value date as per the rules of OTC exchange.

2. **Exercise price:** It is the price at which transaction is to be settled on the future date; this is decided mutually by both the parties on the date of transaction. When exercise price is more than the spot price, forward is at premium. On the contrary, when exercise price is less than the spot price, it is at discount.

3. Duration and value date: Forward transactions and entered for certain duration according to the convenience and mutual agreement between the two parties. The OTC exchange does not regulate this. The value date is the last day of the duration.

4 Margin: Both the parties, i.e., the buyer and the seller of the forward contact are required deposit the initial margin on the date of contract with the OTC exchange; this is called as exposure margin. It is maintained everyday on mark-to-market basis. The margin is deposited to cover up losses arising on account of default by any of the parties, if any on the valve date.

5 Settlement: Generally, forward transactions are settled by taking or going the delivery on value date. However, few transactions get settled by giving/taking the difference in cash.

6 Square up: Square up means reversing the transaction that was entered previously. For example, a particular share is sold in forward, which was purchased previously. Square up is possible only when all the parameters of the transactions match and also, the parties are the same.

7. Position: Forward contracts are defined as 'long on forward' and 'short on forward'. Whenever a party purchases the forward contract, it is called 'long on forward' and the purchaser has the right, as well as obligation to take the delivery of the underlying asset (shares) on the value date or settle the transaction through difference in cash. When a party sells the forward contract, it is called as 'short on forward' and the seller has the right as well as the obligation to sell the underlying asset (shares) on the vale date or settle it by difference in cash.

8. Customized: All forward transactions are entered on OTC exchange and different parameters of these transactions - underlying asset, lot size, duration and value date, mode of settlement etc. - are decided by the two parties mutually according to their convenience and to fulfill their specific requirement. OTC exchange decides only about the margin requirement.

9. No expiration: In a forward contract, both parties have rights as well as obligation, therefore one of the parties will reap benefit and the other will incur loss on the value date. Because of this phenomenon, all forward transactions get exercised by giving/taking delivery or through settlement of difference in cash and it never expire.

15.7.2 Futures Contracts

Like a forward contract, a futures contract is an agreement between two parties to buy or sell a specified quantity of an asset at a specified price and at a specified time and place. Futures contracts are normally traded on an exchange which sets the certain standardized norms for trading in the futures contracts.

Example

A silver manufacturer is concerned about the price of silver, since he will not be able to plan for profitability. Given the current level of production, he expects to have about 20.000 ounces of silver ready in next two months. The current price of silver on May 10 is ` 1052.5 per ounce, and July futures price at FMC is ` 1068 per ounce, which he believes to be satisfied price. But he fears that prices in future may go down. So he will enter into a futures contract. He will sell four contracts at MCX where each contract is of 5000 ounces at ` 1068 for delivery in July.

15.7.3 Options Contracts

Options are the most important group of derivative securities. Option may be defined as a contract, between two parties whereby one party obtains the right, but not the obligation, to buy or sell a particular asset, at a specified price, on or before a specified date. The person who acquires the right is known as the option buyer or option holder, while the other person (who confers the right) is known as option seller or option writer. The seller of the option for giving such option to the buyer charges an amount which is known as the option premium.

Options can be divided into two types: calls and puts. A call option gives the holder the right to buy an asset at a specified date for a specified price whereas in put option, the holder gets the right to sell an asset at the specified price and time. The specified price in such contract is known as the exercise price or the strike price and the date in the contract is known as the expiration date or the exercise date or the maturity date.

The asset or security instrument or commodity covered under the contract is called as the underlying asset. They include shares, stocks, stock indices, foreign currencies, bonds, commodities, futures contracts, etc. Further options can be American or European. A

European option can be exercised on the expiration date only whereas an American option can be exercised at any time before the maturity date.

Example

Suppose the current price of CIPLA share is ` 750 per share. X owns 1000 shares of CIPLA Ltd. and apprehends in the decline in price of share. The option (put) contract available at BSE is of ` 800, in next two-month delivery. Premium cost is ` 10 per share. X will buy a put option at 10 per share at a strike price of ` 800. In this way X has hedged his risk of price fall of stock. X will exercise the put option if the price of stock goes down below ` 790 and will not exercise the option if price is more than ` 800, on the exercise date. In case of options, buyer has a limited loss and unlimited profit potential unlike in case of forward and futures.

15.7.4 SWAP Contracts

Swaps have become popular derivative instruments in recent years all over the world. A swap is an agreement between two counter parties to exchange cash flows in the future. Under the swap agreement, various terms like the dates when the cash flows are to be paid, the currency in which to be paid and the mode of payment are determined and finalized by the parties. Usually the calculation of cash flows involves the future values of one or more market variables.

There are two most popular forms of swap contracts, i.e., interest rate swaps and currency swaps. In the interest rate swap one party agrees to pay the other party interest at a fixed rate on a notional principal amount, and in return, it receives interest at a floating rate on the same principal notional amount for a specified period. The currencies of the two sets of cash flows are the same. In case of currency swap, it involves in exchanging of interest flows, in one currency for interest flows in other currency. In other words, it requires the exchange of cash flows in two currencies. There are various forms of swaps based upon these two, but having different features in general.

15.7.5 Other Derivatives

As discussed earlier, forwards, futures, options, swaps, etc. are described usually as standard or ‘plain vanilla’ derivatives. In the early 1980s, some banks and other financial institutions have been very imaginative and designed some new derivatives to meet the specific needs of their clients. These derivatives have been described as ‘non-standard’ derivatives. The basis of the structure of these derivatives was not unique, for example, some non-standard derivatives were formed by combining two or more ‘plain vanilla’ call and put options whereas some others were far more complex.

In fact, there is no boundary for designing the non-standard financial derivatives, and hence, they are sometimes termed as ‘exotic options’ or just ‘exotics’. There are various examples of such non-standard derivatives such as packages, forward start option, compound options, choose options, barrier options, binary options, look back options, shout options, Asian options, basket options, Standard Oil’s Bond Issue, Index Currency Option Notes (ICON), range forward contracts or flexible forwards and so on.

15.7.6 Warrants and Convertibles

Warrants and convertibles are other important categories of financial derivatives, which are frequently traded in the market. Warrant is just like an option contract where the holder has the right to buy shares of a specified company at a certain price during the given time period. In other words, the holder of a warrant instrument has the right to purchase a specific number of shares at a fixed price in a fixed period from an issuing company. If the holder exercised the right, it increases the number of shares of the issuing company, and thus, dilutes the equities of its shareholders. Warrants are usually issued as sweeteners attached to senior securities like bonds and debentures so that they are successful in their equity issues in terms of volume and price. Warrants can be detached and traded separately. Warrants are highly speculative and leverage instruments, so trading in them must be done cautiously.

Convertibles are hybrid securities which combine the basic attributes of fixed interest and variable return securities. Most popular among these are convertible bonds, convertible debentures and convertible preference shares. These are also called equity derivative securities. They can be fully or partially converted into the equity shares of the issuing company at the predetermined specified terms with regards to the conversion period, conversion ratio and conversion price. These terms may be different from company to company, as per nature of the instrument and particular equity issue of the company. The further details of these instruments will be discussed in the respective chapters.

15.8 REGULATORY OBJECTIVES

A. **Investor Protection:** Attention needs to be given to the following four aspects:

i. **Fairness and Transparency:** The trading rules should ensure that trading is conducted in a fair and transparent manner. Experience in other countries shows that in many cases, derivative brokers/dealers failed to disclose potential risk to the clients. In this context, sales practices adopted by dealers for derivatives would require specific regulation. In some of the most widely reported mishaps in the derivatives market elsewhere, the underlying reason was inadequate internal control system at the user-firm itself so that overall exposure was not controlled and the use of derivatives was for speculation rather than for risk hedging. These experiences provide useful lessons for us for designing regulations.

ii. **Safeguard for clients' moneys:** Moneys and securities deposited by clients with the trading members should not only be kept in a separate clients' account but should also not be attachable for meeting the broker's own debts. It should be ensured that trading by dealers on own account is totally segregated from that for clients.

iii. **Competent and honest service:** The eligibility criteria for trading members should be designed to encourage competent and qualified personnel so that investors/clients are served well. This makes it necessary to prescribe qualification for derivatives brokers/dealers and the sales persons appointed by them in terms of a knowledge base.

iv. **Market integrity:** The trading system should ensure that the market's integrity is safeguarded by minimizing the possibility of defaults. This requires framing appropriate rules about capital adequacy, margins, clearing corporation, etc.

B. Quality of markets: The concept of "Quality of Markets" goes well beyond market integrity and aims at enhancing important market qualities, such as cost-efficiency, price-continuity, and price-discovery. This is a much broader objective than market integrity.

C. **Innovation:** While curbing any undesirable tendencies, the regulatory framework should not stifle innovation which is the source of all economic progress, more so because financial derivatives represent a new rapidly developing area, aided by advancements in information technology.

VALUATION OF OPTIONS

15.9 BINOMIAL MODEL

This model shows the probable paths of asset prices over the option period. The theory is explained by the alternate paths taken by the underlying stock. This model is based on the fundamental that price of the underlying share can either increase or decrease in the future in comparison to the spot price in the present. The underlying assumption in this method is that the price of underlying share moves in a RANDOM WALK. Random walk implies that in each time step, the spot price has a certain probability of moving upward and if it does not move upward, then it has a certain probability of moving downward in the same-time step. This random walk assumption gives logic for the calculation of option price. At the initial stage, this binomial logic is applied as 'One-Step Binomial Model' and then it is can be generalized over 'n-step' binomial method.
The stock price may either increase by (1+x) % or decline by (1-x) %. Following are the factors considered in valuing / pricing an option under the Binomial Tree Approach —

(a) Current Spot Price of the underlying asset,
(b) Exercise Price under the Options Contract,
(c) Set of Expected Future Spot Prices — one above the Exercise Price and one below the Exercise Price,
(d) Risk Free Rate of Return,
(e) Period to Expiry.

The model helps the investor to develop a riskless portfolio of assets and options and hedge his portfolio. The basic premise of the binomial model is the concept of the replicating portfolio. Replicating portfolio consists of a call option with strike price’S’ involves borrowing an amount ‘B’ and buying delta ( ) no. of shares.   is the hedge ratio.

Hedge Ratio ‘Δ‘ = $\Delta\frac{C1-C2}{P1-P2}$ Δ

C_1 = Gain in the call option at high price
C_2 = Gain in the call option at low price
P_1 = Probable high price
P_2 = Probable low price

Borrowing Amount (B) = $\frac{lot\ size}{1+r}\ (\Delta\ P2 - C2)$

r = Interest Rate
Cost of borrowed amount = **B (1+r)**

The fair value of the option contract = lot $(\Delta)\ P - B$

P = Current market price
If the market price deviates from the fair value, the investor has to adopt an appropriate strategy. It is based on deviation.
If the market value of a call is greater than the fair value, the call contract is over priced. The investor must sell or short the call option and buy a replicating portfolio.
If the market value of call is less than the fair value, the investor must keep long position in the call option and short position in the replicating portfolio.

15.10 BLACK & SCHOLES OPTION PRICING MODEL

The option price is the fee paid by the option buyer to option writer. The Pricing of options has been attempted by many experts Sprenkle (1961), Samuel son (1965), Chen (1970) and Black and Scholes (1973). The Black Scholes formula is constructed based on the following assumptions, which are known a “Ideal Conditions".

1. The short-term risk free interest rate is known and is constant throughout the lifetime of the option.
2. The Stock Price is Continuous and is distributed log normally.
3. There are no transaction costs and Taxes.
4. The stock pays no dividend
5. The option is European; it can only exercise at maturity.
6. The risk free interest rate is known and constant
7. There should not be any takeovers or other events that prematurely end the life of the option.
8. Volatility of the asset is constant throughout the option life
9. There are no penalties to short Selling. (A Seller, who does not own a security, will simply accept the price of the security from a buyer, and will agree to settle with the buyer on some future dale by paying him an amount equal to the price of the security on that date.)

Note: The stock Price follows a random walk in continuous time with a variable rate proportional to the square of the stock Price. Thus the distribution of possible stock Prices at the end of any finite interval is lognormal. The Variance rate of return on the stock is constant.

Option price for a call (V_c) = (P * N(d_1)) – (S * e^{-rt} * N (d_2))
Option price for a put (V_p) = (S * e^{-rt} * N (-d_2)) - (P * N(-d_1))

P = Underlying asset market price
S = Strike Price
r = rate of risk free interest
T = time to expiry
N(d_1) = Cumulative normal distribution value for d_1
N(d_2) = Cumulative normal distribution value for d_2

$$d_1 = \frac{\ln\left(\frac{P}{S}\right) + \left(r + \frac{\sigma^2}{2}\right)T}{\sigma * \sqrt{T}}$$

$$d_2 = d_1 - \sigma * \sqrt{T}$$

Note: Volatility is represented by the annualized standard deviation of the continuously compounded returns, and is measured by using the natural logarithm of the asset/ price relative.

15.11 SUMMARY

After studying this lesson, you will be able to understand the meaning of Derivative Contract. Understands different types of Derivatives. Know different features of Futures. Understand the features of Forwards. Understand the characteristics of Forwards. Apply different models of option valuation methods. The term “Derivative” indicates that it has no independent value, i.e., its value is entirely derived from the value of the underlying asset. The underlying asset can be securities, commodities, bullion, currency, livestock or anything else. Derivative means forward, futures, option or any other hybrid contract of predetermined fixed duration, linked for the purpose of contract fulfillment to the value of a specified real or financial asset or to an index of securities. Hedgers, speculators, arbitrators and margin traders participate in the derivative markets. There are different models are available to price the options. Binomial model and Black & Scholes models are the popular among them.

15.12 TECHNICAL TERMS

Derivatives: A derivative is a security with a price that is dependent upon or derived from one or more underlying assets. The derivative itself is a contract between two or more parties based upon the asset or assets. Its value is determined by fluctuations in the underlying asset.

Function: From Middle French function, from Old French function, from Latin functiō ("performance, execution"), from functus, perfect participle of fungor ("to perform, execute, discharge"), from Proto-Indo-European *bʰewg- ("to enjoy").

Binomial Model: The binomial option pricing model is a risk-free method for estimating the value of path-dependent alternatives. With this model, investors can determine how likely they are to buy or sell at a given price in the future.

Option Pricing Model: Option pricing models are theories that can calculate the value of an options contract based on the number of variables within the actual contract. The key aim of a pricing model is to work out the probability of whether the option is 'in-the-money' or 'out-of-the-money when it is exercised.

15.13 SELF-ASSESSMENT QUESTIONS

1. What are the Features of Derivatives?
2. What are the Benefits of Derivatives?
3. Growth of Financial Derivatives in India
4. Who are the Participants in derivatives?
5. What is the Function of Derivatives?
6. What are the Types of Derivatives?
7. What are the Regulatory Objectives?
8. Explain briefly regarding Binomial Model
9. Explain briefly about Black & Scholes Option Pricing Model

15.14 SUGGESTED READINGS

1. Indian Accounting Standard 110 published by Ministry Of Corporate Affairs ("MCA")

2. Educational Material onInd AS 110, Consolidated Financial Statements, published by The Institute of Chartered Accountants of India, Delhi.

3. RSN Pillai, Bagarathi & S. Uma, Fundamentals of Advanced Accounting, Vol.1, S. Chand, New Delhi.

4. Nehru J. Financial Reporting by diversified companies vision Books, New Delhi.

5. Hawkins David, Financial Statements Corporations Dow Jones – Irwin Homewood 1973.

6. Indian Accounting Standard (Ind AS) 27, Consolidated and Separate Financial Statements issued by Ministry of corporate affairs

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LESSON - 16
DEBENTURE VALUATION

AIMS AND OBJECTIVES

After studying this lesson, you will be able to…

- Understand the meaning of Debentures.
- Understand types of Debentures.
- Know different types of Debentures.
- Understands the valuation of debentures.

STRUCTURE

16.1 Introduction
16.2 Features of Debentures
16.3 Types of Debentures
16.4 Mandatory Requirements
16.5 Governing framework for issue of Debentures
16.6 Conditions for issue of Debentures
16.7 Appointment of Debenture Trusty
16.8 Duties of Debentures Trusty
16.9 Liability of Debenture Trusty
16.10 Debenture trusty Deed
16.11 Procedure for issue of Debentures
16.12 Advantages & Disadvantages
16.13 Summary
16.14 Technical Terms
16.15 Self-Assessment Questions
16.16 Suggested Readings

16.1 INTRODUCTION

The word 'debenture' has been derived from a Latin word 'debere' which means to borrow.

Section 2(30) of the Companies Act, 2013 define "debenture" which includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not.

However, the instruments referred to in Chapter III-D of the Reserve Bank of India Act, 1934 and such other instrument, as may be prescribed by the Central Government in consultation with the Reserve Bank of India, issued by a company, shall not be treated as debenture.

Thus, Debenture is a written instrument acknowledging a debt to the Company. It contains a contract for repayment of principal after a specified period or at intervals or at the option of the company and for payment of interest at a fixed rate payable usually either half-yearly or yearly on fixed dates.

16.2 FEATURES OF DEBENTURE

1. **Written Promise:** A company issues a debenture as a written promise to a holder specifying the money it owes to the latter.
2. **Repayment Tenure:** A debenture is a debt instrument that specifies the maturity of the repayment tenure within which an issuing company needs to repay the interest and principal amount to the investor.
3. **Face Value:** A debenture may carry a face value of ₹ 100 or multiples of the same amount.
4. **Fixed Interest Rate:** An interest rate of a debenture is fixed, which an issuing company can pay to the holder either yearly or half-yearly. However, an interest rate may differ with each company, type of business and present market conditions.
5. **Redeemable Debt Instrument:** A redemption means repayment of debt to a holder. A company can redeem debentures at par, premium or discount.
6. **No Right to Voting:** A debenture holder does not enjoy voting rights in an issuing company's general meetings unless it permits him or her to express an opinion in special circumstances.
7. **Parties Involved in Debenture:** There are three parties involved in a debenture -
    - A company that issues debenture and borrows money through it.
    - Another is a trustee, through which a company communicates with a holder. The company draws an agreement between a holder and trustee. This is known as a 'Trust Deed', which specifies obligations of a company, holder's rights and other necessary details.
    - Finally, a debenture holder is an individual who gives a loan to the company. In return, he or she gets a debenture certificate as proof of participation.
8. **Listing:** A debenture is required to be listed at least in one stock exchange.

16.3 TYPES OF DEBENTURES

The following are the different types of debentures:

16.3.1 On the basis of Security:

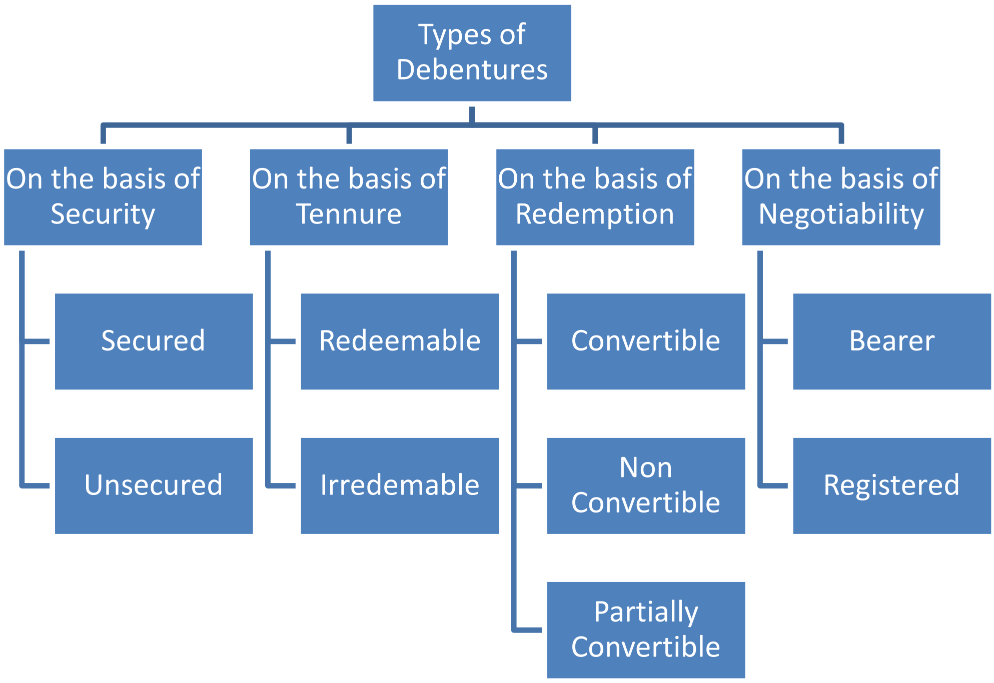
16.3.1.1 Secured Debentures: Secured Debentures refer to those debentures where a charge is created on the assets of the company for the purpose of payment in case of default. A charge ranking Pari Passu with the first charge on any assets referred to in Schedule III of the Companies Act, 2013 excluding intangible assets of the company. The secured debenture holders have greater protection. Holders of secured debentures remain convinced about the payment of interest and payment of principal in the event of redemption.

Condition for Issue of Secured Debenture:
Redemption Period: An issue of secured debentures may be made, provided the date of its redemption shall not exceed ten years from the date of issue.

However, the following classes of companies may issue secured debentures for a period exceeding ten years but not exceeding thirty years,

(i) Companies engaged in setting up of infrastructure projects;
(ii) 'Infrastructure Finance Companies' as defined in clause (viia) of sub direction (1) of direction 2 of Non-Banking Financial (Non-deposit accepting or holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;
(iii) Infrastructure Debt Fund Non-Banking Financial Companies’ as defined in clause (b) of direction 3 of Infrastructure Debt Fund NonBanking Financial Companies (Reserve Bank) Directions, 2011;
(iv) Companies permitted by a Ministry or Department of the Central Government or by Reserve Bank of India or by the National Housing Bank or by any other statutory authority to issue debentures for a period exceeding ten years.

Creation of Charge: Debentures shall be secured by the creation of a charge on the properties or assets of the company or its subsidiaries or its holding company or its associates companies, having a value which is sufficient for the due repayment of the amount of debentures and interest thereon.



16.3.1.2 Unsecured Debentures These debentures are also known as naked debentures. These debentures are not secured by way of charge on the company’s assets. Interest rate payable on unsecured debentures is generally higher than that which is payable on secured debentures.

16.3.2 On the basis of Tenure

16.3.2.1 Redeemable Debentures are those which are payable on the expiry of the specific period (Maximum period 10 years from the date of issue) either in lump sum or in instalments during the life time of the company. Debentures can be redeemed either at par or at premium.

16.3.2.2 Irredeemable Debentures are also known as Perpetual Debentures because the company does not give any undertaking for the repayment of money borrowed by issuing such debentures. These debentures are repayable on the winding-up of a company or on the expiry of a long period. They can legally be framed as payable to bearer.
Under the Companies Act, 2013, it is reiterated that in case of Redeemable Debentures the maximum period of redemption is 10 years from the date of issue, except certain specified companies infrastructure companies where the maximum redemption period can be exceeding ten years but not exceeding thirty years.

16.3.3 Mode of Redemption
These debentures are issued by a company on the basis of option provided to them for conversion of debenture in the equity shares of the company after a certain period. It may be classified in the following categories: —

16.3.3.1 Convertible Debenture These debentures are converted into equity shares of the company on the expiry of a specified period.

16.3.3.2 Non-Convertible Debenture debentures do not have any option to convert the same into equity shares and are redeemed at the expiry of specified period(s). A Company can only issue Secured Non-Convertible Debentures (NCD's). In case of issue of NCD's by a Company not constituting a charge on the assets of the Company, it shall be mandatory for listing of the securities on the recognized stock exchange so that same does not come under the purview of deposits. (Rule 2 (1) (c) of Companies (Acceptance of Deposits), Rules, 2014.

16.3.3.3 Partly Convertible Debenture are divided into two portions, viz., convertible and non-convertible portion. The convertible portion is converted into equity shares of the company at the expiry of specified period. The non-convertible portion is redeemed at the expiry of the specified period in terms of the issue.

16.3.4 Basis of negotiability
Debentures issued by a company may be negotiable or non-negotiable. There are following two types of debentures: —

16.3.4.1 Bearer Debentures These debentures are payable to bearer of the debentures and transferable by mere delivery. These debentures are also known as unregistered debentures.

16.3.4.2 Registered Debentures These debentures are not transferable by mere delivery of debenture certificates and shall be transferred as per the provisions of the Companies Act 2013, by executing transfer deeds and the transfer registered by the company. Registered debentures are not negotiable instruments. A registered holder of a debenture means a person whose name appears both in the debenture certificate and in the register of debenture holders. Principal and interest amount, when due in respect of these debentures are payable to the registered holders thereof only.

16.4 MANDATORY REQUIREMENTS

- Debentures cannot be issued with voting rights.

- On issue of debenture, a Company shall create a Debenture Redemption Reserve (DRR) out of the profits of the company available for payment of dividend and the amount credited to such account shall not be utilised by the company except for the redemption of debentures.
- A company is required to pay interest and redeem the debentures in accordance with the terms and conditions of their issue.
- If there is any default in repayment of amount in the event of maturity or default in payment of the interest thereon then the Tribunal will be approached by the Debenture-holders or Debenture Trustee to take appropriate measures.

16.5 GOVERNING FRAMEWORK FOR ISSUE OF DEBENTURES

The power to issue debentures can be exercised on behalf of the Company at a meeting of the Board under the provisions of Section 179 (3) of the Companies Act, 2013. Further Section 71 read with Rule 18 of the Companies (Share Capital and Debentures) Rules, deals with the provisions relating to the issuance of debentures.
Debentures are Securities within the meaning of Section 2(81) of the Companies Act, 2013. Hence, for issue of Debentures, all procedures for issue of securities as mentioned in Section 23 will be applicable, which states the ways available for a Public Company and Private Company for issue of Securities.

16.5.1 Non-Convertible Debenture For issue of Non-Convertible Debentures on a private Placement basis by a private company, the provisions of Section 42 along with rules made thereunder will be applicable. A Public company can either make public issue of debentures or can make a Private Placement.

16.5.2 Convertible Debentures In case of debentures which are convertible either fully or partly into equity shares (whether compulsorily or optionally), Section 62 will be attracted by virtue of Explanation (ii) of Rule 13(1) of the Companies (Share Capital and Debentures) Rules, 2014, which explains the meaning of the word "shares or other securities" to include "fully convertible debentures, partly convertible debentures or any other securities, which would be convertible into or exchanged with equity shares at a later date".
Where the preferential offer of convertible debentures is made by a company whose share or other securities are listed on a recognized stock exchange, such preferential offer shall be made in accordance with the provisions of the Companies Act, 2013 and regulations made by the Securities and Exchange Board, and if they are not listed, the preferential offer shall be made in accordance with the provisions of Section 62 read with Rule 13 of the Companies(Share Capital & Debentures) Rules, 2014 along with the conditions laid down in Section 42 and Rule 14 of the Companies (Prospectus & Allotment of Securities) Rules, 2014.

16.6 CONDITIONS FOR ISSUE OF DEBENTURES UNDER THE COMPANIES ACT, 2013

16.6.1 Debenture Redemption Reserve

Section 71(4) read with Rule 18(7) of the Companies (Share Capital and Debentures) Rules, 2014 provides that the company shall create a Debenture Redemption Reserve for the purpose of redemption of debentures. The company shall comply with the requirements with regard to Debenture Redemption Reserve (DRR) and investment or deposit of sum in respect of debentures maturing during the year ending on the 31st day of March of next year, in accordance with the conditions given below:-

Quantum of Debenture Redemption Reserve

S. No.	Classes of Company	Condition
1	All India Financial Institutions (AIFIs) regulated by Reserve Bank of India and Banking Companies	No DRR for debentures issued by for both public as well as privately placed debentures
2	Financial Institutions (FIs) within the meaning of clause (72) of section 2 of the Companies Act, 2013	DRR shall be as applicable to NBFCs registered with RBI.
3	For NBFCs registered with the RBI under Section 45-IA of the RBI Act, 1934 and Housing finance companies registered with the National Housing Bank:	
3A	Listed NBFCs and Housing Finance Companies	3A No DRR required for debentures issued for both public as well as privately placed debentures
3B	Unlisted NBFCs and Housing Finance Companies	No DRR is required in case of privately placed Debentures
4A	Listed Companies	No DRR required for debentures issued for both public as well as privately placed debentures
4B	Unlisted companies	Adequacy of DRR shall be 10% of the value of outstanding debentures.

16.6.2 Method of investment in Debenture Redemption Reserve:

Every listed company (including listed NBFCs and Housing Finance Companies) in case of public issue of debentures and other unlisted company (other than unlisted NBFCs and Housing Finance Companies) shall on or before the 30th day of April in each year, in respect of debentures issued by the above mentioned companies is required to invest or deposit at least 15 % of the amount of its debentures maturing during the year ending on 31st day of March of next year. The company may choose any of the below given methods:

(i) in deposits with any scheduled bank, free ;

(ii) in unencumbered securities of the Central methods of deposits or from any charge or lien; Government or any State Government;

(iii) in unencumbered securities mentioned in sub-clauses (a) to (d) and (ee) of section 20 of the Indian Trusts Act, 1882;

(iv) in unencumbered bonds issued by any other company which is notified under sub-clause (f) of section 20 of the Indian Trusts Act, 1882;

Provided that the amount remaining invested or deposited, as the case may be, shall not any time fall below fifteen percent. of the amount of the debentures maturing during the year ending on 31st day of March of that year.

The amount invested or deposited as above shall not be used for any purpose other than for redemption of debentures maturing during the year referred above.

In case of partly convertible debentures, Debenture Redemption Reserve shall be created in respect of non- convertible portion of debenture issue in accordance with Rule 18(7) of the Companies (Share Capital and Debentures) Rules, 2014.

A company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption. However, the issue of debentures with an option to convert such debentures into shares, wholly or partly, shall be approved by a special resolution passed at a general meeting.

16.7 APPOINTMENT OF DEBENTURES TRUSTEE

- A Company cannot issue debentures to more than 500 people without appointing a debenture trustee, whose duty would be to protect the interest of Debenture Holders and redress their grievances.
- The company shall appoint the debenture trustee before the issue of prospectus or letter of offer for subscription of its debentures and not later than sixty days after the allotment of the debentures, execute a debenture trust deed to protect the interest thereon.

16.7.1 Charge/Mortgage in Favour of Debenture Trustee

The security for the debentures by way of a charge or mortgage shall be created in favour of the debenture trustee on:-

(i) any specific movable property of the company or its holding company or subsidiaries or associate companies or otherwise.

(ii) (ii) any specific immovable property wherever situate, or any interest therein.

However, in case of a non-banking financial company, the charge or mortgage under sub-clause
(i) may be created on any movable property.
Further that in case of any issue of debentures by a Government company which is fully secured by the guarantee given by the Central Government or one or more State Government or by both, the requirement for creation of charge shall not apply.
In case of any loan taken by a subsidiary company from any bank or financial institution the charge or mortgage may also be created on the properties or assets of the holding company.

16.7.2 Conditions for Appointment of Debenture Trustee

The company shall appoint debenture trustees under Section 71(5) of the Companies Act, 2013, after obeying with the following conditions, namely:-

(a) The names of the debenture trustees shall be stated in letter of offer inviting subscription for debentures and also in all the subsequent notices or other communications sent to the debenture holders;

(b) Before the appointment of Debenture Trustee or trustees, a written consent shall be obtained from such debenture trustee or trustees proposed to be appointed and a statement to that effect shall appear in the letter of offer issued for inviting the subscription of the debentures;

(c) A person shall not be appointed as a debenture trustee, if he:

- beneficially holds shares in the company;

- is promoter, director or key managerial personnel or any other officer or an employee of the company or its holding, subsidiary or associate company;
- is beneficially entitled to moneys which are to be paid by the company otherwise than as remuneration payable to the debenture trustee;
- is indebted to the company, or its subsidiary or its holding or associate company or a subsidiary of such holding company;
- has furnished any guarantee in respect of the principal debts secured by the debentures or interest thereon;
- has any pecuniary relationship with the company amounting to two per cent or more of its gross turnover or total income or fifty lakh rupees or such higher amount as may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year;
- is relative of any promoter or any person who is in the employment of the company as director or key managerial personnel.

(d) The Board of directors may fill any casual vacancy in the office of the trustee but while any such vacancy continues, the remaining trustee or trustees, if any, may act. However, where such vacancy is caused by the resignation of the debenture trustee, the vacancy shall only be filled with the written consent of the majority of the debenture holders.

(e) Any debenture trustee may be removed from office before the expiry of his term only if it is approved by the holders of not less than three fourth in value of the debentures outstanding, at their meeting.

16.8 DUTIES OF DEBENTURES TRUSTEE

It shall be the duty of every debenture trustee to-

(a) satisfy himself that the letter of offer does not contain any matter which is inconsistent with the terms of the issue of debentures or with the trust deed;
(b) satisfy himself that the covenants in the trust deed are not prejudicial to the interest of the debenture holders;
(c) call for periodical status or performance reports from the company;
(d) communicate promptly to the debenture holders' defaults, if any, with regard to payment of interest or redemption of debentures and action taken by the trustee therefor;
(e) appoint a nominee director on the Board of the company in the event of-
    - two consecutive defaults in payment of interest to the debenture holders; or
    - default in creation of security for debentures; or
    - default in redemption of debentures
(f) ensure that the company does not commit any breach of the terms of issue of debentures or covenants of the trust deed and take such reasonable steps as may be necessary to remedy any such breach;
(g) inform the debenture holders immediately of any breach of the terms of issue of debentures or covenants of the trust deed;
(h) ensure the implementation of the conditions regarding creation of security for the debentures, if any, and debenture redemption reserve;
(i) ensure that the assets of the company issuing debentures and of the guarantors, if any, are sufficient to discharge the interest and principal amount at all times and that

such assets are free from any other encumbrances except those which are specifically agreed to by the debenture holders;

(j) do such acts as are necessary in the event the security becomes enforceable;

(k) call for reports on the utilization of funds raised by the issue of debentures;

(l) take steps to convene a meeting of the holders of debentures as and when such meeting is required to be held;

(m) ensure that the debentures have been converted or redeemed in accordance with the terms of the issue of debentures;

(n) perform such acts as are necessary for the protection of the interest of the debenture holders and do all other acts as are necessary in order to resolve the grievances of the debenture holders.

16.9 LIABILITY OF DEBENTURE TRUSTEE

Any provision contained in a trust deed for securing the issue of debentures, or in any contract with the debenture-holders secured by a trust deed, shall be void in so far as it would have the effect of exempting a trustee thereof from, or indemnifying him against, any liability for breach of trust, where he fails to show the degree of care and due diligence required of him as a trustee, having regard to the provisions of the trust deed conferring on him any power, authority or discretion.

The liability of the debenture trustee shall be subject to such exemptions as may be agreed upon by a majority of debenture-holders holding not less than 3/4th in value of the total debentures at a meeting held for the purpose.

Where at any time the debenture trustee comes to a conclusion that the assets of the company are insufficient or are likely to become insufficient to discharge the principal amount as and when it becomes due, the debenture trustee may file a petition before the Tribunal and the Tribunal may, after hearing the company and any other person interested in the matter, by order, impose such restrictions on the incurring of any further liabilities by the company as the Tribunal may consider necessary in the interests of the debenture-holders.

Where a company fails to redeem the debentures on the date of their maturity or fails to pay interest on the debentures when it is due, the Tribunal may, on the application of any or all of the debenture-holders, or debenture trustee and, after hearing the parties concerned, direct, by order, the company to redeem the debentures forthwith on payment of principal and interest due thereon.

Meetings of Debenture Holders by Debenture Trustee

The meeting of all the debenture holders shall be convened by the debenture trustee on-

(a) requisition in writing signed by debenture holders holding at least one-tenth in value of the debentures for the time being outstanding;

(b) the happening of any event, which constitutes a breach, default or which in the opinion of the debenture trustees affects the interest of the debenture holders.

16.10 DEBENTURE TRUST DEED

Debenture Trust deed is a written instrument legally conveying property to a trustee often for the purpose of securing a loan or mortgage. It is the document creating and setting out the terms of a trust. It will usually contain the names of the trustees, the identity of the beneficiaries and the nature of the trust property, as well as the powers and duties of the trustees. It constitutes trustees charged with the duty of looking after the rights and interests of the debenture holders.
A trust deed in Form No. SH. 12 or as near thereto as possible shall be executed by the company issuing debentures in favour of the debenture trustees within three months of closure of the issue or offer.

A trust deed for securing any issue of debentures shall be open for inspection to any member or debenture holder of the company, in the same manner, to the same extent and on the payment of the same fees, as if it were the register of members of the company; and a copy of the trust deed shall be forwarded to any member or debenture holder of the company, at his request, within seven days of the making thereof, on payment of fee.

Non Applicability
Rule 18 of the Companies (Share Capital and Debentures) Rules, 2014 is not applicable

- on any amount received by a company against issue of commercial paper or any other similar instrument issued in accordance with the guidelines or regulations or notification issued by the Reserve Bank of India. or
- in case of any offer of foreign currency convertible bonds or foreign curency bonds issued in accordance with the Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 or regulations or directions issued by the Reserve Bank of India, the provisions of this rule shall not apply unless otherwise provided in such Scheme or regulations or directions.

16.11 PROCEDURE FOR ISSUE OF DEBENTURES UNDER THE COMPANIES ACT, 2013

S. No.	Particulars	Time frame
1	Obtain a valuation report from the registered valuer with respect to the Convertible Debentures to be issued. In case of Non-Convertible Debenture, there is no dilution of share-holding in the share capital of the company, valuation of securities and justification of price are not applicable.	
2	Hold a meeting of Board: (i) To consider and approve issue of Debentures including the terms and conditions of issue. (ii) To identify the group of persons to whom debentures are proposed to be offered. (iii) To approve the offer letter (iv) To fix day, date and time and agenda for General Meeting for passing Special Resolution (v) To approve draft notice of General Meeting	
3	In case of a Public Company, a copy of Board	File E-Form

	Resolution for issue of debentures with ROC is required to be filed by the company	MGT-14 within 30 days of passing of Board Resolution
4	Convene and hold Extra-Ordinary General Meeting to consider and approve the following items: – (i) Increase in the Borrowing power of the Board of Directors by passing Special Resolution, in case it exceeds the limit, in terms of Section 180(1)(c) (ii) Issue of Debentures	File E-Form MGT-14 along with explanatory statement within 30 days of passing of Special Resolution.
5	Open a separate Bank Account in a scheduled bank for keeping monies received on the application.	
6	Prepare the list of such persons to whom offer to subscribe debenture will be given in draft offer letter under PAS-4.	
7	Offer letter shall be accompanied by an application form serially numbered and addressed specifically to the person to whom the offer is made.	
8	Dispatch of Letter of Offer to identified persons.	
9	Maintain a complete record of persons to whom offer letter is sent in Form PAS-5.	
10	Receiving of Application Money through cheque or demand draft or other banking channel and not by cash. Keep the record of the bank account from where such payments for subscriptions have been received.	
11	Convene Board meeting within a period of 60 days from the date of receipt of subscription money: a. to consider the allotment of Debentures b. Approval of draft agreement for Charge creation & authorizing the director for signing the same, if applicable. c. Approval of the draft of Debenture Trust Deed [SH–12], if applicable. d. Issue of Debentures Certificate and authorize two directors and a person to sign the same.	Filing of CHG-9 within 30 days from the date of creation of charge in case of Secured Debenture. Filing Return of Allotment in PAS-3 within 15 days of allotment.
12	Make necessary entries in the Register of	within 7

	Debenture holders in Form MGT-2 Make necessary entries in the Register of Charges in Form CHG-7; if applicable	days of the Board Meeting in which allotment of debentures was approved forthwith after the registration of creation of charge
13	Issue of Debenture Certificate	Within 6 months from date of allotment of debentures
14	Stamp Duty settlement as per provisions & rates of Stamp Act	

Note: Board resolution under clause (c) of subsection (3) of section 179 would be adequate, in case of offer or invitation for non-convertible debentures, where the proposed amount to be raised through such offer or invitation does not exceed the limit as specified in clause (c) of Section 180(1).

Further, in case of offer or invitation for non-convertible debentures, where the proposed amount to be raised through such offer or invitation exceeds the limit as specified in clause (c) of sub-section (1) of section 180, it shall be sufficient if the company passes a previous special resolution only once in a year for all the offers or invitations for such debentures during the year.

16.12 ADVANTAGES AND DISADVANTAGES OF DEBENTURES

The following are the advantages and disadvantages of debentures

16.12.1 Advantages of Debentures

- Investors who want fixed income at lesser risk prefer them.
- As a debenture does not carry voting rights, financing through them does not dilute control of equity shareholders on management.
- Financing through them is less costly as compared to the cost of preference or equity capital as the interest payment on debentures is tax deductible.
- The company does not involve its profits in a debenture.
- The issue of debentures is appropriate in the situation when the sales and earnings are relatively stable.

16.12.2 Disadvantages of Debentures

- Each company has certain borrowing capacity. With the issue of debentures, the capacity of a company to further borrow funds reduces.
- With redeemable debenture, the company has to make provisions for repayment on the specified date, even during periods of financial strain on the company.

- Debenture put a permanent burden on the earnings of a company. Therefore, there is a greater risk when the earnings of the company fluctuate.

16.13. SUMMARY

The word 'debenture' has been derived from a Latin word 'debere' which means to borrow. Section 2(30) of the Companies Act, 2013 define "debenture" which includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not. A company issues a debenture as a written promise to a holder with repayment tenure, coupon rate and with no voting right. There are different types of debentures viz., secured, unsecure, bearer, registered, convertible and non-convertible debentures. Debenture trusty should be appointed to honour the repayment.

16.14. TECHNICAL TERMS:

Financial Instruments: A financial instrument is defined as a contract between individuals/parties that holds a monetary value. They can either be created, traded, settled, or modified as per the involved parties' requirement.

Cash Instruments: Cash instruments include things like deposits and loans, as well as easily transferable securities. This type of instrument is directly influenced by the market, so any market fluctuations will be directly reflected in the cash asset's value.

Derivative Instruments: A derivative is a financial instrument that derives its performance from the performance of an underlying asset. The underlying asset, called the underlying, trades in the cash or spot markets and its price is called the cash or spot price.

Foreign Exchange Instruments: Foreign exchange instruments are transactions that are concluded on the currency market. These include, for example: Spot transactions. Outright Forwards. Currency swaps.

Derivatives: A derivative is a security with a price that is dependent upon or derived from one or more underlying assets. The derivative itself is a contract between two or more parties based upon the asset or assets. Its value is determined by fluctuations in the underlying asset.

Futures: Futures are a type of derivative contract agreement to buy or sell a specific commodity asset or security at a set future date for a set price. Futures contracts, or simply "futures," are traded on futures exchanges like the CME Group and require a brokerage account that's approved to trade futures.

Options: Options are financial derivatives that give buyers the right, but not the obligation, to buy or sell an underlying asset at an agreed-upon price and date. Call options and put options form the basis for a wide range of option strategies designed for hedging, income, or speculation.

Swaps: Swap refers to an exchange of one financial instrument for another between the parties concerned. This exchange takes place at a predetermined time, as specified in the contract. Description: Swaps are not exchange oriented and are traded over the counter, usually the dealing are oriented through banks.

Regulatory norms: Regulatory Standards means all laws, rules, regulations and Regulatory Authority advisory opinions or orders applicable to the manufacturing, marketing, sale, and reimbursement and/or pricing of any Products.

Debentures: A debenture is a type of long-term business debt not secured by any collateral. It is a funding option for companies with solid finances that want to avoid issuing shares and diluting their equity.

Secured: secured means that it has been made secure at some point in the past, but may no longer be secure in the present. Whereas secure describes the state of the garage currently, which is more relevant for the parker.

Unsecured: “Unsecured” means not secured, fastened, or guaranteed. “Insecure” is a bona fide word that means lacking in security.

Debenture Trustee: A Debenture Trustee is appointed by the issuer company and is given the task to protect the interests of the debenture holders and he will also serve as a mediate factor between the issuer company and the debenture holder.

Debenture Trust Deed: A debenture trust deed is an instrument that a company executes in favour of a debenture trustee, thereby appointing them and defining their role and duties to protect the interest of debenture holders before debentures are offered for public subscription.

16.15. SELF-ASSESSMENT QUESTIONS

1. Define financial asset & financial liability with suitable examples?
2. Discuss different types of Financial Assets?
3. What is Recognition & Derecognition? Discuss?
4. What is compound financial instrument? Explain with examples?
5. Define Derivative? Discuss the features of Derivatives?
6. Discuss the differences between futures & forwards?
7. Options are more standard than forwards? Comment?
8. Who are the participants in the derivatives market?
9. What is debenture? Discuss the features of Debentures?
10. Classify debentures with features of different debentures?
11. How debentures are more secured than equity? Comment?
12. Discuss the advantages and disadvantages of debentures?

16.16 SUGGESTED READINGS:

1. Bhole & Mahakud, Financial Institutions and Market, TMH, New Delhi
2. Vasanth Desai, Financial Markets & Financial Services, Himalaya, Mumbai
3. John C. Hull & Sankarshan Basu, ―Options, Futures and Other Derivatives‖, 7th Ed, Pearson Education.
4. Jayanth Rama Varma, ―Derivatives and Risk Management‖, TMH.
5. S.C. Gupta, Financial Derivatives: Theory, Concepts and Problems, Prentice Hall of India.

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304CO21

MODEL QUESTION PAPER

M.Com – Accountancy/Banking

FINANCIAL REPORTING

Max. Marks: 70 **Time: 3 hrs.**

SECTION A (Total: 5x3=15 Marks)

(Answer the following questions. Each answer carries 3 marks)

1. a) Income Statement (OR) b) Profit & Loss A/C
2. a) Restructuring (OR) b) Holding Company
3. a) Minority Interests (OR) b) Goodwill
4. a) Subsidiaries (OR) b) Cash flow Statement
5. a) Financial Instruments (OR) b) De-recognition

SECTION B (Total: 5x8 = 40 Marks)

(Answer the following questions. Each answer carries 8marks)

1. a) Explain about Corporating Financial Reporting
. (or)
b) Discuss briefly about Issues in published financial statements.

2. a) What isAccounting?Explain the Accounting for corporate Restructuring.
(or)
b) Discuss about Inter- company holdings

3. a) What is consolidation? Discuss briefly about consolidation procedures.
(or)
b) Discuss about the treatment of pre-acquisition profit.

4. a) Explain about the consolidated profit and loss account.
(or)
b) Briefly explain about consolidation with foreign subsidiaries.

5. a) What is Reporting ? Discuss about reporting of financial instruments.
(or)
b) Briefly discussed about compound financial instruments.

SECTION C (Total: 1x15 =15 Marks)

6. a) What is Group Companies? Explain about purposes of consolidated financial statements.
(or)
b) Explain about measurement of financial instruments with hypothetical example.