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UGC-NET

Commerce

National Testing Agency (NTA)

Paper 2 || Vol – 2

SIERRA INNOVATIONS

UGC NET Paper – 2 (Commerce)

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IV UNIT

Business Finance

Scope of Finance

- The main objective of financial management is the efficient planning, acquisition and use of funds. Its scope can be understood in the following points:

1. **Financial Decisions:**
   - ✓ Deciding where to get the money from, how to get it (e.g. debt, equity).
   - ✓ Three main financial decisions:
     - **Investment Decision:** Deciding which projects to invest in through capital budgeting.
     - **Financing Decision:** Deciding the source of capital – equity, debt or hybrid instruments.
     - **Dividend Decision:** Deciding whether to pay dividends or reinvest them.

2. **Capital Structure Management:**

- Determining the capital structure by balancing equity and debt.

3. **Working Capital Management:**

- Managing cash, stock, liabilities so that there is no hindrance in daily operations.

4. **Risk Management:**

- Identifying financial risks and creating strategies for them (eg: interest rate risk, currency risk).

5. **Financial Planning and Control:**

- Preparing budgets, controlling costs, and monitoring financial performance.

Sources of Finance

There are various sources to meet financial requirements, which may be classified as follows:

1. **On the Basis of Time Period:**

   (a) Short-Term Sources:
   - ✓ Tenure: Up to 1 year
   - ✓ Examples: Commercial Loans, Trade Credit, Bank Overdraft, Bill Discounting

(b)Medium-Term Sources:
- ✓ Tenure: 1 to 5 years
- ✓ Example: Debentures, Term Loans, Leasing

(c)Long-Term Sources:
- ✓ Tenure: More than 5 years
- ✓ Example: Equity share capital, preference shares, public deposits, long term loans

2. On the Basis of Ownership:

(a)Owner's Funds:
- ✓ Money invested by the entrepreneur.
- ✓ Example: Equity share capital, profits earned

(b) Borrowed Funds:
- ✓ Money borrowed from external sources and has to be repaid with interest.
- ✓ Examples: Bank loans, bonds, public deposits

3. **Internal and External Sources:**
   - ✓ **Internal:** Profits earned, Return on Investment, Depreciation Fund
   - ✓ **External:** Banks, Financial Institutions, Investors, Public Issues (IPO)

Lease Financing

Definition:

Leasing is a financial arrangement in which one party (the lessor) rents an asset to another party (the lessee) for a fixed period of time. In return, the lessee has to make regular payments.

Key Features:

- The lessee does not get ownership of the asset, only the right to use it.
- Leasing does not require capital expenditure.
- The user gets the benefit of the asset without purchasing it.

Types of Lease:

1. **Operating Lease:**
   - ✓ Short-term lease
   - ✓ Ownership remains with the Lessor
   - ✓ Maintenance is the responsibility of the Lessor
2. **Financial Lease:**
   - ✓ Long-term lease
   - ✓ All risks and benefits of the asset are transferred to the lessee
   - ✓ Ownership may eventually pass to the lessee
3. **Sale and Leaseback:**
   - ✓ The company first sells the property and then takes it on lease
   - ✓ Method of raising cash
4. **Direct Leasing:**
   - ✓ Direct contract between the lessor and the lessee

Advantages of Lease Financing:

- No initial capital investment required
- Tax benefits
- Improved cash flow
- Access to latest technology

Limitations of Lease Financing:

- Long-term costs can be high
- The lessee does not get ownership
- The contract terms can be harsh

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- ✓ Management of cash, stock, liabilities so that there is no hindrance in daily operations.

4. Risk Management:

- ✓ Identifying and developing strategies for financial risks (e.g. interest rate risk, currency risk).

5. Financial Planning and Control:

- Budgeting, cost control, and monitoring financial performance.

1. International Monetary System

Definition:

- The International Monetary System (IMS) is a global framework under which the exchange of currencies of different countries, international payments, and capital flows take place. Its purpose is to provide stability to global trade and investment.

Stages of development:

(1) Gold Standard - 1870-1914:

- ✓ Each currency was linked to a certain amount of gold.
- ✓ Countries held gold reserves and the value of the currency was based on gold.
- ✓ Exchange rates were fixed.
- ✓ This system collapsed after World War I.

(2) Bretton Woods System – 1944:

- ✓ The US dollar was pegged to gold (1 dollar = 1/35 ounce gold).
- ✓ All other currencies were pegged to the dollar.
- ✓ The IMF (International Monetary Fund) was established.
- ✓ This arrangement ended in 1971 when the US delinked the dollar from gold.

(3) Floating Exchange Rate System – Current Time:

- ✓ Exchange rates are determined according to market demand and supply.
- ✓ IMF plays the role of protecting countries from disorderly fluctuations.

2. Foreign Exchange Market

Definition:

- The foreign exchange market is the place where the currency of one country is converted into the currency of another country. It is the largest and most liquid market in the world.

Main verbs:

(1) Exchange of Currency
(2) Exchange Rate Determination
(3) Risk Management
(4) Hedging
(5) Currency Speculation

Participants:

- Central banks (like RBI)
- Commercial banks
- Multinational companies
- Exchange dealers
- Investors and tourists

Types of exchange rates:

(1) **Spot rate –** immediate exchange

(2) **Forward rate –** exchange rate fixed for a future date

(3) Nominal and real exchange rates

(4) Floating and fixed rate systems

3. Exchange Rate Risk

Definition:

- When a firm's international transactions are affected by fluctuations in exchange rates, it is called exchange rate risk.

Major types:

1. **Transaction Exposure:**
   - ✓ When the firm makes a payment or receipt in foreign currency.
2. **Translation Exposure:**
   - ✓ When converting accounts in foreign branches to home currency.
3. **Economic Exposure:**
   - ✓ The impact of exchange rate changes on the company's competitive position and future earnings.
4. **Hedging Techniques**
   - ✓ Hedging means protecting against exchange rate risk.

Key techniques:

1. **Forward Contract:**
   - ✓ An individual contract between a customer and a bank in which the exchange rate is fixed for a future date.
2. **Futures Contracts:**
   - ✓ Contract traded on a regulated exchange.
   - ✓ Standardized, liquidity is high.
3. **Options Contracts:**
   - ✓ It gives the holder the right, but not the obligation, to buy or sell a currency at a certain price.
4. **Currency Swap:**
   - ✓ Two parties exchange currency and interest with each other in the future.

5. International Financial Markets and Instruments

Euro Currency Market:

- When a country's currency is deposited, borrowed, or invested outside that country.
- Example: Euro Dollar = US Dollar held in banks in Europe.

GDRs (Global Depository Receipts):

- A means for foreign investors to invest in Indian companies.
- GDRs are listed in Europe or other markets.

ADRs (American Depository Receipts):

- A means for US investors to invest in shares of foreign companies.
- ADRs are listed on US stock exchanges (e.g. NYSE, NASDAQ).

Difference	GDR	ADR
Listed	Europe	US
Currency	USD/EUR	USD Only
Investor	Global	US

6. **International Arbitrage**

   Definition: strategy for earning profits without risk by taking advantage of price differences in different countries or markets.

Major types:

1. **Geographic Arbitrage:**

➢ Buying cheap from one market and selling in another to make a profit I

2. **Triangular Arbitrage:**

➢ Take advantage of the unfair exchange rate between three currencies.

3. **Interest Rate Arbitrage:**

➢ Borrowing money from a country with low interest rates and investing in a country with high interest rates.

7. **Multinational Capital Budgeting**

Definition:

When an MNC (Multinational Corporation) invests in foreign projects, that investment is evaluated by multinational capital budgeting.

Prime factors:

1. **Foreign Cash Flow Forecasting:**
   - ✓ Assessment of project income and expenses in local currency.
2. **Exchange rate changes:**
   - ✓ Analysis of the impact of changes in exchange rates over time.
3. **Taxes and Repatriation:**
   - ✓ Taxes, duties, etc. levied on bringing foreign profits into the country of origin.
4. **Political risk:**
   - ✓ Foreign government policies, war, currency control etc.
5. **Evaluation Techniques:**
   - ✓ NPV (Net Present Value), IRR (Internal Rate of Return), Payback Period etc.
6. **Valuation in base currency:**
   - ✓ Finally, all cash flows are converted into the parent company's currency and evaluated.

Conclusion:

Subject	Summary
International Monetary System	Global Currency Exchange Arrangement
Foreign Exchange Market	Platforms for Buying and Selling Different Currencies
Exchange Rate Risk	Financial Risk from Exchange Rate Fluctuations
Hedging Techniques	Risk Protection
GDR / ADR	Modern Means of Raising International Capital
Arbitrage	Profiting from Price Differences in Markets
Capital Budgeting	Analysis of Foreign Investment Projects

Capital Management

Capital

➢ **Fixed Capital / Long Term Capital**

For the arrangement of land, building, machinery, etc.

- **Short Term Capital**
    1. Working Capital - W.C.
    2. Liquid Capital
    3. Circulating Capital

Concept of Working Capital: Quantitative Concept

- (Quantitative Concept) / Gross Concept: According to this concept, the total of all current assets is the working capital.
- "The total of all current assets is the working capital."
- (Mid, Belt, and Fill)
- **Qualitative State or Net Working Capital:**
    - ✓ Working Capital = Current Assets – Current Liabilities
    - ✓ Deficit of Working Capital = C.L. – C.A.
- **Other Concepts: According to Kennedy and MacMullen–**
    - ✓ Gross Working Capital = Total of Current Assets
    - ✓ Net Working Capital = Current Assets – Current Liabilities
- Adam Smith referred to working capital as circulating capital.
- Shelton's class circulating capital path
    - ✓ **Current Assets:** Those which are generally converted within one financial year.
    - ✓ **Current Liabilities:** Those which are payable within one financial year.
    - ✓ **Note:** The amount payable in the current year on long-term loans will be treated as current liabilities for the current year.
    - ✓ **Note:** Working capital is called the "lifeblood" of a business.

Sources of Working Capital

Long Term Sources

1. **Original Sources:**
    - ✓ Issue of Share
    - ✓ Retained Earnings
    - ✓ Repayment of Current Liabilities below book-value
    - ✓ (Payment of current liabilities at less than their book value)
    - ✓ Sale of Fixed Assets
    - ✓ Reserve

- **Borrowed Sources:**
    - ✓ Debentures
    - ✓ Long Term Debts

Short Term Sources

Internal Sources:

- Depreciation Funds
- Provision for Taxation
- Outstanding payments
- Employee Securities

External Source

1. Trade Credit
2. Commercial Credit
3. Bank Loans
4. Public Deposits
5. Financial Institutions / Advances
6. Loans from Managers and Directors
7. Government Assistance

Methods for Estimating Working Capital

1. Operating Cycle Method

- This method is the most important one. It calculates the cash working capital.
- **Operating Cycle** = Direct Material + Direct Overheads + Indirect Expenses

- **Operating Cycle Period:** The average time taken from the receipt of raw materials to the recovery of dues after sale of finished materials is called "Operating Cycle Period".

(a) **Material Storage Period:** = Average Stock of Material × 365/12/ Material Consumption for Year

Average Stock of Material = $\frac{\text{Opening Stock + Closing Stock}}{2}$

Material Consumption = Opening Stock of Raw Material + Purchases − Closing Stock

(b) **Material Conversion Period:** = $\frac{\text{Average Stock of WIP} \times 365/12}{\text{Total Factory Cost of Production}}$

Factory Cost of Production = Opening stock of WIP + Material Consumed + Wages + Factory Overhead − Closing of WIP

Note: Depreciation will not be included in Factory Cost as it is a non-cash expense.

(c) Finished Goods Storage Period $= \frac{\text{Average Stock of fectory}}{\text{Cost of Goods Sold}} \times 365/12$

Cost of Sales = OP of FN + Factory Cost of Production + Excise Duty − Closing Stock of FG

Note: Both Office & Administration and Selling & Distribution will not be included in this.

Debtors Collection Period $= \frac{\text{Average Receivable} \times 365/12}{\text{Net Credit Sales}}$

Average Receivable $= \frac{\text{Opening BR /Debtors + Closing Balance}}{2}$

Creditors Payment Period $= \frac{\text{Average Payable} \times 365/12}{\text{Not Credit Purchase}}$

Average Payable $= \frac{\text{CR/BP+CR/BP (Closing)}}{2}$

No. of Operating Cycle in the Year $= \frac{365}{\text{Period of Operating Cycle}}$

Working Capital $= \frac{\text{Operating Expenses}}{\text{No.of Operating Cycles}}$

$$= \frac{\text{Operating Expenses} \times \text{Period of Operating Cycle}}{365}$$

- **Note:** Here depreciation will be deducted while finding operating expenses.
- **Traditional Method or Forecasting Method:** It is the most commonly used method for estimating working capital in India.
- In this, current assets (CA) and (CL) of the next year are estimated on the basis of past experience, and on this basis (CA - CL) working capital is calculated.
- Prakash Tandon Committee (1975) suggested adopting this method for estimating working capital. The committee presented estimates for 15 important industries of India.
- Note: In this, adjustments are presented for contingencies.

Projected Method

- This is a simple method of estimating working capital. In this method, a Projected Balance is prepared by estimating various assets (excluding cash) and liabilities on the basis of sales and production level of the future period.
- If the sum of total assets is more than the total liabilities, then this difference expresses the amount of additional resources that must be arranged. And if the sum of total assets is less than the sum of liabilities, then the amount of difference expresses the cash.
- Working Capital = Current Assets - Current Liabilities (including cash)

- Profit-loss adjustment method: - Used by banks.
- This method is a form of cash flow statement. It is used by banks to estimate the working capital of a business organization.
- In this, first of all, the profit or loss of the organization is estimated for the future period, after that working capital is determined by adjusting cash inflow/outflow in it.
- Percentage of sales method:- In this, a fixed percentage of working capital is determined from sales on the basis of past experience and working capital is determined by estimating sales for future period.
- Cash forecast method:- This is a type of cash budget based on cash budget. In this, cash is forecast for a future period.
- Regression analysis:- In this method, W.C. is calculated by fixing regression equation between sales, working capital and its various components.
- Least square method is used.
- The following committees were formed by RBI regarding working capital control and bank policy:
  1. Daulalia Committee – 1969
  2. Chore Committee – 1980
  3. Tandon Committee – 1975
  4. Marathe Committee – 1984
- Most among these are the reports of Chore Committee and Tandon Committee.

Tandon Committee

- Period of using the traditional method: 3 July 1974 to August 1975
- They determined the standards of stock and receivables for 15 industries of India.
- This committee has mentioned three methods of providing maximum working capital loan by banks to any institution.
- First: Max. Permissible Bank Credit = 0.75 (CA - CL)
- Second: 0.75 (CA) - (CL)
- Third: 0.75 [CA - CCL] - CL
- CCL: Basic Current Assets - Current assets which are required by the institution from time to time, such as minimum stock level, wages, minimum cost etc.
- The committee determined two components of the credit to be provided.
- Tandon Committee suggested quarterly budgeting and reporting system.

Chore Committee

- **Study: K.V. Chore April - 1979**
- Main suggestion of Chore Committee:
  1. The system of Loan Component or Deemed Cash-Credit should be discontinued.
  2. The maximum credit should be determined on the basis of the second method of Tandon Committee.

0.75 (CA) - CL

- **Note:** Maximum Possible Bank Credit (MMBA) was abolished on 15th April 1997. Now all banks are free to determine maximum credit amount.

Company Restructuring Accounting – Amalgamation

- Accounting for Corporate Restructuring Amalgamation - AS-14
- **(Integration):** In integration, two or more companies currently operating are closed and a new company is established in their place. The newly formed company takes over the business of the old companies.

- **Absorption:** In this also two or more companies are merged, but all the companies except one are closed and their business is reduced by the company which is not closed.
- **Forced reconstruction:** In this an existing company is closed and its assets and liabilities are reduced by the new company. The new company is formed only to reduce the ASL of the old company.
- Sections 232 to 240 of the Companies Act, 2013 provide the provisions for amalgamation.
- AS-14 applies only in the following cases.
- This SA applies only to the books of the transferor company.
- This Standard will not apply if the transferee company is not wound up, i.e., continues to be a separate entity.
- **Types of amalgamation as per SA-14: Merger: In this the method of amalgamation of two entities is adopted for accounting.**

Purchase in nature:

- Purchase method will be used for its accounting.
- In this only statutory reserves are taken into account.
- In amalgamation of sequential nature, adjustment of trading reserves is done through "Amalgamation Adjustment 916".
- And this 916 is shown in Other Non-Current Assets in the Balance Sheet.
- Note: Investment allowance reserve, development allowance reserve have now been excluded from the category of statutory reserve, now dividend can be distributed from their amount.

  1. Purchase Consideration - Net Assets = Goodwill
  2. Net Assets - Purchase = Capital Reserve
- Calculation of purchase consideration in merger natured amalgamation: Purchase Consideration = Total Assets of Seller Company (Book Value) - Total External Liabilities of Seller Company
- After calculation of purchase consideration, it is paid in full in equity shares or preference shares. Where there is talk of pieces of shares, that piece can be paid in cash on the basis of market price.
- Calculation of purchase consideration will be done practically as follows –
- First of all, the combined purchase consideration of both the companies will be found out.
- The combined purchase consideration will be divided in the ratio of net assets, so that the separate consideration of the seller companies is known.
- Formula to find purchase consideration of individual selling company:

$$\frac{\text{Net Assets Value of Specific Vendor Company}}{\text{Combined Net Assets Value}} \times \text{Combined Purchase Consideration} \times$$

Calculation of purchase consideration in a consolidation of purchase nature

1. Fixed term method: A fixed term contract is made.
2. Net asset method: The sum of the liabilities taken by the buyer will be subtracted from the sum of the assets taken by the buyer. The balance will be the purchase consideration. In this, the buyer will not take any reserve other than the statutory reserve.
3. Net payment method: In this, the purchase consideration is paid only to the shareholders of the selling company in the form of shares and other securities.
4. Intrinsic value of shares method: In this method, the purchase consideration is determined on the basis of the intrinsic value of the shares of the buying company and the selling company.

- To find the intrinsic value of shares, the present value of all the liabilities will be deducted from the revalued value of all the assets and divided by the number of shares.
- Partial consolidation of accounts: Consolidation in the nature of purchase.
- Here only the grammatical and spelling errors of the text given by you have been corrected - no change has been made in the meaning, words and order:

Q: Amalgamation Adjustment 916 is opened in which method of amalgamation?

Ans: To adjust statutory reserves in amalgamation of purchase nature.

Q: In which method purchase consideration cannot be paid in cash?

Ans: In amalgamation of merger nature.

Q: The status of accounting treatments of which company has been clarified in AS-14?

Ans: Only the accounting treatments of the buyer company.

Note: If consolidation is done in the middle of the year: Generally consolidation is done at the end of financial year, but if consolidation is done in the middle of the year then P&C and Balance Sheet are prepared for the operations till that date, later consolidation is done.

Disapproval by shareholders Section-235

- According to section 235 of the Company Act 2013, only when at least 90% of the shareholders of the seller company support the merger of the company, the merger takes place. Even now, those shareholders who oppose it are called "dissenting shareholders".
- Inter-company dealings in amalgamation: When there is mutual dealing between the buyer and the seller company, these are mainly divided into notable ones.
  1. interacting particles
  2. Unrealized profit on stock purchased intra-company
  3. intra company investment
- **Mutual Agreement:** Note: Mutual agreement has no effect on the books of the seller company. It will be accounted for in the same manner as if it were an agreement of any other person.
- Its effect will be eliminated by setting off the mutual agreement in the books of the buyer company.
- In case of mutual bills of exchange in the books of the buyer company and the seller company: If mutual payment is accepted through bills of exchange and on the date of merger that bill has not been forgotten or sold, then these mutual bills will also be accounted for by the buyer company by setting off. Mutual long term loan is also accounted for by setting off in the books of the buyer.
- Unrealized profit on stock purchased inter-company: When there is mutual purchase and sale of stock between the buyer and the seller company and this stock has been sold till the date of merger, then the entire profit will be considered realized and no adjustment will be made for it. But when on the date of merger some of the said goods remains unsold, then adjustment of unrealized profit is made on it.

1. When the amalgamating company (seller) has stock:

- In this situation, no adjustment will be made in the books of the seller company.
- The buyer company will adjust the unrealized profit first from the Capital Reserve and then from Goodwill.

  Capital Reserve A/c Dr.
  Goodwill A/c Dr.
  To Stock A/c

2. When the amalgamating company (buyer) has stock:

- When the buyer company has purchased goods from the seller and on the date of amalgamation these goods are available as stock with the buyer company, no adjustment will be made in the accounting of the amalgamation because, as per AS-02, stock is valued at the lower of cost or market price, and the buyer has already valued it accordingly.

Inter-Company Investment:

- There can be 3 situations of inter-company investment –

1. When the buyer company holds shares in the seller company: In this case, the payment will be made after deducting the value of shares held by the buyer company from the lesser consideration. The buyer company will write off such investments in its books after the merger.

2. When the seller company holds shares in the buyer company: In this case, the lesser consideration will be determined first.
3. If the buyer and seller have mutually invested in each other, then the net assets value of one company will be determined using algebraic equations.

Demerger::

- The term Demerger has never been clearly defined in Indian Accounting Standards or Companies legislation.
- Internationally, it is called a Spin-off, which is exactly the opposite of a merger or acquisition.
- "In a demerger, one or more divisions of a merging company are separated to form a new company, called the resulting company."
- Internal Reconstruction of a Company: Just as serious diseases in human health are treated surgically, similarly, the surgical procedure of a company is called internal reconstruction. In this process, the company becomes free of its ailments and takes on a new lease of life.

Reconstruction

1. Internal Reconstruction 2. External Reconstruction

Internal reconstruction is necessary in the following situations –

- If the company has accumulated excessive past losses that need to be written off so that dividends can be distributed from current year profits.
- When the company wants to simplify its capital structure.
- When the company needs to alter the face value of its shares.
- When the company wants to adjust its capital gearing ratio.
- In internal reconstruction, the company is not wound up; rather, the existing company is given a new lease of life.
- Kohler called this semi-reconstruction, whose key feature is reaffirmation.
  Alteration in Share Capital
  Reduction in Share Capital
  Alteration in Share Capital
- According to Section 61 of the Companies Act, 2013, a company limited by shares has the right to alter its share capital if its articles of association permit it.
- For this, the company must pass a resolution in the general meeting; no approval from the court is required.

- **Alteration in share capital can be done by the following methods –**
  - ✓ Increasing share capital by issuing new shares.
  - ✓ Consolidating shares of lower value into shares of higher value. [Section 61(9)]
  - ✓ Converting shares into stock. [Section 61(c)]
  - ✓ Subdividing existing shares into shares of lower value.
  - ✓ Cancelling unissued authorized capital.
- A company can also increase its Authorized Capital by amending the Articles of Association.
- Newly issued shares are first offered to existing equity shareholders in proportion to their paid-up capital.
- The company can consolidate shares of lower value into shares of higher value, but the difference between the face value and the paid-up value of the shares not yet issued must be in the same proportion as before. This does not affect the company's paid-up capital.

Conversion of Shares into Stock [Section 61(c)]

- Section 61(c) of the Companies Act, 2013 clearly provides that a company can convert fully paid-up shares into stock.

- The advantage of converting shares into stock is that thereafter the company can transfer any number of stock units in smaller portions.
- Lord Cairnes: The use of the term "Stock" means that the company has accepted the fact of full payment on shares and now allows the transfer of any portion of the Stock Capital, whereas shares cannot be transferred in parts.
- **Journal Entry:**
- Equity Share Capital Account Dr.
- To Equity (Stock) Account
- Being equity capital changed into equity stock.
- When a company has surplus funds in reserves and believes there is no need to issue unissued shares in the future, it can cancel these unissued shares.
- No entry is made in the company's books for this; only the number of shares in the balance stock will change.
- **Note:** Canceling unissued share capital is not considered a reduction of share capital.

Reduction of Share Capital

- A company can reduce its share capital by complying with the provisions of Section 66 of the Companies Act, 2013; however, prior approval from the tribunal (authority) is mandatory. Some important provisions related to this are as follows –
  1. A company can reduce its share capital only if its articles of association permit it, a special resolution is passed in the general meeting, and permission is obtained from the appropriate authority (tribunal).
  2. Share capital includes: authorized capital [issued, unissued, fully paid].
  3. A company that has reduced its share capital must add the words "And Reduced" to its name for a specified period.
- **Share Capital can be reduced by the following methods:**
  - ✓ Reducing the unpaid amount on shares — by extinguishing such liabilities.
  - ✓ Returning excess capital to members beyond the company's requirements.
  - ✓ Cancelling received share capital.
- Once permission is obtained from the authority, this must be reported to the Registrar.
- Extinguishing the unpaid amount on shares benefits shareholders because they will not have to pay the outstanding amount in the future. The related entries will be made accordingly.
- Returning excess share capital to members: When a company returns excess capital to its members, it reduces the protection available to creditors.

  (Old Denomination) Share Cap A/c Dr
  To (New Denomination) Share Cap A/c
  To Share Fidder

  Shareholder A/c Dr
  To Bank A/c
- **Writing off Lost Capital:** When a company incurs continuous losses, the accumulated losses in its Balance Sheet increase, causing its assets to no longer accurately represent the capital.
- For this, the Board of Directors must pass a resolution in their meeting and obtain consent from both equity shareholders and preference shareholders.
- In this process, the amounts surrendered by all those from whom capital is relinquished are transferred to the Capital Reduction Account.

  Share Capital Account Dr (Surrendered Capital)
  Creditors Account Dr (Surrendered Amount)
  Debenture Account Dr

  Assets Account Dr (Available Reserves)
  To Capital Reduction Account

- This entire amount is used to set off the accumulated losses available in the company, such as:

  Capital Reduction A/c Dr
  To P&L A/c (Loss)
  To Discount on issue of Deb.
  To Other assets / Other Contingent Liabilities
  To Preliminary Exp. A/c
  To Goodwill
  To Patients A/c

- If there is any balance left in the Capital Reduction Account after this, it will be transferred to the Capital Reserve.

  Capital Reduction A/c Dr
  To Capital Reserve A/c

Outstanding dividend on cumulative preference shares

- In the case of continuous losses, the arrears of dividend on cumulative preference shares keep accumulating. Since the company has not yet declared this dividend, it should be shown as Contingent Liabilities in the Balance Sheet.
- **Adjustments in the Capital Reduction Programme include the following:**
  - ✓ When a preference shareholder surrenders the entire amount of outstanding dividend, no entry is made because no account was opened earlier for it.
  - ✓ When the Preference Shareholder surrenders part of the accumulated dividend and receives the remaining amount, or receives the entire amount, no entry will be made for the surrendered amount, and the following entry will be recorded:

    Capital Reduction A/c Dr
    To Preference Shareholder A/c
- **On payment:**

  Preference Shareholder A/c Dr
  To Bank
  To Equity Share
  To Debentures / Loan

- Sometimes, a company declares a dividend and, after opening the Preference Share Dividend Account on the liabilities side, starts its Capital Reduction Programme. The following entry will be made:

  Preference Share Dividend A/c [In total amount]
  To Capital Reduction A/c
  To Preference Shareholder A/c [Amount paid]

Scheme of Agreements with Shareholders, Debenture Holders and Creditors [Priority among Shareholders, Debenture Holders, and Creditors]:

- Sometimes the company's condition becomes so poor that if it were to be wound up today, shareholders would be the last to receive anything, and debenture holders and creditors would not receive their dues.
- In this situation, all three parties together relinquish their excess or entire shares so that the company can write off its dormant capital. This is called "Re-Organisation Through Surrender of Shares."
- **Insurance Company Accounts –** An insurance contract is a contract of indemnity in which the insurer promises to compensate for losses arising from specified causes in exchange for a fixed amount. This agreement is called a Policy.
- **Types of Insurance**
  - ✓ **Life Insurance**

    (Nationalisation - 1956)
    1 Sep 1956 – LIC Act – 1956
    IRDA – Oct 2000
  - ✓ **General Insurance**

    Regulated by Insurance Act – 1938

- In India, to conduct general insurance business, a license must be obtained from the Controller of Insurance of India.
- Insurance companies prepare their accounts in accordance with the Insurance Act. Where the Insurance Act is silent or additional provisions are needed, the provisions of the Companies Act, 2013 are followed.

Key Provisions of the Insurance Act, 1938:

- **Section - 11 (1): Insurance companies include the following in their Final Accounts –**
  1. Balance Sheet
  2. Income Statement
  3. Revenue

Kinds of General Insurance and Its Risk

1. **Fire Insurance –** Loss due to fire
2. **Marine Insurance –** Loss due to transportation of goods, ships, or freight
3. **Motor Insurance –** Insurance against accidents and theft
   - ✓ Accident Insurance – Loss due to accidents
   - ✓ Theft Insurance – Loss due to theft
   - ✓ Fidelity Insurance – Loss due to dishonesty of employees
   - ✓ Consequential (Loss of Profit) Insurance – Insurance against loss of profit

Financial Statement [Accounts] Format

- **Life Insurance**
  - ✓ Revenue A/c [Form – ARA]
  - ✓ Profit and Loss Statement [Form – APL]
  - ✓ Balance Sheet [Form – ABL]
- **General Insurance**
  - ✓ Revenue A/c [Form – BRA]
  - ✓ P&L Statements [Form – BPL]
  - ✓ Balance Sheet [Form – BBL]
- **Claims:** When the insured suffers a loss, they apply to the insurance company for compensation, which is called a claim.
- All expenses incurred by the insurance company in relation to the claim are included in the claim amount, e.g., survey fees.
- **Re-Insurance:** When an insurance company considers that a particular case involves high risk, it transfers part of that insurance liability to another company. This is called re-insurance.
- In the Revenue Account, the total amount related to claims is shown, regardless of whether the claim has been paid or not.
- Claims paid in India and claims paid outside India are shown separately.
- **Note:** Insurance companies calculate their profits twice a year.
- Net Premium: Premium (Re-insurance Received – Premium Paid)
- Premiums received in India and premiums received outside India are shown separately at the bottom of the Revenue Account.

Reserve for Unexpired Risks:

- In an insurance contract, there is a fixed period for covering risk, and since insurance policies are sold throughout the year, at the end of the financial year there are some policies for which the risk period has not yet expired.
- For this, a reserve is created, known as the Reserve for Unexpired Risks.
- This reserve is 100% for general insurance and 50% for other insurance (but as per the Income Tax Act, 50% is considered).

Life Insurance Business

- In the life insurance business, the insurance company provides coverage for the risk on the insured's life up to a certain amount.
- After the death of the insured, the nominee receives the insurance amount; and if death does not occur, the specified sum is paid upon the completion of the policy term.
- In the year 2000, through an amendment, life insurance was opened to the private sector.
- At present, along with LIC, several companies are engaged in the life insurance business.

Life insurance as Assurance

- Life insurance is also called assurance business.
- Surrender of Policy: In life insurance, before the completion of the financial contract, the policyholder can surrender the policy. For this, a surrender amount is paid.
- Paid-up Policy: If the policyholder becomes unable to pay the insurance premium during the term of the contract, they can use this option. In this case, the contract is not terminated; instead, it is converted into a fully paid-up policy up to the premiums already paid.

$$\text{Paid} - \text{up Policy} = \frac{\text{Sum Assured} \times \text{No. of Premium Paid}}{\text{Total Number of Premiums Payable}}$$

Bonus:

Types of Life Policy

With Profit

- In this type of insurance, the insured is given a share of the company's surplus, called a bonus, either at maturity or upon death, along with the sum assured.

Without Profit

- At maturity or on death, whichever occurs earlier, a fixed sum is paid.
- Insurance companies calculate their profits every 2 years, and hence, bonuses are also distributed every 2 years.
- The insured can receive this bonus in cash or in another form at the time of declaration, or it can be adjusted against their premium amount. (In both cases, it is treated as an expense for the company in that year.)
- Interim Bonus: When a bonus is declared by the insurance company at any time before the calculation of profits, based on estimated profits, it is called an interim bonus.
- This is generally paid only upon the death of the policyholder.
- Agent: An insurance company conducts its business primarily through agents.

Commission Rate:

- First Year: 35%
- Second Year / Third Year: 7.5%
- Other Years of Policy: 5%
- Actuary: In the context of an insurance company, for policies that have not yet expired, a provision is created, which is called a Provision for Unexpired Risk.
- Life Insurance: A life insurance company distributes 95% of its profits as bonuses to policyholders and the remaining 5% to shareholders.

In the case of general insurance:

- For general insurance: 100% provision is made.
- For other types of insurance: 50% provision is made.

- However, in the case of life insurance, since life is uncertain, such estimates are prepared with the help of life tables, which are prepared by an actuary.
- As per the rules issued by IRDA, insurance companies must prepare their financial statements in a vertical format, and 15 schedules must be attached along with them.

Accounting for Banking Company

- In India, banking companies must operate in compliance with the Banking Regulation Act, 1949 and the guidelines of the RBI. Where both provisions exist, the provisions of the Companies Act, 2013 will apply.
- Companies engaged in banking business are required to use the words "bank," "banking," or "banker" with their name.
- "Banking means accepting deposits from the public. These funds are then lent or invested to others. Such funds are repayable on demand or otherwise, and are withdrawable by cheque, draft, or other means." – Section 5
- No banking company can, directly or indirectly, engage in the trading or exchange of goods.

Non-Banking Assets:

- All the assets held by a bank that are not in its direct use are called non-banking assets. These usually come into the bank's possession as security for loans and remain with the bank if the borrower defaults on payment.
- Banks are required to dispose of these assets within 7 years (this period may be extended by the RBI).
- The Statutory Liquidity Ratio (SLR) must be maintained between 21.5% and 40%.
- RBI Strip System: Banks use the slip system for ledger maintenance.
- In 1992, based on the recommendations of the Narasimham Committee, the RBI implemented the Risk-Weighted Assets Ratio Method to assess banks' capital adequacy.
- Under the Companies Act, 2013, the RBI allows even Public Limited Companies with a minimum capital of ₹100 crore to operate as banks.
- Commission and brokerage cannot exceed 2.5% of the paid-up capital.
- Note: A banking company cannot grant loans against the security of its own shares.
- Since 21st September 2013, banks maintain the Cash Reserve Ratio (CRR) on a daily basis.
- For valuation purposes, banks divide their investments into three categories:
  1. Held to Maturity (Based on Maturity)
  2. Available for Sale (Available for Sale)
  3. Held for Trading (For Buying and Selling)

NON-Performing Assets :-

- NPA (Non-Performing Asset) includes those assets from which no returns have been received for a specified continuous period. In the context of banks, it refers to loans and advances on which neither interest nor instalments have been received for a set period.
- According to the Master Circular issued by the RBI (1–3 July 2015), this specified period for NPA classification is 90 days.
- Note: In the case of agricultural loans, the NPA period is two consecutive crop seasons—if interest and instalments remain overdue for two crop seasons, the loan is treated as NPA.
- A banking company cannot declare dividends until all its capital expenditures have been written off.
- To adjust transactions between the Head Office and Branch, a Branch Adjustment Account is opened.
- Every year, on 30th September, banks close their books for internal control purposes.
- Since 1992, the final accounts (Profit & Loss Account, Balance Sheet) of banking companies are prepared in the prescribed vertical format.

Double Account System :- (Related to the accounts of electricity companies)

- Public utility undertakings such as railways, electricity generation and supply companies, transport companies, telephone companies, etc., prepare their annual accounts using a special method known as the Double Account System.
- This system originated in England. It is a method specifically for the preparation and presentation of final accounts only.

Final Account

- Revenue Account
- Net Revenue Account
- Statement of Receipts and Payments on Capital Account
- General Balance Sheet
- In this system, instead of one Profit and Loss Account, two accounts are prepared, and instead of one balance sheet, two separate statements are prepared. Therefore, this system is called the Double Account System.
- On replacement of a fixed asset, the cost of the new asset is divided into two parts:
- Revenue Expenditure: Expenses up to the current value of the old asset are treated as revenue expenditure.
- Capital Expenditure: Any amount exceeding that is treated as capital expenditure.
- Depreciation on fixed assets is not deducted from the asset balance; instead, it is credited annually to a Depreciation Reserve Account.
- Accumulated depreciation is shown on the liabilities side.
- If an asset is destroyed or sold during the year, in general accounting, that asset account is closed and the difference is transferred to the Profit & Loss Account.
- However, in a public utility company, this does not affect the asset account. Any amount received from such a sale is treated as income for that year and transferred to the Revenue Account.
- In the double account system, depreciation is calculated on the original cost of the asset.
- In this system, the distinction between loans and capital is not maintained. Both are shown in the Statement of Receipts and Payments on Capital Account, while interest and dividends are treated as appropriations of profit and shown in the Net Revenue Account.

1. Revenue Account

- This is generally similar to the first part of the Profit and Loss Account and is prepared by public utility undertakings.
- Its resulting balance (deficit or surplus) is transferred to the Net Revenue Account.
- However, electricity companies do not prepare a single Revenue Account; instead, they present two separate statements:
- Statement of Operating Expenses
- Statement of Operating Revenue

2. Net Revenue A/c

- The balance of the Revenue Account is transferred to this. First, the balance of last year’s Net Revenue Account is recorded, followed by Non-Operating Income, Non-Operating Expenses, and Appropriation of Profit.

3. Statement of Receipts and Expenditure or Capital Account

- In the double account system, the ledger (balance sheet) is prepared in two parts. In the first part, only fixed assets and fixed liabilities are shown. Other assets and liabilities are shown in the General Balance Sheet.
- On the left side, Expenditure is shown.
- On the right side, Receipts are shown.

General Balance Sheet

- Apart from fixed assets and fixed liabilities, other assets and liabilities are shown under this.
- In companies other than electricity companies, the balance of the depreciation account is shown on the liability side of the ledger as a separate item.
- Whereas in electricity companies, the accumulated depreciation is deducted from the total of fixed assets, and the assets are shown at their written-down value.

Treatment of replacement of fixed assets under the Double Account System

- When an asset is reinstalled, under normal circumstances, the current value of the asset is treated as a revenue gain or loss and is written off.
- In the double-account system, the account of the reinstalled asset is not affected at all; instead, the expenditure incurred on the newly installed asset is divided into two parts.
  - ✓ Revenue Expenditure: This is treated as the expense of the relevant year and transferred to the Revenue Account.
  - ✓ Capital Expenditure: This is capitalized by debiting it to the Capital Account.
- Revenue expenditure is considered to be the amount required to reinstall the old asset at the same capacity.
- To determine this, the Indigenous Value of the previously installed asset is calculated.
- Any amount spent in excess of this is treated as capital expenditure and debited to the asset account.
- Moreover, if the efficiency of the newly installed asset is higher compared to the old one, then the entire expenditure incurred on its acquisition is treated as capital expenditure.
- Indian Electricity Act – 1910
- Indian Electricity Supply Act – 1948
- The Indian Electricity Act, 1910 was amended in the year 2010.
- When providing an electricity connection, the supplier collects a security deposit. This amount remains with the board as long as the connection remains active.
- On the security deposit, interest is paid at the rates determined by the ABI on the first day of the financial year, and this is adjusted in the consumer's bill.

Capital received by electricity companies | Service line contribution:

- Electricity companies, under Section 49 of the Electricity Act, 2003, charge a service line contribution. Its accounting treatment is done as follows:
- Record it as a reserve and then proportionately transfer the amount to the general statement so that the amount equals the depreciation on the total value of the asset.
- Under the Accelerated Power Development Program, electricity companies can do this in two ways:

1. **Appropriation element – This is of a capital nature.**
   - ✓ **Loan –** It will be accounted for under Long-Term Loans.
   - ✓ **Grants –** These are transferred to capital reserves, and every year a proportionate amount is charged to the general statement (income statement).
2. **Incentive element –** This is of a revenue nature and is given to reduce cash losses.

Depreciation-related provisions concerning electricity companies:

1. Depreciation rates will be determined by the Central Electricity Regulatory Commission.
2. Depreciation will be charged using the Straight Line Method (SLM).
3. The residual value of the asset will be a minimum of 10%, meaning depreciation will be charged only on the remaining 90% [whereas under the Companies Act, 2013, the minimum residual value is 5%].
4. The financial statements of electricity companies are also prepared in accordance with Schedule III of the Companies Act, 2013.